Investing In Client.Com

The New Economy or the Same Old Moral Hazard?

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Have you ever seen a business plan of a exciting start-up company - one of those that makes tons of money for everyone lucky enough to buy stock at the initial public offering? The surprising thing about them is they often lack any budget for essential services such as advertising, accounting, and even legal. Is this an example of the business naiveté of brilliant nerds confirming your suspicion that they really don't know what they're doing? Not in the least. They are way ahead of the game. They know that people providing these services will share the entrepreneurial risk by gladly taking stock or stock options for their services. Service providers want to get rich too and the nerd gets vital services on the cheap.

This new economy syndrome has hit law firms in a big way. The claims manager for the company that insures the largest law firms in the US stated last June at the ABA 26th National Conference on Professional Responsibility that he had received 50 calls in the last three months from firms regarding coverage when investing in clients - more than in the prior ten years! At the same conference the problem of retention of partners as well as recruiting new associates when a firm does not allow investing in clients was discussed. It seems the old safe risk management policy of never investing in a client's business has gone the way of the electric type-writer.

This article focuses on the professional responsibility and risk management considerations when a lawyer invests in a client's business. These considerations apply to other business transactions with clients as well. They include loans to and from clients, purchases from and sales to clients, acquisition of the subject matter of the retention, and purchase of client accounts receivable.[i] Closely related to business transactions with clients is the question of using client information for the lawyer's own purposes. This issue is not covered here. Kentucky Rules of Professional Conduct (KRPC) 1.9(c), 1.8(b), and 1.8 Comment (1) provide the professional responsibility guidance on use of client information. Consult agency law for liability exposure.

The Enhanced Fiduciary Obligation

It is important to understand when entering a business transaction with a client that a fair arm's length deal is not good enough. We all know the standard lawyer's fiduciary obligation, but may not be aware of the enhanced fiduciary obligation when doing a deal with a client. The rules are more in the nature of those that govern trustee and beneficiary dealings in which any trustee advantage is presumed to have been without adequate consideration and the result of improper influence. The burden is on the trustee to prove otherwise.[ii]

The public policy concern is client vulnerability to lawyer overreaching as a result of client trust and the lawyer's superior knowledge and skills. For this reason a strict scrutiny standard applies to lawyer-client business dealings. In applying this standard courts have held that such transactions are presumptively fraudulent and the lawyer has the burden of showing it to be completely fair. Some courts use the stranger test -- only if a reasonable lawyer would advise the client to enter the same transaction with a stranger is a lawyer's contract with a client fair.[iii] In a Kentucky case the court held:

> "Although the law sometimes shuts its eyes to grasping shrewdness practiced by all trades upon another dealing at arm's length, unfairness such as here displayed will not be condoned when employed by a lawyer dealing with his client. Even when a conveyance by a client to his attorney is fair upon its face, it is presumed invalid, and the burden of establishing its fairness is upon the attorney."[iv]

As a result of strict scrutiny and the presumption of invalidity almost all business transactions with lawyers challenged by clients are voided. This point cannot be stressed too much. If you are going to do a business transaction with a client, it must be bulletproof to have any chance of withstanding challenge when the deal goes bad or the client simply changes his mind. Failure to do so raises the risk of bar discipline, restitution, disgorgement of profits, and civil liability for fraud or breach of trust.

Doing the Math: 1.5 -- 1.7(b) -- 1.8(a)

The key professional responsibility numbers in client transactions are KRPC 1.5 on fees, KRPC 1.7(b) on lawyer personal interest conflicts, and KRPC 1.8(a) on business transactions with a client. What follows is a brief analysis of each rule in the context of acquiring an interest in a client's business.

