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Business Transactions with Clients
Ethical or Ill-Advised?

By Howard W. Brill

Picture the scene: A client enters your office. Not a new client, but an established client. Not a financially unstable client, but one who always pays the fees. Not a client in trouble, but a client with an opportunity. Not a greedy client, but a client who is willing to share part of an expected financial bonanza. The opportunity may be to purchase Blackacre, to open a restaurant as partners or to invest on the ground floor of the next Wal-Mart stock. To your amazement, and delight, the client invites your participation with her on the road to riches.

Kitty Harvill

As you mull over the offer, you remind yourself of lawyers who have been disciplined, suspended and disbarred and who have been held financially liable for business transactions with clients. But you convince yourself that most of those involved scoundrels and renegades who should never have been permitted in the profession at all. Further, the transactions were blatantly flagrant – borrowing money from clients with inadequate or no security [1]; encouraging clients to gamble in speculative investments[2]; purchasing client property at below market value prices without the knowledge of the client [3]; failing to disclose to the client the attorney's personal interest in the investment [4]; or in some other fashion gaining a personal advantage vis a vis the client. But you are responsible; your client is intelligent and financially sound; and, the proposed transaction is fair and above board. Why not seize the opportunity and just do it?

The Ethical Standards: Following the Code [5] of Professional Responsibility [6], the Arkansas Rules of Professional Conduct do not prohibit such transactions. Despite its negative wording, Rule

1.8(a) permits business transactions between attorneys and clients if four requirements are satisfied: (1) the terms and the transaction are fair and reasonable to the client; (2) the provisions are fully disclosed and transmitted to the client in written and understandable terms; (3) the client consents in writing; and (4) the client is given a reasonable opportunity to seek the advice of independent counsel.

The attorney must ask herself whether she can comply with each of the four requirements. Even beyond that, the more appropriate inquiry is the objective test – whether a reasonable, prudent attorney could comply. The lawyer's conduct is subject to the strictest scrutiny. [7]

The rule demands the terms be fair and reasonable, but that guidance may not be sufficient. The relationship between the attorney and the client is fiduciary in nature requiring a high degree of fidelity and good faith. [8] The relationship gives the attorney power and influence over the client, while the client places confidence in the attorney and depends on her. [9]

The positions of the attorney and client are ordinarily unequal. [10] The client expects the attorney to place the client's interest above that of the attorney and to safeguard the client's interest with extraordinary diligence. The transaction must be as beneficial to the client as it would be if the client were dealing with a third party rather than his attorney. [11] Occasionally courts use the "stranger test" in defining a fair business transaction as one that an independent lawyer would advise a client to enter with a stranger. [12]

Even prior to the adoption of the Model Rules, the common law was clear that in a dispute between an attorney and client concerning a business transaction, the burden rests upon the attorney to demonstrate the fairness and equity of the transaction, and the adequacy of any consideration. [13] Equity will relieve the client from "hard bargains or any undue advantage secured over him by his attorney." [14] The client need not expressly establish fraud or imposition or invalidity. Instead, if the relationship between the parties "might reasonably have exerted . . . any influence in the attorney's favor, then the burden of establishing its perfect fairness is thrown upon the attorney." [15] Indeed, some authority suggests the fairness must be demonstrated with clear and convincing evidence. [16] Upon the failure of the attorney to make such a showing, the court of equity will treat the transaction as one of constructive fraud. [17] Constructive fraud will support a claim for either rescission of the transaction or damages. [18]

The terms must be understandable to the client. With less financially sophisticated clients, even more detailed explanation is necessary. But with all clients, the terms must be put in writing, and the client must consent in writing. A mere shake of the hands does not comply with the Rule, no matter how established, intelligent or wealthy a client, no matter how lengthy the attorney-client relationship and no matter how fair the terms.

