Ethics of Attorney-Client Transactions: How To Avoid Tripping the Wires

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The Issues

- Attorney-client transactions often seem unlikely to the lawyer (think: massive joint venture real estate deal with a client where the lawyer Is not really a lawyer anymore), but in fact they are all too common.
- Many arrangements attorneys and clients make in fact trigger the ethical rules governing the propriety of transactions
- Common scenarios: renegotiation of fee arrangement when client is behind where lawyer gets a stake in case or other security to continue litigating or a lien on case proceeds to pay the fees

Governing Rules

- Cal Rules of Professional Responsibility 3-300
- ABA Rule 1.8
- State Fiduciary Duty Law

Cal. Rules of Prof. Resp. 3-300

A member 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 each of the following requirements has been satisfied:

(A) The transaction or acquisition and its terms are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which should reasonably have been understood by the client; and

(B) The client is advised in writing that the client may seek the advice of an independent lawyer of the client's choice and is given a reasonable opportunity to seek that advice; and

(C) The client thereafter consents in writing to the terms of the transaction or the terms of the acquisition.

NY Rule 1.8/ABA Rule 1.8

(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 in a manner that can be reasonably understood by the client;

(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

(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

3-300/1.8 Overarching Governing Principles

- "The relation between attorney and client is a fiduciary relation of the very highest character, and binds the attorney to most conscientious fidelity— *uberrima fides.*" *Cox v. Delmas* (1893) 99 Cal. 104, 123
- '[i]n civil cases, "there are no transactions respecting which courts … are more jealous and particular, than dealings between attorneys and their clients." ' " *Eschwig v. State Bar* (1969) 1 Cal.3d 8, 16
- "must avoid circumstances where it is reasonably foreseeable that his acquisition may be detrimental, i.e., adverse, to the interests of his client." *Ames v. State Bar* (1973) 8 Cal.3d 910, 920

Net Result: **Any** agreement with a client that gives the lawyer an interest in client's property must comport with 3-300.

Attorney-client original engagement

- Original engagement agreement is presumed at arm's length and 3-300 generally inapplicable unless agreement confers ownership or possessory interest adverse to client.
- *Contingency:* securing right to share of recovery from suit and a charging lien on said recovery is **not** subject to 3-300. *Lanz v. Goldstone* (2015) 243 Cal.App.4th 441, 464.
- *Hourly:* But in an hourly case, a charging lien on the recovery is subject to 3-300. *Fletcher v Davis* (2004) 33 Cal.4th 61, 69.
  - Rationale: a charging lien that allows the lawyer to detain the recovery to pay outstanding fees is detrimental to the client (especially where lien far exceeds amount owed in fees), whereas in a contingency case the attorney shares the risk of nonpayment.

Presumption of Undue Influence

- Probate Code Section 16004: "A transaction between the trustee and a beneficiary which occurs during the existence of the trust or while the trustee's influence with the beneficiary remains and by which the trustee obtains an advantage from the beneficiary is presumed to be a violation of the trustee's fiduciary duties. This presumption is a presumption affecting the burden of proof. This subdivision does not apply to the provisions of an agreement between a trustee and a beneficiary relating to the hiring or compensation of the trustee."

- Applies to the fiduciary relationship between attorney and client. Accordingly, "[a] transaction between an attorney and client which occurs during the relationship and which is advantageous to the attorney is presumed to violate that fiduciary duty and to have been entered into without sufficient consideration and under undue influence… To rebut the presumption of undue influence under section 16004, the attorney must " 'show that the dealing was fair and just, *and* that the client was fully advised.'"

