June 2019 WSBA *NWLawyer Ethics & the Law* Column

Taking Stock:
Navigating Risk When Investing in Clients

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Lawyer investments in clients are nothing new. In fact, the seminal American Bar Association ethics opinion on the subject was issued in 2000 near the height of the "dot com" bubble.[1] At the same time, the mix of client businesses in which lawyers are investing has broadened. While technology start-ups remain popular, emerging areas such as marijuana businesses have also drawn lawyer investments.

Although lawyer investments in client businesses is permitted, the risks can be significant and warrant careful evaluation by law firms. In this column, we'll look at four risk management aspects of investing in clients. First, we'll outline the basic conflict considerations that must be addressed. Second, we'll survey the consequences that can occur if a firm fails to deal with these inherent conflicts. Third, we'll touch on the potential impact that investments in firm clients may have on malpractice coverage. Finally, we'll discuss potential internal controls available to firms to manage these risks.

Before we do, however, a caveat is in order. The lawyer investments discussed do not include standard commercial transactions made by individual lawyers or their firms in publicly traded companies using publicly available information—such as a lawyer at a firm that represents Microsoft who buys 100

shares through a broker after reading a positive review of the company's prospects in The Wall Street Journal. Standard commercial transactions of this kind are generally excluded from the conflict considerations addressed in the RPCs because the lawyers are not leveraging their relationships with the clients concerned. Rather, the common scenarios discussed here include law firms taking stock in lieu of fees or firm lawyers investing in clients through other avenues not available to the general public.

Conflicts

The principal conflict rule governing lawyer investments in clients is RPC 1.8(a). It imposes exacting standards and merits quoting verbatim:

> "(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:
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> "(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;
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> "(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of an independent lawyer on the transaction; and
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> "(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction."

Comment 1 to RPC 1.8 explains both the nature of the conflict and the corresponding high bar to informed consent imposed by the rule:

> "A lawyer's legal skill and training together with the relationship of trust and confidence between lawyer and client, create the possibility of overreaching when the lawyer participates in a business, property or financial transaction with a client, for example, a loan or sales transaction or a lawyer investment on behalf of a client."

The Washington Supreme Court has underscored this high bar by describing attorney-client business transactions as "prima facie fraudulent" unless the exacting informed consent standards in RPC 1.8(a) are met.[2]

It is important to note, however, that RPC 1.8(a) is not the only conflict rule that may come into play from lawyer investments. A particularly dangerous conflict might arise, for example, if a law firm lawyer was handling a lawsuit for a client against a company in which the lawyer had a significant undisclosed investment that might reasonably be harmed if the client prevailed. This scenario raises a conflict under RPC 1.7(a)(2)—which governs "material limitation" conflicts. It is triggered in our example by a lawyer investment in an adversary rather than a client. The risk to the firm if the litigation does not go well and the lawyer investment is only discovered later is that the client may claim that the lawyer "pulled his/her punches" in handling the matter to protect the lawyer's own

financial interest. As will be addressed later when discussing law firm internal controls, it can be critical to have any such investments included in the firm's conflict system.

Consequences

Although lawyer investments that do not meet the standards in RPC 1.8(a) expose the lawyers involved to regulatory discipline, in many instances there are two other practical consequences that loom equally large: enforceability and civil damage risks.

The Washington Supreme Court in *LK Operating, LLC v. The Collection Group, LLC*, 181 Wn.2d 48, 331 P.3d 1147 (2014), highlighted enforceability risk. *LK Operating* involved an investment by two lawyers through a family corporation with a firm client in a debt collection business and a subsequent falling-out. The business had been structured as joint venture and in the later litigation over their respective ownership interests, the (by then former) client argued that the lawyers' claimed interest could not be enforced because they had not complied with RPC 1.8(a). The Supreme Court concluded that the lawyers' failure to comply with RPC 1.8(a) had rendered the joint venture agreement unenforceable and affirmed rescission of the deal.

