

The Perils Of Investing In A Client

BY MARY C. DALY

Hardly a day goes by without another article in the press reporting the fantastic profits being made by law firms that invest in clients' businesses. *E.g.*, Renee A. Deger, *Stake Diner, All The Fixings*, Am.Law., Feb. 2000, at 28. While these articles often pay lip service to the ethical perils of these investments, they mostly celebrate the good luck and financial astuteness of the firms' investment strategies. In the March issue of NYPRR, I provided a general introduction to the recently amended DR 5-104, the disciplinary rule that governs the conduct of lawyers who enter into business transactions with a client. In this column, I will tentatively explore how DR 5-104 impacts on the decision of a law firm to invest in a client's business.

Investing in a client's business is not a new phenomenon. For example, if a client was experiencing a cash flow problem, a law firm might agree to accept payment of its fees in stock. Sometimes, the arrangement was an act of desperation, the only way the law firm could receive any remuneration. On other occasions, the law firm might regard investment in a client's fledgling business as a way to capture and maintain the client's loyalty and solidify the attorney-client relationship for many profitable years to come. While some law firms undoubtedly invested solely because the firm recognized a promising opportunity to make money, the majority appear to have acted out of a concern related to the preservation and nurturing of the attorney-client relationship. On some occasions, the impetus for the investment actually came from the client, who would offer an individual lawyer in a firm a personal opportunity to invest in a business transaction as a way of rewarding the lawyer for outstanding service. In short, investments in the past were principally relationship-driven.

Current Investments Profit-Driven

The current investment frenzy is very different. It is much more profit-driven. The frenzy began on the West Coast, as the Silicon Valley became the epicenter for technology start-up companies. At first, the law firms accepted stock as payment for their legal fees out of necessity. The start-ups had no other way of paying the firms' bills. When the start-ups went public or were purchased by other companies, the law firms saw the value of their stock holdings soar. The lawyers quickly realized that smart investments in technology companies could return handsome profits.

Silicon Valley law firms structure their investments in different ways. One popular strategy is to take a certain percentage of a client's stock in lieu of a cash fee. Another is to create a law firm investment fund that purchases the stock of both clients and nonclients. Still another is to invest a portion of the firm's funds in a venture capital fund operated by one of the firm's clients. Many firms have adopted a rule that prohibits individual lawyers from accepting a client's offer of an investment opportunity without the lawyer's first making the opportunity available to the firm.

There is no uniform practice among the Silicon Valley firms about who can have an ownership interest in the investment portfolio. Initially, investment opportunities were limited to partners, with the firms taking different views on whether the contributions were mandatory or optional. In recent years, in part to stem the loss of talented associates to dot.com clients, some firms have established a fund in which associates also may invest. *See* Renee Deger, *Firms Give Associates a Share of Investment Pool*, N.Y.L.J., Apr. 7, 2000, at 23. At least one firm plans to establish a fund in which nonlawyer staff members may invest.

But Silicon Valley no longer has a stranglehold on high-tech companies. Many start-ups these days have Silicon Alley, New York City addresses and are establishing themselves in other parts of the state as well. The pressure on New York State law firms to invest in clients a la Silicon Valley firms is building on two fronts. First, some high-tech clients view a law firm's investment as a credential that has a positive influence on the decisions of venture capital firms. These companies are consequently pressing New York law firms to acquire stakeholder positions. Second, the firms' partners and associates themselves are aggressively proclaiming their eagerness to share in similar grand-scale profits.

New York firms must proceed with trepidation in considering whether to copy the Silicon Valley firms. The Code of Professional Responsibility cautions against a business transaction between a lawyer and a client "if they have differing interests therein" and the client "expects the lawyer to exercise professional judgment" for the client's protection. DR 5-104(a). While it does not flatly prohibit a transaction, it requires three conditions. First, the transaction and the terms on which the lawyer acquires the interest must be "fair and reasonable to the client" and "fully disclosed and transmitted in writing to the client in a manner that can be reasonably understood by the client." Second, the lawyer must advise the client to seek the advice of independent counsel. Third, the client must consent "in writing, after full disclosure, to the terms of the transaction and to the lawyer's inherent conflict of interest in the transaction."