Although the rule expressly requires disclosure of the transaction and terms, it is generally interpreted to mandate full disclosure. [19] Full disclosure means the type of disclosure that a disinterested, objective and competent attorney would give to a client in the traditional attorney-client relationship, free of business entanglements. The attorney must ensure "an entire absence of concealment or suppression of any facts within the attorney's knowledge which might influence the client. . ." [20] Full disclosure by the attorney requires the client be given all the facts and circumstances needed to make an intelligent and informed decision. [21] In particular, full disclosure includes: (a) a complete explanation of the transaction and all of its terms; (b) a full explanation of the divergence in interests between the attorney and client; (c) the nature and extent of the lawyer's interests in the transaction; (d) a discussion of the risks and disadvantages to the client

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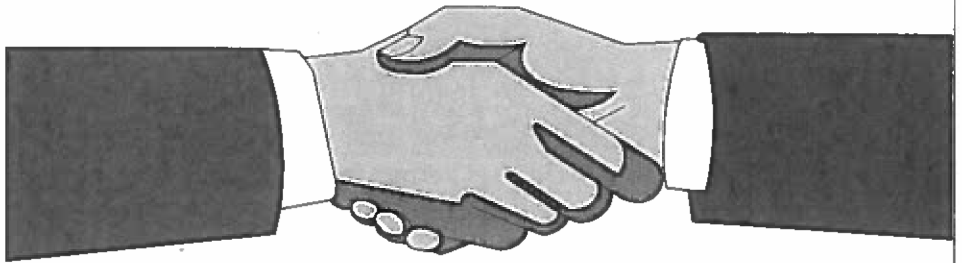
and to the attorney from the transaction; and (e) the manner in which the lawyer's participation in the transaction might affect the lawyer's independent professional judgment. [22] The duty to disclose is affirmative and must be initiated by the attorney. For example, suppose the client suggests to the attorney that they jointly, and equally, purchase Blackacre. What disclosure is necessary? A competent, disinterested attorney might discuss, among other topics: the nature of the ownership interest; the financing and its ramifications; the security for the transaction; relevant statutory law; the impact of bankruptcy, divorce, death, condemnation or litigation upon the property interests; the issue of property management; the claims of third parties; tax liability and tax planning.

Without full disclosure, the client is likely, justified or not, to blame any problems on the attorney. If an environmental agency concludes the land violates governmental standards and the present owners are responsible, the client is likely to ask, or demand, "Why didn't you tell me that I could be held liable for the toxic wastes left by the prior owners? You were my lawyer. I trusted you."

Finally, the rule requires the client be given a "reasonable opportunity" to have an independent attorney evaluate the transaction before the client enters into it. The comment to the Rules only states, "a review by independent counsel on behalf of the client is often advisable."

Unfortunately, the rule is not as strong or precise as it should be. The rule does not require the attorney to recommend evaluation by a competent third party, nor does it mandate written advice. [23] But a cautious attorney would certainly instruct the client in a contemporaneous writing to the effect that "I strongly urge you to have another attorney or qualified person evaluate this transaction before we sign the papers in ten days." The disclosure and advice to the client should be contained in a document separate from the business transaction



itself. Indeed some courts have placed an obligation on the attorney to assure the client had independent counsel before the agreement was executed. [24]

To be absolutely safe (which is no guarantee, given the creativity of malpractice claims), the attorney can refuse to enter into the transaction until a disinterested attorney evaluates it and issues a written opinion as to the fairness and reasonableness of the transaction. Such an opinion would provide the maximum protection to the attorney. Realistically, however, many clients will be reluctant to hire a separate attorney to evaluate the fairness of the original attorney whom they trust.