BGJ Associates, 113 Cal.App.4th 1217-1227-28

- *But see: Walton v Broglio*, 52 Cal.App.3d 400 (1975) (held statutory presumption inapplicable to fee agreement where lawyer secured DOT to pay **fixed** fee)

- *Best Advice:* Assume presumption applies and follow 3-300

Factor 1: Fair and Reasonable & Disclosed in Writing In Understandable Manner

- Even if deemed fair and reasonable, absent of writing fully explaining the terms renders the deal voidable at client's election. *Fair*, 195 Cal.App.4th 1135 (2011).
- Best Practice: In writing advise client to find an independent lawyer.
  - If client is not using an independent lawyer, then must lay out terms in writing in a manner as if you were negotiating for client against yourself – pros and cons with everything explained in manner adverse to your own interest.
  - If client uses independent counsel, then case law holds that the interested lawyer does not need to also lay out the pros-cons in writing because that is the job of independent counsel. Example: *Yaspan*, 233 Cal.App.4th 676 (2014)

Factor 2: Advise in Writing of Ability to Seek Independent Counsel

- Sending draft deal documents on the transaction that contain a statement that the parties have the right and ability to seek independent counsel "arguably" satisfies the second prong of 3-300

BGJ, 113 Cal.App.4th at 1226

- *Safest Practice*: as well as putting the provision in the draft transaction documents, also send a written cover memo/letter that specifically tracks 3-300(B)'s requirement because *BGJ* did not absolutely hold the underlying deal documents' reference to independent counsel always sufficed. There is enough room for disagreement that other courts may hold contra to it.

Factor 3: Client Consent in Writing

- Must be in writing.
- Even if client consents and later agrees it consented, the absence of written consent makes transaction voidable.
- Example: Client did not dispute that it consented to the transaction orally, but there was no written consent so client sought to void transaction and court agreed even though there had been undisputed oral consent and even though there had been post-consent conduct that ratified the existence of consent. *BGJ*, 113 Cal.App.4th at 1226.
- *Safest Practice:* Insure client signs a written document consenting to the deal.

Independent Counsel

- Safest course is to have client find its own independent counsel to represent client and you negotiate with the independent counsel.
  - "Specific recommendations by an interested attorney might *inhibit*, rather than aid, the client's effort to obtain objective advice." *Maltaman v State Bar*
- Remember: express client consent in writing is still required even with independent counsel and give original advise of seeking independent counsel in writing too.
- *Practice Pointer*: Do not send to a friend of yours because then the lawyer may be challenged as non-independent. Safest course is to not give referrals so as to avoid risk of challenge down the road.
  - Example: *Yaspan* done right, despite litigation and challenge.

Example 1: Charging Lien on Future Recovery Proceeds

- Charging lien is contractual lien against proceeds/recovery, not automatic upon provision of services, and is the right to be paid from a certain source if the specified events come to pass, i.e., judgment/settlement/recovery. *Fletcher v. Davis*, 33 Cal.4th 61, 72 (2004)
- Facts: attorney-client relationship, oral lien on future proceeds, not reduced to writing.
- "We therefore conclude that an attorney who secures payment of hourly fees by acquiring a charging lien against a client's future judgment or recovery has acquired an interest that is adverse to the client, and so must comply with the requirements of rule 3–300."
  - Note: simple statement in written engagement agreement is insufficient as it does not meet all of 3-300.
  - Note: Contingency (on recovery) engagement is not subject to 3-300. Cal. State Bar Formal Op. No. 2006-170.

Example 2: Client assignment of right to statutory attorney's fees

- Common in civil rights scenario where statutory fee awards exist.
- If attorney client agreement includes an assignment of the right to an attorney's fees award, then 3-300 applies. If complied with, the assignment is acceptable public policy. Cal State Bar Op. 1994-136.

Example 3: Deed of Trust Secured by Note to Pay Fees

- Facts: lawyer agreed to represent client for $15k through trial. Client lacked cash so gave lawyer a PN/DOT.
- Holding: an attorney's acquisition from the client of a note secured by a deed of trust in real property in order to secure payment of legal fees is subject to 3-300.
- *Hawk v. State Bar* (1988) 45 Cal. 3d 589, 593-94.

Example 4: Business Transactions Intertwined with Case Representation

- *BGJ* case→ representation led to possible resolution that lawyer could invest in. *Held* intertwined and so 3-300 applied

Example 5: Joint ventures with clients

- *Joint Venture Deals (Bakhtiari* case): representation in transactional matters for client led to long term business deals with lawyer even employee of joint venture. *Held:* although fair and good deal and long lasting for many years, client could void many years later under 3-300 and no *quantum meruit* right either.