The first of the three conditions is likely to present the most difficulty for the law firm. Determining whether a transaction is fair and reasonable to a client raises a host of issues, many of them involving complex stock valuation. For example, at some point before an initial public offering, a law firm may invest in the client's business or accept stock in payment of the client's bill for legal services. Federal law prohibits the firm from selling the stock during a six-month lock-up period after the IPO. During this period, the stock's value may increase many times and by large multiples. Whether the return can be considered fair and reasonable under DR 5-104 is debatable. If the stock represents a fee for legal payments, DR 2-106, forbidding an excessive fee, may be implicated.

Full Disclosure A Difficult Task

Satisfying the requirement of full disclosure in a manner that can reasonably be understood by the client is not easy. Something more is required than simply multiplying the present value of the stock by the number of shares assigned to the law firm. If a representative of the law firm is a member of the client's board of directors, the disclosure must address the conflicts of interest the board membership creates as well as how the membership might weaken the client's invocation of the attorney-client privilege.

The disclosure must also consider the impact on confidential client information, if there is a later falling out between the principal investors, including the law firm, and the client's management. What happens to the attorney-client privilege if the law firm concludes that it has been a victim of the client's fraud and

sues for damages? Perhaps the wisest way for a law firm to approach the disclosure issue is to imagine itself in the role of the independent counsel the client might consult in considering the wisdom of entering into the transaction. What information would the law firm want to know? What advice would it give to the client?

The public policy underlying DR 5-104 is straightforward. The more a lawyer's financial interest is at risk in a client relationship, the more likely that the lawyer will not exercise the independence of professional judgment on the client's behalf that the Code requires. See *Rhodes v. Buechel*, N.Y.L.J., Mar. 18, 1998, at 28, *aff'd*, 258 A.D.2d 24, 685 N.Y.S2d 65 (1st Dep't 1999). The Silicon Valley firms defend their decisions to invest in clients by stressing that they limit each investment to a small percentage of the firms' funds or that the firms own only a small percentage of the client's shares. While these restraints may help to preserve the lawyer's independence, they don't guarantee it. Imagine the predicament of a law firm that has invested \$25,000 in a client, but has happily watched the value of the investment increase to \$1.25 million. In counseling the client about two possible courses of action, the law firm may deliberately or subconsciously short change the alternative that threatens its investment. See Debra Baker, *Who Wants to Be a Millionaire?*, A.B.A.J., Feb. 2000, at 36. Furthermore, the conflict will redouble its force if any of the partners have personal investments in the client, especially the partner counseling the client. See N.Y.S.B.A. Comm. on Professional Ethics, Op. 712 (1998) (concluding that the lawyer's financial interest in a trust was too attenuated to constitute a conflict).

Scholarly attention to the issues that the new profit-driven investment decisions raise is scant. See Gwyneth E. McAlpine, Comment, *Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in their Client's Stock?*, 47 U.C.L.A.L. Rev. 549 (1999). Bar associations are just beginning to study them. In 1998, the Committee on Lawyer Business Ethics of the ABA's Business Law Section issued a report exploring the risks inherent in these investments. The ABA Litigation Section has appointed a task force to conduct a similar examination. At the state level, only the Utah State Bar Ethics Advisory Opinion Committee has formally grappled with these issues. In Opinion 98-13, the Committee concluded that a law firm's acceptance of a financial interest in a client, whether as a fee for legal services or as an investment, was not per se unethical. It raised concerns similar to the ones expressed in this article about the proper valuation of the law firm's interest and the potential compromise of independent professional judgment.

Investing in clients triggers liability as well as ethical concerns. A client may sue the investor law firm for breach of fiduciary duty or malpractice, arguing either that the client's consent was not fully informed or that the disclosure of the risks was inadequate. In some cases, malpractice insurance policies may exclude coverage if the law firm or its lawyers have invested in the plaintiff-client.

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