The requirement of fair terms applies to all business transactions between attorney and client, whether in the form of loans, partnerships, investments, common ownership, sales, purchases and joint ventures. The only terms excluded from the scope of the Rule are those that involve "standard commercial transactions . . . for products or services that the client generally markets to others. . [25] For example, an attorney can purchase a computer system from a client who is in the computer business without putting the terms in writing and without resorting to independent counsel. Likewise, the client can offer a computer system to the attorney at a reduced price without the safeguards of the Rule. In these situations the lawyer has no advantage. In contrast, if the client urges the attorney to enter a computer franchising arrangement, the Rule applies. Similarly, if the attorney wishes to sell used office equipment to a client, the Rules are applicable. In the latter situations the attorney, with knowledge of the law or the facts, may have an advantage.

A frequently suggested solution is for the attorney to refuse to handle any legal work directly connected to the transaction. For example, if the business opportunity involves the operation of a business, the lawyer would limit her advice to such unrelated legal issues of the client as an adoption, the purchase of a residence or the defense of a minor child in a vehicular misdemeanor.

That solution has three problems: 1) The client may earnestly seek legal advice regarding the transaction. In part, the client came to the lawyer for legal advice in connection with the business opportunity, rather than going to a grocer or a beautician. 2) In unanticipated ways the legal work may not be separable from the business opportunity. 3) The solution does not avoid the issue, because the client is still relying on the legal advice of the attorney.

The attorney may argue her role was limited to the extraneous legal matters, and in this business transaction she was only wearing the hat of the investor. However, in the absence of a separate attorney who is advising the client on the business relationship, the case law permits the client to assert that "she was my lawyer for other matters and I assumed that she was acting as my lawyer in this capacity also." Such a position is particularly justifiable if the attorney-client relationship is of long duration. A lengthy relationship of trust and confidence may erode the normal prudence of a client. [26]

Similarly, a statement, no matter how direct or clear, to the client that the attorney is not acting as the

attorney for the business transaction is probably insufficient to free the attorney of responsibility under the Rule. [27] Indeed, established Arkansas case law placing the burden upon the attorney applies to any transaction where the relationship may be presumed to give the attorney an advantage over the client. [28]

Another potential defense by the attorney is that no attorney-client relationship existed. The individual was a former client, a prospective client [29] or a neighborhood friend who occasionally asks legal questions. However, the determination of whether an attorney-client relationship exists is a question of fact. The relationship may exist in the absence of an express agreement, [30] in the absence of fees being paid or requested, in the absence of an on-going relationship and even in the absence of a law office environment.

In determining the relationship, at least some weight is given to the good faith belief of the client as to a relationship. To protect the public, particularly vulnerable or dependent clients, courts are willing to find an attorney-client relationship. For example, in the absence of documents or other evidence clearly indicating the conclusion of an attorney-client relationship, the courts may find the client was justified in concluding the attorney was still serving in that role, particularly if the client had not sought any other legal assistance. For example, consider a client who buys a house with the assistance of an attorney, and returns in six months with a proposed business opportunity. Certainly that client is likely to believe that an on-going relationship exists and that the attorney is protecting the client. Most likely the court will evaluate the transaction under the provisions of Rule 1.8(a). Similarly, if the business opportunity follows the completion of a legal matter and involves funds generated in that matter, the courts will look with askance on the business relationship. For example, an attorney who successfully settles a personal injury case and then enters into a business relationship with the client using the settlement proceeds is not likely to be favorably perceived. [31] A court or jury will conclude the client is likely to have continued to place trust in the attorney.

As the bottom line, the Arkansas Supreme Court has suggested the appropriate inquiry asks, in effect, whether an ordinary person would be looking to the attorney as an adversary or as a protector. [32] Unless the client understands the attorney to be an adversary, the client is justified in believing the attorney is looking out for the best interests of the client.

The Wisdom and Propriety of the Transaction: Beyond that ethical inquiry is the broader inquiry: even if the attorney can ethically participate in the transactions, is it advisable? Is she completely protected? What protection is available to the attorney? What risks are involved? What entanglements are presented? Are the potential rewards worth it? What alternatives are available?

