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Risky Business:
Investing in Clients

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Investing in clients has long been a dicey prospect from both the regulatory and liability perspective. At the same time, neither the old Disciplinary Rules nor the new Rules of Professional Conduct prohibit lawyers and their firms from investing in clients—either directly or in lieu of all or part of a fee.[1] Although some of the ardor for investing in clients cooled in the wake of the "Dot Com Bust," lawyers still find investment opportunities coming their way either from their own initiative or client requests. Moreover, in many of these situations, the client is often looking to the lawyer or law firm for all of its legal counsel.

In this column, we'll look at the "Three Cs" of investing in clients from the vantage point of law firm risk management: conflicts; carrier notification; and consequences. Although this column focuses on investments in clients, the same cautionary principles apply to any business transaction with a client beyond standard commercial transactions such as having a business checking account at a bank you represent.[2] Similarly, although this column is oriented to investments being made law firms, the cautions generally apply with equal measure to investments in clients made by individual lawyers within a firm.[3]

Conflicts

Conflicts can develop at two stages when investing in clients.

The first is when the investment is made. RPC 1.8(a) frames the issue broadly: there is a conflict between the respective financial interests of the lawyer and the client every time the lawyer invests in a client. As a result, RPC 1.8(a) imposes a uniform conflict waiver standard that goes to both the substantive fairness of the transaction and the procedural disclosure the lawyer makes to the client. RPC 1.8(a) addresses these dual prerequisites by mandating for each investment that:

> "(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 independent legal counsel 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."

The second point at which a conflict can arise is later in the representation when the lawyer's interest in protecting the investment may run counter to the client's interests. For example, the client may ask the lawyer for advice on a corporate restructuring that would dilute the value of the lawyer's investment. In this post-investment scenario, RPC 1.7(a)(2) requires the lawyer to obtain a conflict waiver from the client before proceeding:

> "(a) Except [when waived by the client] …, a lawyer shall not represent a client if the representation involves a current conflict of interest. A current conflict of interest exists if:
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> *****
>
> "(2) there is a significant risk that the representation of one or more clients will be materially limited … by a personal interest of the lawyer[.]"

Both the Oregon State Bar and the American Bar Association have ethics opinions available to help navigate through and to properly document client consent when investing in clients. OSB Formal Ethics Opinion 2005-32 and ABA Formal Ethics Opinion 00-418 are available on the web at, respectively, www.osbar.org and www.abanet.org/cpr. RPCs 1.8(a) and 1.7(a)(2) are facially broader in this context than their counterparts under the former Disciplinary Rules, respectively, former DR 5-104(A) and former DR 5-101(A)(1), because they apply to all investments in firm clients whereas former DR 5-104(A) only applied to transactions where the lawyer and the client had "differing interests." Nonetheless, because the Oregon Supreme Court generally interpreted DR 5-

104(A) broadly, the Oregon cases under these former DRs should still be useful interpretive guides until we have case law applying the new rules.

Carrier Notification

In light of the risk of conflicts and attendant claims from any investment in a client, malpractice insurance carriers, including the Oregon Professional Liability Fund, may exclude such transactions from coverage unless they are notified of the investment at the time it is made.

The PLF, for example, both specifies the kind of disclosure the lawyer must make to a client and requires contemporaneous notification to the Fund.

On the former, Exclusion V.8 to the PLF's basic plan excludes coverage for claims arising from business transactions with clients falling within RPC 1.8(a) unless very detailed disclosure in a form specifically developed by the PLF (or an alternative substantially equivalent) is executed by the client. The PLF also requires that a summary of risks of lawyer-client business transactions authored by the OSB's Chief Disciplinary Counsel be provided as a part of the conflict waiver. Both forms are available on the PLF's web site at www.osbplf.org.

On the latter, Exclusion V.8 also conditions coverage on giving the PLF contemporaneous notice of the transaction in one of two forms. First, a copy of the conflict waiver must be forwarded to the PLF within 10 days after the client signs it. Second, if providing a copy of the waiver would violate RPC 1.6's confidentiality rule, the lawyer is required instead to provide the PLF with the name of the client involved and confirmation that the required consent has been obtained within 10 days after the client signs the conflict waiver.

