



PROFESSIONAL RESPONSIBILITY

WHEN THE LAWYER TAKES A STAKE

BY EDWARD J. CLEARY

Most partners of Pricewaterhouse Coopers, the world's largest accounting firm, violated rules requiring that they not have investments in companies audited by their firm . . . the SEC said that 31 of the 43 partners in the firm's top leadership had committed at least one violation, as had 6 of the 11 partners responsible for enforcing the rules . . .

"lawyers must follow a treacherous ethical path if they . . . invest in their clients' businesses"

Now that the legal profession is considering the implications of a multidisciplinary practice, it seems reasonable to examine the ethical restraints (and failures) of other professions. In January of 2000, as noted above, Pricewaterhouse Coopers (PWC), the biggest of the Big Five, was cited by the Securities and Exchange Commission (SEC) for widespread violation of the rules on conflicts of interest. The impact was significant as 52 of the largest companies in the nation that had been audited by PWC were informed by the SEC that, due to the conflicts found within the accounting company, the integrity of the companies' financial statements was at risk.² A scandal, to be sure, that raises significant questions regarding the importance of ethical parameters within the "culture" of the accounting profession.

Since accountants, when they act as auditors, must be independent as they attest to financial statements, their role in relationship to a client is different from that of an attorney, who acts as an advocate for her client's interests. Consequently, accountants are prohibited by law and professional rules from investing in clients they audit, while "no bright line rule" prevents lawyers from investing in their clients' businesses. However, lawyers must follow a treacherous ethical path if they choose to cross the line and invest in their clients' businesses and they must not allow greed to overwhelm their ethical duties.

A NEW SPIN

As long as there have been attorneys serving business clients, there have been attorneys running afoul of ethical provisions involving duties to those clients, particularly when borrowing money from clients or soliciting investment money

from clients.³ The overreaching between an attorney and an unsophisticated client has often resulted in a type of exploitation resembling misappropriation. Lately, however, the form of business interaction between attorney and client that has captured headlines has involved lawyers investing in the business of clients. Often this type of investment is venture capital by way of funds from the attorney or in lieu of fees for services, followed by the issuance of shares of stock that may or may not soar at the time of an initial public offering. Recently, an ABA review of Securities and Exchange Commission records showed "that one in three lawyers representing the more than 500 companies that went public in 1999 held stock in the clients at the time of the offering."⁴ One law firm in Silicon Valley has, according to the *Wall Street Journal*, "routinely turned investments of \$20,000 to \$40,000 into multi-million dollar gains" in helping to launch new businesses.⁵

Clearly the ethical travails of the accounting profession raise serious concerns as to the future of multidisciplinary practice. However, before those of us in the legal profession condemn others, it might be wise to take a long hard look at concerns raised by our own business involvement with clients.

WHERE IT CAN GO WRONG

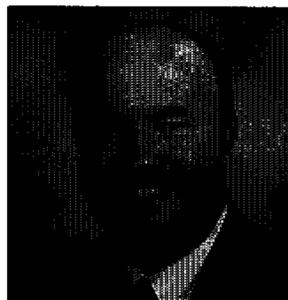
DISCLOSURE. Rule 1.8(a), MRPC, spells out the absolute duties an attorney must fulfill before entering into a business transaction with a client or before acquiring an interest adverse to a client. Summarized, the rule provides that the attorney must

give written notification to the client that independent counsel should be considered to examine the proposed transaction, along with enough time for the client to do so; the client must be given full and clear written disclosure of the "transaction and terms" on which the lawyer acquires the interest, which must be "fair and reasonable"; and, finally, the client must consent to the transaction in a written document separate from the transaction documents, a document that also spells out the lawyer's duties, possible conflicting interests, and the reasonably foreseeable risks for the client from any conflict.⁶

The last portion of Rule 1.8(a) was amended in August of 1999. Prior thereto, a client could consent in writing to a proposed business transaction with his lawyer by simply counter-signing and returning a copy of the letter sent by the lawyer outlining the transaction and terms of the proposed arrangement. Now the document must be separate from the transaction documents and spell out the duties, interests, and risks at stake.

Even under the less demanding version of the rule, some attorneys found, to their great regret, that because of the possibility of self-dealing, they are vulnerable to claims made by a client regarding the business arrangement. In a California case from several years ago, a lawyer attempted to enforce an agreement whereby his client was to pay him three percent of the company stock for services. Neglecting to follow the parameters of the rule by advising the board of the company to consider obtaining separate counsel, the lawyer lost the entire value of his purported portion of the stock, which had been calculated by a jury at \$32 million.⁷

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LAWYER AS DIRECTOR. There are less obvious pitfalls for an attorney who gets involved in her client's business. Over the years it has not been unusual for a lawyer to attempt to occupy the dual role of director and legal counsel. Both 1.7(b), MRPC, and the ABA in a Formal Opinion have addressed this issue.⁸ Once again, at the very beginning of the business relationship, the attorney should ensure that the members of the board in question understand the different responsibilities of legal counsel and director; understand that communications with the attorney acting as a director will not have the protection of attorney-client privilege; and understand that due to occasional conflicts of interest, the lawyer may need to recuse himself as a director. Further, the lawyer, while acting as a director, must maintain her independent professional judgment as an attorney, understanding and honoring the differing duties inherent in each role and conducting herself accordingly.