If a dispute between attorney and client arises, ultimate victory may be long delayed. For example, an Arkansas attorney approached his clients about investing in a limited partnership he was forming and discussed the potential tax benefits with them. The attorney advised the clients he would be acting in different capacities and conflicts of interest could arise. In the documents, the attorney warned his clients in obvious language, saying in effect "You may lose your entire $700,000 investment." However, when the venture failed, they still sued. The clients alleged, inter alia, their attorney had them sign personal guaranties with blank spaces, failed to advise them of their potential liability and breached a fiduciary duty to avoid conflicts of interests by leasing equipment and obtaining undisclosed profits.

The attorney lost at the trial court level as a jury found malpractice. Ultimately, more than a decade later, his statute of limitation defense prevailed on appeal. [33] In retrospect, would the attorney have been willing to skip the initial transaction to avoid 11 years of litigation with his clients? [34]

The attorney also needs to consider the impact her business transaction with a client will have upon her relationship within her law firm. [35] Will her billable hours decline because she is devoting more time to the business investment? Will conflicts of interest arising from her involvement mandate or suggest that her firm decline other clients? If the investment is wildly profitable, will her firm expect part of the financial rewards? Will publicity arising from her investment bring to the firm undesired attention? To what extent can members of the firm partners be held liable for the business transactions between another member of the firm and a client? [36] Does malpractice insurance of the firm cover transactions between attorneys and clients? [37]

The attorney should evaluate the practical aspects of wearing the hats of both the attorney and the business partner. Is the business partner expecting free or reduced legal fees? Is the attorney competent in the business arena?

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Finally, the attorney should consider the stigma of professional discipline. The rule requires strict compliance. An attorney who violates Rule 1.8(a) is subject to professional discipline, regardless of whether the client suffered any financial loss and regardless of whether the transaction was fair at the time. Likewise it is no defense the attorney acted in good faith or had the best intentions. [38] The error may be categorized as technical misconduct, serious misconduct or substantial serious misconduct. [39] Arkansas attorneys have been suspended from the practice of law for violation of the Rule. [40] Although the sanction will vary, the stigma does not.

Conclusion: When confronted with the business opportunity, the attorney has three essential options: a) graciously turn down the opportunity and continue to provide legal counsel to the client; (b) terminate all legal services to the client and become strictly an investor; or (c) try to wear simultaneously the hats of both a business partner and an attorney by strictly complying with the requirements of Rule 1.8(a). The first option is the cautious approach; given the scope of the attorney-client relationship and the wishes of the client. The second may not be feasible; the third is the most difficult. The risks include the cancellation of a transaction, the loss of an attorney's fee, the disgorgement of profits, the posture of a defendant in a malpractice suit, professional discipline and public notoriety.

Are the rewards really worth the risks?

ENDNOTES

1. See Annotation, Disciplinary Action Against Attorney Taking Loan from Client, 9 A.L.R. 5th 193.

2. For example, *Sexton v. Ark. Supreme Court Committee on Prof. Conduct*, 299 Ark. 439, 774 S.W. 2d 114 (1989), cert. denied, 110 S. Ct. 1782 (1990).

3. For example, *Committee on Professional Ethics and Conduct v. Baker*, 269 N.W. 2d 463 (Iowa 1978).

4. For example, *In the Matter of Wolk*, 413 A. 2d 317 (New Jersey 1984). The attorney persuaded an elderly widow to invest her $10,000 inheritance in a mortgage on garden apartments. He failed to inform her that (1) the property was in a depressed section of Hoboken; (2) the property had recently been sold for $8000; (3) the mortgage was a second mortgage; (4) the property taxes were not paid; and (5) he was partial owner of the property. Concluding that he "exploited the client for his own personal gain", the New Jersey Supreme Court disbarred him.

5. The Code of Professional Responsibility governed Arkansas attorneys from February 23, 1970. See Thomas A. Robinson, The Arkansas Code of Professional Responsibility, 33 Ark. L. Rev. 605 (1980). The Arkansas Rules of Professional Conduct became effective January 1, 1986.