- ***Rule 1.8(a) Business Transactions With Clients:*** This key rule establishes specific requirements for entering any business transaction with a client. It and the rule comment provide:

  > (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:
  > (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 to the client in a manner which can be reasonably understood by the client;
  > (2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
  > (3) the client consents in writing thereto.
  >
  > Comment
  >
  > Transactions Between Client and Lawyer

(1) As a general principle, all transactions between client and lawyer should be fair and reasonable to the client. In such transactions a review by independent counsel on behalf of the client is often advisable. Furthermore, a lawyer may not exploit information relating to the representation to the client's disadvantage. For example, a lawyer who has learned that the client is investing in specific real estate may not, without the client's consent, seek to acquire nearby property where doing so would adversely affect the client's plan for investment. Paragraph (a) does not, however, apply to standard commercial transactions between the lawyer and the client for products or services that the client generally markets to others, for example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has no advantage in dealing with the client, and the restrictions in paragraph (a) are unnecessary and impracticable.

When acquiring an interest in a client's business or going into business with a client full disclosure in strict compliance with KRPC 1.8(a) is critical. Ethics experts suggest to comply with the rule the following aspects of the transaction be communicated in writing to the client in a full and clear manner:

1. The nature of the transaction and each of its terms including all circumstances of the transaction known to the lawyer.

2. The nature and extent of the lawyer's interest in the transaction and any potential adverse effects the transaction could have on the client including the effect they could have on the lawyer's and client's relationship.

3. The ways in which the lawyer's participation in the transaction might affect the lawyer's exercise of professional judgment on concurrent legal work for the client, if any.

4. A clear statement of the risks and advantages to each of the parties to the transaction.

5. An agreement that if future circumstances affecting the lawyer's independent judgment occur, renewed disclosure and consent must precede continued representation.

6. The kind of advice the client would have received if the client had been a stranger.

7. Specific advice stressing the importance of seeking independent legal counsel to obtain a detailed explanation of all risks associated with the business transaction. [v]

As a practical matter most clients do not seek independent legal advice no matter how diligently the lawyer urges that they do. What is so unfortunate about this is that independent legal advice is the best indicator of all that the lawyer did not overreach and that the transaction was fair to the client. In the likely event the client will not seek independent counsel do not consummate the deal on the same day you make the recommendation. Arrange for the client to see you a few days later to complete the transaction so that there was clearly time to think things over. Be sure that you and the client both sign the 1.8(a) disclosure letter. Document the file showing this deliberate procedure.

- ***Rule 1.7(b) Lawyer Personal Interest Conflicts:*** All the conflict rules apply to lawyers with a financial interest in a client even when the lawyer is not providing legal advice on the operation of the business (*e.g.*, represents the client only in litigation matters). Paramount among these is the personal interest conflict that arises when the lawyer's financial interest in the business conflicts with the interests of the client. The independent legal advice owed the client could be compromised if the client contemplates an action the lawyer believes will reduce the value of the business. Should the client settle? Should the client testify? Should the client continue to do business with an adversary? These are only some of the litigation issues that could conflict with the interest of the client and the value of the lawyer's interest in the business.

  The personal interest conflict is even more obvious when the lawyer is providing legal services in a joint venture with the client or is serving as counsel for a business in which the lawyer has a passive investment. Expanding the business, borrowing money, or merging with another business are all actions that have legal considerations that may conflict with the lawyer's financial interest in the business. It has only recently been recognized that this is a conflict issue for employed lawyers who receive company stock and stock options as part of their compensation.

  Strict compliance with KRPC 1.8(a) using the seven criteria suggested in this article is a structured way to make required disclosures and resolve the conflict by obtaining written client consent. While current conflict rules do not require that disclosure and consent be in writing, Rule 1.8(a) does. It should be followed even in financial interest situations not involving a business transaction (*e.g.*, a lawyer inherits an interest in a client's business).