Example 6: Stock

- *Stock in start ups:* Generally accepting stock for legal services is subject to 3-300 & ABA 1.8.
  - ABA Formal Opinion Letter 000-418
- Beware: make a mistake and do not comply with 3-300 can lose your investment. *Passante v. McWilliam* (1997) 53 Cal.App.4th 1240 (Corporate attorney to get 3% of stock for organizing funding. Unenforceable)
- Establishing reasonableness of exchange is critical in 3-300 analysis. ADVICE: If possible, the stock should be valued at the amount per share that cash investors agreed to pay about the same time the stock was issued to the lawyer or law firm. If that is not possible, "the percentage of stock agreed upon should reflect the value, as perceived by the client and the lawyer at the time of the transaction, that the legal services will contribute to the potential success of the enterprise." (ABA Op. 000-418)

Example 7: Loans

- Loans to client are subject to 3-300.
- Loans from client are subject to 3-300.
  - Failure to comply with 3-300 can render the loan non dischargeable in bankruptcy
- But: sending client to broker to get financing for legal services is not a 3-300 transaction so long as the attorney does not receive referral fees/compensation on the loan from broker.

Example 8: Renegotiating Fee Agreements in a Case

- Law presumes that once a case is relatively substantially underway, all balance of bargaining power shifts to the attorney→ triggers applicability of 3-300 and lawyer has burden to justify transaction.
- *Examples: Lossman* case, 274 Ill. App. 3d 1 (1995) (subsequent renegotiation for flat fee for appeal, no compliance with PR rules, void at client's election); *In re Kindy's Estate*, 310 So. 2d 349 (Fla. App. 1975) (subsequent renegotiation for contingent interest; new facts come out that make that very valuable; known before client takes necessary steps to finalize the deal; held invalid even though at time of agreement lawyer did not know of new facts that made the 20% so lucrative)
- All underscore importance of complete disclosure and compliance when renegotiating fee agreements because the law sees such unequal bargaining power once a case is underfoot.

Effect of Violating 3-300

- Not automatically void by law, but transaction becomes voidable at client's election. (*BGJ*)
- Can lose even quantum meruit-based recovery for work done, even indisputably successful work. (*Bakhtiari*)
- Can lead to state bar discipline.
- Triggers presumption of undue influence, which has downside in a potential breach of fiduciary duty-based damages action.

State Fiduciary Duty Law

- Violations of the transactions rules can also constitute a breach of fiduciary duty creating additional liability beyond losing your transaction and experiencing state bar discipline:

"A violation of the Rules of Professional Conduct subjects an attorney to disciplinary proceedings, but does not in itself provide a basis for civil liability. But the rules, 'together with statutes and general principles relating to other fiduciary relationships, all help define the duty component of the fiduciary duty which the attorney owes to his or her client.' " *Fair v Bakhtiari*, 195 Cal.App.4th 1135, 1152 (2011)

Damages Still Required

- 3-300 may constitute a breach of fiduciary duty but plaintiff in such a tort claim still needs damages.
- If breach did not damage client, client can void fees or gain from transaction under 3-300 but absent injury no tort claim. *(Bakhtiari)*