Civil damage risk flowing from lawyer investments is often a blend of claims for legal malpractice and breach of the fiduciary duty of loyalty. These blended theories are usually framed around the core contention the law firm shaded its advice to the law firm's benefit and the client's detriment. Arguments with this tenor most often follow if the business has failed, "finger-pointing" results and, for example, a receiver or bankruptcy trustee has been appointed to recover any available assets. Other instances are closer to the earlier illustration of a firm handling a matter against a company in which a firm lawyer has an undisclosed investment.

Coverage

Lawyers considering an investment in a firm client should closely review the firm's malpractice insurance policy. Many policies exclude or limit coverage for claims arising out of investments in or transactions with firm clients. Such restrictions are neither new nor novel. A commentator 15 years ago observed pointedly:

> "Lawyers should recognize that entrepreneurial activities with clients may leave them and their clients with no insurance coverage. While it is generally imprudent to do business with a client, it is positively foolhardy to do so if the policy's business pursuits exclusion eliminates coverage for all claims relating to the business enterprise."[3]

The fact that sophisticated insurance carriers include exclusions or limitations based on claims experience implies that any anticipated economic return on an investment should exceed the corresponding financial risk of a potentially uncovered claim.

Controls

The inherent risks that come with investing in law firm clients suggest that firms should have clearly articulated internal controls in place before any investments are made. Although the particular controls implemented will vary by firm size, culture and practice, several in particular warrant careful consideration:

- Form a management group within the firm charged with ensuring that investments in non-public firm clients are both vetted and, if approved, are done with appropriate documentation. Although input from the firm lawyer with the principal relationship with the client involved will no doubt be central to a firm's evaluation of the potential investment, consider recusing that lawyer from the actual decision to enhance the independence of the process.

- A conflict waiver meeting the exacting standards of RPC 1.8(a) should be central to the overall process of approving a particular investment. Although using a template makes sense to ensure relative uniformity, waivers should be detailed and customized to the specific circumstances. The client-executed waiver for each investment should be adequately safeguarded with other relevant transaction documents.

- Require that investments in firm clients be made in the name of the firm rather than individual lawyers. The risk otherwise is that

individual lawyers will hold the potential upside financial benefit of an investment while the firm is left with the downside risk of a claim.

- Require that other lawyer investments in non-publicly traded companies be reported to the firm so that they can be entered in the firm's conflict system. Again, it will be the firm that will bear the risk—both financial and reputational—if an undisclosed investment by a firm lawyer in an adversary leads to a claim by a firm client.

- If the law firm is taking stock in lieu of fees, carefully evaluate whether the resulting return can be justified as a reasonable fee under RPC 1.5(a). In *Holmes v. Loveless*, 122 Wn. App. 470, 94 P.3d 338 (2004), for example, the Court of Appeals refused to further enforce a lawyer investment in a firm client where over time an $8,000 discount in fees had returned over $380,000 to the lawyers involved.

- Keep any given investment relatively small and in line with the terms available to other professional advisors who are receiving a similar opportunity. The greater the investment, the more difficult it will be to credibly contend that the law firm's professional judgment in rendering its services has not been affected.[4] Similarly, structuring a law firm investment so that it is on the same terms as other professional service firms will lessen (but not completely eliminate) the risk the law firm will be accused of preferential treatment later.

ABOUT THE AUTHOR

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[1] ABA Formal Opinion 00-418 (2000). Despite its age, this opinion remains one of the best resources for law firms in this area. It is available on the ABA web site.

[2] *See, e.g., In re Holcomb*, 162 Wn.2d 563, 580, 173 P.3d 898 (2007).

[3] Susan Saab Fortney, *Legal Malpractice Insurance: Surviving the Perfect Storm*, 28 J. Legal Prof. 41, 51 (2004).

[4] This may be compounded if the firm lawyer who shepherded the firm's investment is also serving as director of the client concerned. Lawyer-director conflicts are discussed at length in ABA Formal Opinion 98-410 (1998). It, too, is available on the ABA web site.