  This is a good place to point out that if there is no attorney-client relationship, the conflict and business transaction rules do not apply. Lawyers can have a life outside their profession. The problem is that most people always see the lawyer as lawyer and often think they are getting legal advice when the lawyer thinks they are having a non-legal business discussion. As a practical matter anyone going into business with a lawyer implicitly expects legal guidance as part of the deal. In situations when the lawyer is not acting in a professional capacity a non-representation disclosure letter should be sent to the business entity to avoid confusion and prevent future claims. The lawyer must then scrupulously avoid giving any legal advice - a very difficult thing to avoid. The least legal activity will trigger the presumption of invalidity of lawyer-client business transactions. [vi]

- ***Rule 1.5 Stock For Fees:*** Prior to entering the attorney-client relationship there is no fiduciary obligation. Thus, lawyers may negotiate fees on an arm's length basis with potential clients without a presumption of invalidity and complying with KRPC 1.8(a).[vii] Keep in mind, however, that the reasonableness of fees is always subject to close scrutiny using the criteria in KRPC 1.5(a). Comment 2 to the rule stresses this point when property is given for legal services:

> A lawyer may accept property in payment for services, such as an ownership interest in an enterprise, providing this does not involve acquisition of a proprietary interest in the cause of action or subject matter of the litigation contrary to Rule 1.8(j). However, a fee paid in property instead of money may be subject to special scrutiny because it involves questions concerning both the value of the services and the lawyer's special knowledge of the value of the property.

Taking stock or a percentage interest in a business for fees is both a fee negotiation and a business transaction, i.e., the lawyer's fee is determined to be of a certain cash value which in turn purchases stock in the client's business. If the fee is later challenged as unreasonable because the stock holdings of the lawyer are now worth millions after only a few thousand dollars worth of service, the lawyer has the problem of proving the value of the services, the fair market value of the stock at the time of the fee negotiation, and why this does not amount to an unreasonable fee windfall for the lawyer prohibited by Rule 1.5(a).[viii]

An argument can be made that KRPC 1.8(a) does not apply to stock for fees, but the better view is that it does.[ix] Given the precariousness of these transactions good risk management demands that the requirements of 1.8(a) be followed using the seven criteria suggested in this article. The 1.8(a) letter also should include a detailed description of the services to be performed for the stock and make it clear that the lawyer's stock ownership vest at the inception of the representation to avoid a later claim that it was a retainer that is refundable. Even this precaution cannot preclude a claim based on the nonrefundable retainer ethical issues that they are often unearned and restrict client choice of lawyer.

<u>One Firm's Client.Com Investment Policies and Procedures</u>

At the ABA 26th National Conference on Professional Responsibility Donald E. Bradley described how the 150 member California law firm of Wilson, Sonsini, Goodrich & Rosati invests in clients. What follows are the highlights of Mr. Bradley's presentation which emphasized investing in start-up venture capital clients:

- All investment opportunities concerning firm clients are presented to the firm's investment committee. The committee performs due diligence by evaluating the investment and assuring compliance with all ethics rules and SEC requirements applicable to the investment. For start-up companies the committee considers who are the founders, what is their track record, how sophisticated are they, how trustworthy are they, are they first time venture capital entrepreneurs or professional speculators, etc.

- Approved client investments are sent for execution to a separate investment partnership owned by the firm and operated by some of the firm partners.

- Individual lawyers are not permitted to invest directly in firm clients or to participate individually in the investment partnership - it is an investment pool. This eliminates the firm morale problem created when one lawyer realizes a big gain on a client investment. The investment committee management and review serves to insulate the investment finder lawyer from the stress of responsibility for its success or failure. Another benefit of this policy is that it reduces the higher risk of a malpractice claim when only one lawyer in the firm has an interest in the client. There is safety in anonymity.

- The firm does not take stock for fees. They obtain clients' stock as an investment - not as compensation. An exception is when a client is financially unable to pay owed fees and the choice is to take pennies on the dollar or take stock with hope of financial recovery.

- The firm makes only a moderate investment in any one client - making several small investments instead of one big bet. The policy is to take at most a 1% interest in any company with a dollar cap of $75,000. The idea is keep the problems small by keeping the investments small.

- The firm does not do equity or debt deals. They primarily buy preferred stock on the same terms as the venture capitalist. The firm does little communication with the client and no negotiation. The stock value benchmark is the stock option price to employees.