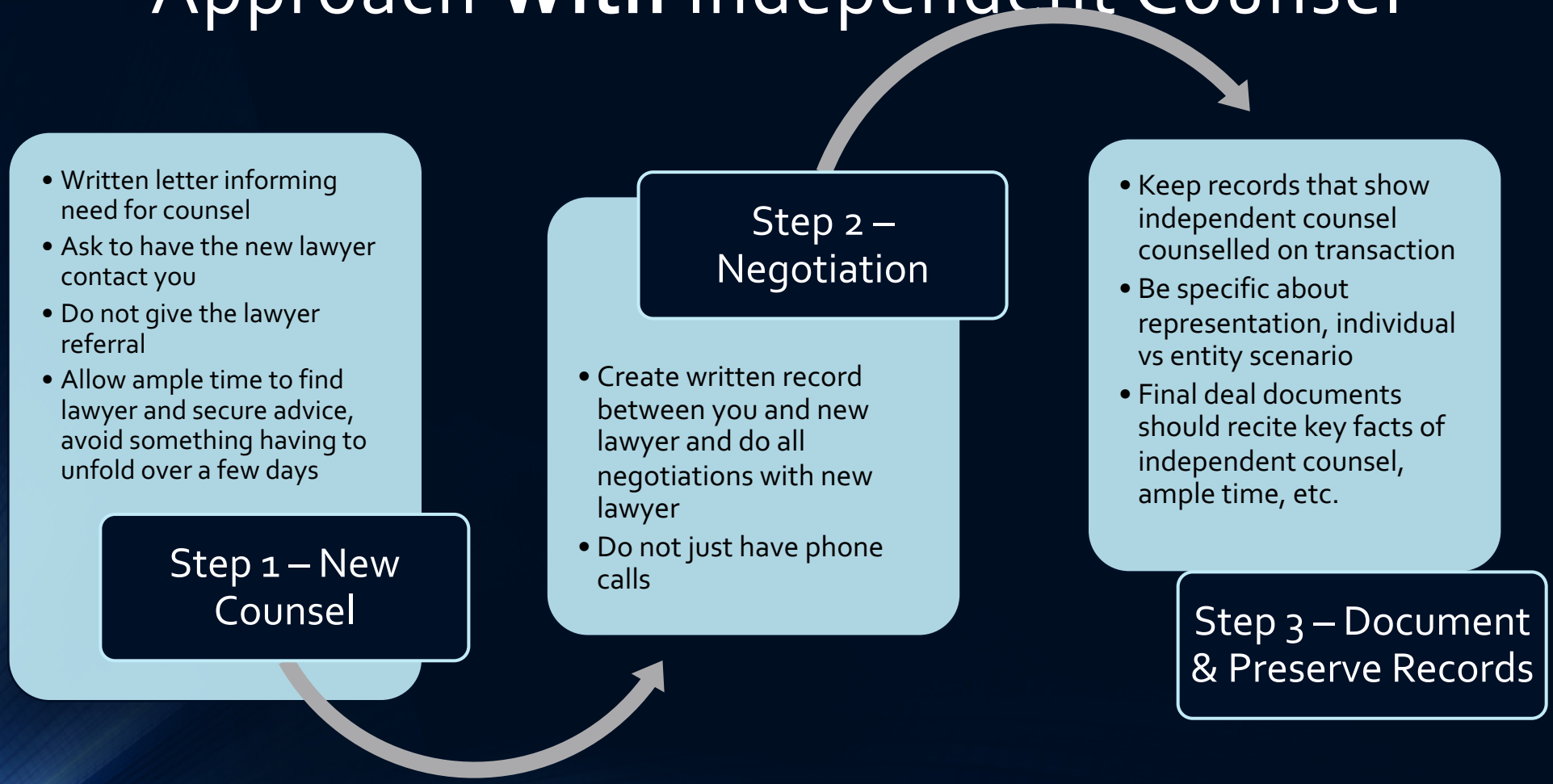
Key Tips

- (1) If you want to avoid even risk of controversy, don't do business deals with clients where you are providing legal services no matter how lucrative it may seem. Extreme conservative approach.
- (2) If you must, best approach is to insure they retain their own independent counsel, not recommended by you, and you negotiate in writing with that lawyer before client signs deal documents AND have deal documents note the existence of independent counsel and have the independent counsel sign that she provided independent counsel to the client regarding the subject matter of the transaction.
- (3) Terms to put in final deal documents: (a) had independent counsel, time to secure, and consult, and in fact consulted, (b) you are relying on representation of independent counsel's participation for client as basis for entering the deal, (c) have the independent lawyer sign the documents and say more than approved as to form, but say approved by undersigned independent counsel who has advised client on the reasonableness of the transaction terms herein.

Why so uber cautious?

- Even if transaction is ultimately fair and reasonable, even if never used undue influence, non-compliance is a violation.
- Courts are hyper-strict and hyper-vigilant in voiding attorney-client transactions so one must comply fully and perfectly.
- Think of lawyer contracts with clients as the opposite of normal rules regarding contract formation, rules that favor enforcement and only void in rarest of cases.

Practice Pointers: Flowchart of Safe Approach **With** Independent Counsel



Practice Pointers: Flowchart of Safe Approach **Without** Independent Counsel

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