

# When Doing Deals Is Risky

Don't get involved in a client's business unless you're prepared to cover losses

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While nearly every business transaction presents its share of risks and uncertainties, the greatest risk of all for lawyers may be in doing business with clients.

Courts cast a wary eye on the practice of lawyers making loans to or investing funds with clients for start-up businesses. These transactions are presumed fraudulent, until they are proved otherwise. *In the Matter of Disciplinary Proceeding Against McMullen*, 896 P.2d 1281, 1290 (Wash. 1995).

Lawyers must not only establish that they disclosed all material aspects of the deal, but also that the transaction was fair and reasonable to their clients.

Many of the disciplinary actions stemming from these transactions have been under Disciplinary Rule 5-104(A) of the Code of Professional Responsibility, predecessor to the ABA Model Rules of Professional Conduct.

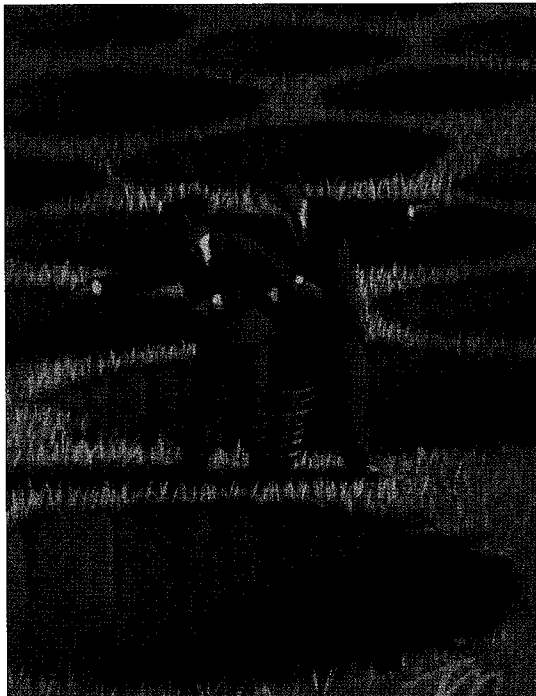
The rule requires full disclosure, which includes a complete explanation of the differing business interests of lawyers and their clients. There is also an obligation to explain the risks and disadvantages to clients as well as the benefits in obtaining independent legal counsel.

Courts have added the requirement that the transaction be fair and reasonable to clients. *Radin v. Opperman*, 407 N.Y.S.2d 303 (1978). This provision was based on the concern that lawyers had an inherently unfair advantage in these relationships that was incompatible

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with their roles as fiduciaries.

Lawyers had the advantage of being knowledgeable about the legal aspects of the transaction while also being privy to information about their clients' businesses that they gained in the course of representation. For that reason, there was a rebuttable presumption that lawyers had exerted



undue influence over their clients in these matters.

The ABA Model Rules codified these disclosure and fairness standards in Rule 1.8(a). This rule prevents lawyers from entering a business transaction with or acquiring a pecuniary interest adverse to their clients unless:

- The transaction and terms on which the lawyer acquires an interest are fair and reasonable to the client and are fully disclosed and given in writing to the client in a manner that can be reasonably understood by the client.
  - The client is informed that use of independent counsel may be advisable and is given a reasonable opportunity to seek outside advice.
  - The client consents in writing to the transaction.
- Anything less than strict com-

pliance with these requirements is courting disaster. At minimum, all material elements of the deal must be revealed, although the client's knowledge and sophistication will determine the actual information given.

Potential risks to clients must be outlined, and lawyers can be required to reveal their financial status and the potential consequences of their failure to perform under the business agreement. Also, if lawyers know of alternatives to the proposed transaction that are more beneficial to their clients, they are obligated to disclose them.

Moreover, an admonishment to seek the advice of independent counsel is meaningless unless clients receive time to do so. In one disciplinary matter, the court held that consummating a business loan in a single day deprived the client of the opportunity to consult independent counsel. *In re Discipline of Hartke*, 529 N.W.2d 678 (Minn. 1995).

## Fair and Reasonable

The thorniest task of all, however, may be establishing that the transaction was fair and reasonable to clients, particularly when lawyers fare better financially than the clients. If clients did not have independent advice, it is almost impossible for lawyers to prove that they did not exercise undue influence.

What seems fair and reasonable at the beginning of a business deal may be perceived quite differently when the deal sours. Risks that clients agreed to bear, however minimal, may later be viewed as unreasonable. Opportunities seized by lawyers at clients' expense are sure to be frowned on by a court.

While Rule 1.8(a) does not prevent lawyers from doing business with clients, those who do so should bear in mind the increased risks and disclosure requirements. Independent representation for clients will buttress lawyers' defenses later on that the transaction was fair and reasonable.

If adequate precautions are not taken, lawyers who start out as investors in clients' businesses could find themselves winding up as insurers. ■