- The firm's insider trading policy is that client stock will not be bought or sold without client approval. It will follow the client's policies on when stock can be sold. Priority stock bought at an initial public offering will be held for at least six months.

    - A client letter of full disclosure similar to the requirements of KRPC 1.8(a) is executed. Investment information is integrated into the firm's conflict check system. The firm's malpractice insurance is reviewed for coverage and exclusions that might apply.[x]

Summing Up

There is no *per se* prohibition against investing in a client's business or going in business with a client. Carefully complying with the professional responsibility rules governing business transactions with clients should avoid bar discipline. Risk managing these transactions is the real issue. The next recession is expected to produce numerous claims against new economy lawyers who have taken financial interests in clients and people claiming to be clients. Unfortunately, these claims threaten to be for large sums of money. Additionally, investing in a start-up company later accused of fraudulent conduct could embroil the lawyer in a suit or SEC action for aiding and abetting the fraud. Lack of knowledge of the client's fraud is a valid defense, but if the lawyer owns stock the jury may well see motive causing the innocent lawyer to go down with the client.

Given the presumption of invalidity of lawyer transactions with clients and the benefit of the doubt given to people who claim to be clients, business transaction claims are difficult to defend in the extreme. The claimant wins the great majority of the time. Upping the ante is the fact that most malpractice insurance policies exclude from coverage claims arising from lawyer business activities, although in certain circumstances some will provide a defense. The old economy policy of law firms not taking a financial interest in clients remains the best risk management. If you are considering investing in clients, do so only if it is needed for the welfare of the firm - not as part of a personal investment strategy. Be sure to have written policies on how investments are managed and controlled. Then consult with your malpractice carrier to be clear on coverage, claims defense, and whether seeking indemnification from the business or other insurance is appropriate. Finally, read the recently issued ABA Standing Committee On Ethics and Professional Responsibility Formal Opinion 00-418, July 7, 2000, Acquiring Ownership in a Client in Connection with Performing Legal Services. It is packed with useful guidance on doing a deal with a client.

Endnotes

[i] *See* ABA Standing Comm. On Ethics and Professional Responsibility Formal Op. 00-416, 4/7/00, *re* purchasing client accounts receivable.
[ii] § 14.21 Legal Malpractice, Mallen & Smith (4th ed.).
[iii] Wolfram, § 8.11.3 Modern Legal Ethics.
[iv] *Hunt v. Picklesimer*, 290 Ky. 573, 162 S.W.2d 27(1942).
[v] This list is a combination of disclosure recommendations in Wolfram, § 8.11.4 Modern Legal Ethics and the ABA/BNA Lawyers' Manual on Professional Conduct, Business Transactions with Clients, 51:501 at 51:504.
[vi] § 14.23 Legal Malpractice, Mallen & Smith (4th ed.).
[vii] §14.24 Legal Malpractice, Mallen & Smith (4th ed.).
[viii] In ABA Standing Comm. On Ethics and Professional Responsibility Formal Op. 00-418 (7/7/00), Acquiring Ownership in a Client in Connection with Performing Legal Services, it is recommended that reasonableness of stock fees be determined by valuing the stock "at the amount per share that cash investors, knowledgeable about its value, have agreed to pay for their stock about the same time."
[ix] *See* ABA Standing Comm. On Ethics and Professional Responsibility Formal Op. 00-418 (7/7/00), Acquiring Ownership in a Client in Connection with Performing Legal Services. A synopsis of this opinion is reported in ABA/BNA Lawyers' Manual on Professional Conduct, Current Reports, Vol. 16. No. 13 (7/19/00), p. 358, "ABA Panel Finds No Per Se Ethical Barrier To Lawyers' Investing in Client Start-Ups."
[x] For more information on investing in clients *see* ABA/BNA Lawyers' Manual on Professional Conduct, Current Reports, Vol. 16. No. 10 (6/7/00), p. 285, "Ethics Rules Permit Law Firms to Invest in Clients, but Panelist Urge Great Caution."