It should also be noted, as one commentator observed, that for lawyers involved in businesses, particularly those involved with publicly traded companies, "you not only have the opportunity to become a multimillionaire, you have the opportunity to get sued."⁹ Because the attorney may suffer from impaired professional judgment brought on by the desire to acquire wealth, she may become a target for a lawsuit. Consequently, many professional liability insurance companies "have exclusions that take away coverage if firms have an equity interest. It is a status exclusion. It turns on the ownership interests, not the activity."¹⁰

ACQUIRING A PROPRIETARY INTEREST IN LITIGATION. Rule 1.8(j) prohibits lawyers from acquiring a proprietary interest in the "cause of action or subject matter of litigation the lawyer is conducting for a client" with several exceptions.¹¹ Once again, the obvious danger is that the lawyer's independent professional judgment will be impaired. Thus an additional problem that may arise in a situation where the lawyer has invested with a client is a business transaction that evolves into a proprietary interest in a cause of action. When that occurs, the lawyer must either rid herself of her proprietary interest in the matter, or cease her representation of the client in the litigation.

TWO CASES

In the last several years, two attorneys have been issued private discipline for infractions of these ethical provisions. In one case, an attorney was hired to defend a

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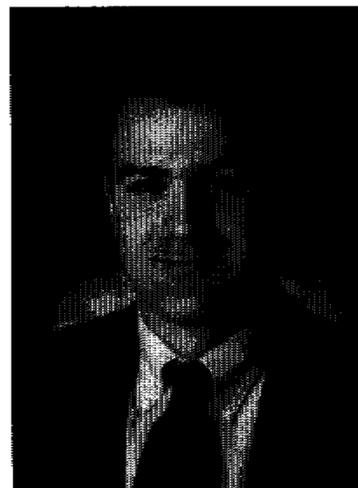
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corporation against a patent infringement action. After the company fell behind in paying the legal fees for the attorney, the attorney unsuccessfully attempted to withdraw. Subsequently, he insisted that his client give his law firm a security interest in the very patent that formed the basis for the litigation. Rule 1.8(j) prohibits this, in part to prevent an attorney from allowing his interest to influence the ensuing litigation. The case later settled, a complaint was filed, and the attorney received private discipline.

In another case, an attorney was retained to represent a party in litigation over a wrestling ring. As the attorney provided services to the client, the bills started to mount up. The attorney's law firm then asked for a security agreement in the subject matter of the litigation, namely, the wrestling ring. Eventually, the law firm seized the ring, which was eventually sold by a storage facility for unpaid storage fees. A complaint was later filed and the attorney received private discipline for violation of 1.8(a) and (j).

Although these two local cases involve business deals that are far removed from the multimillion dollar transactions occurring daily in Silicon Valley, the principle remains the same. A lawyer engaging in a business transaction with a client had best be very familiar with a) the requirements of 1.7 and 1.8, MRPC; b) any pertinent SEC regulations regarding publicly traded companies (if applicable); and c) the coverage afforded by his professional liability policy. For every business transaction where the attorney complies with the pertinent ethical provisions and where both the lawyer and the client are happy with the outcome, there is the opposite (and, perhaps, more likely) possibility of an unsuccessful business deal, an unhappy client, and a lawyer facing a disciplinary complaint and/or a lawsuit. □

NOTES

1. Floyd Norris, "Accounting Firm Is Said To Violate Rules Routinely," *The New York Times*, 1/7/00, A1.
2. Elizabeth MacDonald, "Accountant Faces Salvo From SEC," *Wall Street Journal*, 2/28/00, A3.
3. See Marcia A. Johnson, "Borrowing And Lending With Clients," *Bench & Bar of Minnesota*, August 1995, 14.
4. Debra Baker, "Who Wants To Be A Millionaire?" *ABA Journal* (February 2000).
5. Richard B. Schmitt, "Little Law Firm Scores Big By Taking Stake In Clients," *Wall Street Journal*, 3/22/00, B1.
6. 1.8(a), MRPC:

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(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 client is notified in writing by the lawyer that independent counsel should be considered and is given a reasonable opportunity to seek the advice of independent counsel in the transaction;

(2) 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; and

(3) the client consents to the transaction in a document separate from the transaction documents that specifies:
(i) whether the lawyer is representing or otherwise looking out for the client's interests in the transaction;
(ii) the nature of the lawyer's conflicting interests, if any; and
(iii) the reasonably foreseeable risks for the client from any conflict.

7. Passante v. McWilliam, 53 Cal. App. 4th 1240, 62 Cal. Rptr. 2d 298 (1997).

8. 1.7(b), MRPC:

(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

(1) the lawyer reasonably believes the representation will not be adversely affected; and

(2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

See also ABA Formal Opinion 98-410: "Lawyer Serving as Director of Client Corporation."

9. Baker, op. cit.

10. Ibid.

11. 1.8(j), MRPC:

(j) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

(1) acquire a lien granted by law to secure the lawyer's fee or expenses; and

(2) contract with a client for a reasonable contingent fee in a civil case.