6. Disciplinary Rule 5-104(A) provided that:

A lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise his professional judgment therein for the protection of the client, unless the client has consented after full disclosure.

7. Charles W. Wolfram, Modern Legal Ethics (1986) 481.

8. *Swaim v. Martin*, 158 Ark. 469, 251 S.W. 26 (1923).

9. *Swaim v. Martin*, 158 Ark. 469, 251 S.W. 26 (1923).

10. *Johnson v. Rolf*, 208 Ark. 554, 187 S.W. 2d 877, 188 S.W. 2d (1945).

11. *Sexton v. Ark. Supreme Court Committee on Prof. Conduct*, 299 . 439, 774 S.W. 2d 114 (1989).

12. See *Marilyn Lindgren Cohen, A Risky Business: Entering into Business Transactions with Clients is Full of Potential Conflicts*, 54 oregon State Bar Bulletin (Dec. 1993) 29.

13. *Swaim v. Martin*, 158 Ark. 469, 251 S.W. 26 (1923) (deed from client to attorney set aside). Compare *Duvall v. Laws, Swain & Murdoch*, P.A., 32 Ark. App. 9g, 797 S.W. 2d 474 (1990) (transfer of land to attorney was an absolute conveyance for fees, not an eguitable mortgage). The dissent found "a total absence of evidence of negotiations between the parties as to the relative value of the minerals with relation to the balance of the fee owed. . ."

Clients may pay fees in real or personal property. See Rule 1.5, Paragraph 2 of Comment. Because of the difficulty of valuing the property, the nature of future legal services, and the knowledge available to the attorney, they will be carefully scrutinized. Those that are obviously fair will be upheld. For example, *Blake v. Denman*, 218 Ark. 351, 236 S.W. 2d 433 (1951).

14. *Fletcher v. Long*, 271 Ark. 942, 947, 611 S.W. 2d 779 (Ark. 1981) (J. Cloninger, dissenting).

15. *Fletcher v. Long*, 271 Ark. 942, 947, 611 S.W. 2d 779 (Ark. 1981) (J. Cloninger, dissenting).

16. See *Charles W. Wolfram, Modern Legal Ethics*, (1986) 481; *Fletcher v. Long*, 271 Ark. 942, 947, 611 S.W. 2d 779 (Ark. 1981) (J. Cloninger, dissenting). Monco v. Janus, 583 N.E. 2d 575 (Ill. App. 1991).

17. *Bond v. Marlin*, 199 Ark. 806, 136 S.W. 2d 460 (1940).

18. See Brill, *The Arkansas Law of Damages* (2nd edition, 1994 Supplement) Section 35-7.1.

19. See Note, *Conflict of Interest, Prohibited Transactions*, 13 U. Ark. Little Rock L. J. 398 (1991).

20. *Norfleet v. Stewart*, 180 Ark. 161, 20 S.W. 868 (1929).

21. *Sexton v. Ark. Supreme Court Committee on Prof. Conduct*, 299 439, 774 S.W. 2d 114 (1989), cert. denied, 110 S.Ct. 1782.

22. See Charles W. Wolfram, Modern Legal Ethics (1986) 484.

23. Some states do require that the advice be in writing. See Kathleen M. McKnight, *Hazards of Business Relationships with Clients*, 2 Legal Malpractice Rep. 3 (1990).

24. For example, *Monco v. Janus*, 583 N.E. 2d 575 (Ill. App. 1991)

25. Comment to Rule 1.8 (first paragraph) (given examples include banking and brokerage services, medical services, products manufactured or distributed by the client, and utilities services).

26. See Marilyn Lindgren Cohen, *A Risky Business: Entering into Business Transactions with Clients is Full of Potential Conflicts*, 54 Oregon State Bar Bulletin (Dec. 1993) 29.