Particularly if you are an Oregon-based firm with an excess carrier other than the PLF, you should also consult any exclusions or other requirements mandated by your excess carrier. Multi-state firms (or lawyers licensed in more than one state) providing services to a client in more than one state should also consult the requirements and limitations in the other states involved.

Consequences

The consequences of unwaived conflicts in this area are usually severe and break along three lines: regulatory; civil liability; and enforceability.

The disciplinary reporters are filled with cases that illustrate the regulatory consequences of unwaived conflicts flowing from lawyer-client investments. They range from lawyers who handled the investment transaction involved (*see, e.g., In re Brown*, 277 Or 121, 559 P2d 884 (1977)), to lawyers who were handling other matters for the client at the time the transaction occurred (*see, e.g., In re Montgomery*, 292 Or 796, 643 P2d 338 (1982)), to lawyers who did not waive conflicts that developed later as a result of an earlier investment (*see, e.g., In re Wittemyer*, 328 Or 448, 980 P2d 148 (1999)). Although the sanction imposed in any given case is necessarily driven by the facts of that case, discipline is often on the severe end of the scale because lawyers in these situations have typically benefited financially at the expense of their clients.

The liability consequences can be no less severe. Conflicts in this setting can easily translate into claims of breach of fiduciary duty. The Oregon Supreme Court discussed the relationship between violations of the conflict rules and lawyer breach of fiduciary duty generally in *Kidney Association of Oregon v. Ferguson*, 315 Or 135, 843 P2d 442 (1992), and applied that relationship directly in the lawyer-client transaction context in *In re Brown*, 326 Or 582, 956 P2d 188 (1998). Depending on the kind of investment and the kind of client (*i.e.*, public or private), securities laws may be involved, too. Finally, an investment in a client may strip the law firm of the liability shield for assisting in the breach of a fiduciary duty that the Oregon Supreme Court created last year in *Reynolds v. Schrock*, 341 Or 338, 142 P3d 1062 (2006). *Reynolds* specifically excepted situations where the lawyer is furthering the lawyer's own interest from the liability shield. For example, a lawyer-investor in a start-up might not have the liability shield available if the lawyer provided the corporate client with advice on ousting a "whistleblowing" director where doing so constituted assisting in a breach of the client's fiduciary duty to the ousted director and also protected the lawyer's investment.

Finally, unwaived conflicts or otherwise unreasonable transactions may also imperil the investment itself. The Oregon Supreme Court noted in *Brown* that the failure to make adequate disclosure to a client may constitute fraud and fee forfeiture is an accepted remedy for breach of fiduciary duty under *Kidney*

Association. Beyond the adequacy of the conflict waiver, whether the resulting fee is reasonable is governed by both RPC 1.8(a) and the general fee-standard rule, RPC 1.5. ABA Formal Ethics Opinion 00-418 suggests that, at least when the investment transaction is complete at the point the associated legal services are rendered, the “reasonableness” of the fee should be assessed at the time of the transaction. But, there is recent authority from Washington in the form of *Holmes v. Loveless*, 122 Wn App 470, 94 P3d 338 (2004), that when the investment involves a continuing pay-out over time that the “reasonableness” requirement for an investment in lieu of a fee extends over the life of the agreement (even after the underlying legal services have been completed).

Summing Up

Investing in clients may seem like an attractive way to boost firm revenues from a static number of hours worked. In many situations, though, the risks outweigh the potential rewards.

ABOUT THE AUTHOR

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[1] Most ordinary fee agreements do not constitute a business transaction with a client. *Welsh v. Case*, 180 Or App 370, 382-83, 43 P3d 445 (2002). But, where a component involves an attendant venture where "the client expects that the attorney is using his or her judgment for the protection of the client," the fee arrangement constitutes a business transaction that triggers the associated professional rule and fiduciary considerations. *Id.*

[2] Cmt. 1, ABA Model Rule 1.8.

[3] *See, e.g., Roach v. Mead*, 301 Or 383, 722 P2d 1229 (1986) (holding a law partner vicariously liable for the negligence of his partner who secured a personal loan from a firm client without the disclosure required under former DR 5-104(A); *see also* RPC 1.10(a) (the "firm unit rule").