27. *See Sexton v. Ark. Supreme Court Committee on Prof. Conduct*, 299 Ark. 439, 774 S.W. 2d 114 (1989).

28. Swaim v. Martin, 158 Ark. 46g, 251 S.W. 26 (1923).

29. See *Johnson v. Rolf*, 208 Ark. 554, 187 S.W. 2d 877, 188 S.W. 2d 137 (1945) ("in preliminary discussions which have for their purpose creation of the relationship of attorney and client, good faith is likewise demanded").

30. See *Sexton v. Supreme Court Comm. on Professional Conduct*, 295 Ark. 141, 147, 747 S.W. 2d 94, 97 (1988) (dissenting opinion of Justice Hays).

31. *See Sexton v. Ark. Supreme Court Committee on Prof. Conduct*, 299 Ark. 439, 774 S.W. 2d 114 (1989).

32. *Sexton v. Ark. Supreme Court Committee on Prof. Conduct*, 299 Ark. 439, 774 S.W. 2d 114 (1989).

33. *Smith v. Elder*, 312 Ark. 384, 849 S.W. 2d 513 (1993).
34. For another example of litigation to be avoided, see *Buffalo v. Blackmon*, 1994 Ark. App. Lexis 2 (not designated for publication). While representing a client in various matters, including a partnership dispute and a divorce, a Little Rock attorney loaned the client money to keep a service station in operation. The client assigned an interest in a promissory note to the attorney and assigned all of his service station assets to the attorney. The attorney also purchased from a third party the real property on which the service station was situated. When the client defaulted, the attorney sued on the promissory note and sought foreclosure. In defense the client argued the attorney had violated Rules 1.8(a) and 1.8(b), and further, should be denied equitable relief because of his unclean hands.
35. This paragraph was suggested by comments made by Jack Butt, of Davis, Cox and Wright, Fayetteville, at an Inns of Court presentation in October 1994.
36. See, for example, *Roach v. Mead*, 301 Oregon 383, 722 P. 2d 1229 (1986) (holding partner vicariously liable for negligent advice of another partner to client regarding personal loan from client to the partner).

An evaluation of this question requires a careful analysis of partnership law, professional corporation law and limited liability company law. Act 1146 of 1991, codified as Ark. Code Ann. 5 4-29-101, provides that a shareholder, employee, or officer of a professional corporation shall not be personally liable for the obligations or liabilities of the corporation, of those of any person connected with the corporation, simply virtue of occupying a position with the corporation.

Act 1003 or 1993, codified as Ark. Code Ann. § 4-32-101 et seq., creates a limited liability company which is designed to offer its members the limited liability of a corporation while preserving the tax status of a partnership. This business entity is clearly designed for the professional services of attorneys and others. See Beard, *The Small Business Tax Entity Pass Through Act — The Birth of a Duck*, 1993 Ark. L. Notes 15. However, the limited liability company may not offer any greater protection from malpractice liability than a professional corporation would. See Mary Elizabeth Matthews, *The Arkansas Limited Liability Company: A New Business Entity Is Born*, 46 Ark. L. Rev. 791, 843-48 (1994), for a comparison of the options available to attorneys and other professionals.

37. Malpractice insurance may exclude intentional conduct or investment advice, either of which may be alleged in a subsequent suit by the client. See Charles W. Wolfram, *Modern Legal Ethics* (1986) 241.
38. For example, *In re James*, 452 A. 2d 163 (D.C. 1982); *Matter of Johnson*, 826 P. 2d 186 (Wash. 1992)
39. These terms are suggested by *Dixon v. State Bar*, 32 Cal. 3rd 728, 187 Cal. Rptr. 30, 653 P.2d 321 (1982).
40. *Sexton v. Ark. Supreme Court Committee on Prof. Conduct*, 299 Ark. 439, 774 S.W. 2d 114 (1989) (one year suspension).

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