

***Is a Lawyer Entering into a Business Transaction with a Client Protected if the Client Relies upon Independent Counsel?*** [By Steven A. Lewis © 2004]

While most lawyers know there are rules and risks associated with entering into business transactions with clients, many lawyers assume they are protected if they advise the client to consult with independent counsel and the client does so. In this article, we will set up a plausible scenario and then examine whether a lawyer is in fact protected when the client hires independent counsel.

**Scene 1: Client Invites Attorney to Participate in a Joint Venture.**

Carl Client retained Anne Attorney to obtain a prescriptive easement for use of parking spaces on an adjacent parcel. The parties were in the midst of expensive discovery when opposing counsel called Anne and conveyed an offer: His client would settle if Carl would purchase the parcel with the parking spaces together with a larger adjoining parcel and dismiss his lawsuit.

Complying with Rule 3-500, Anne explained the settlement offer to Carl. Anticipating that Carl would be interested in the deal but unable to afford it, Anne told Carl that another one of her clients, Donna Developer, might be interested in exploring a joint venture, and arranged for them to meet.

Carl and Donna hit it off and decided they wanted to buy both parcels, but that they should bring one other person into the deal. Not surprisingly, they invited Anne Attorney to become the third member of their joint venture. Anne replied, "Deal me in."

**Scene 2: Formation of the Joint Venture**

At the meeting, Carl, Donna and Anne agreed they would each contribute 1/3 of the capital, and obtain a 1/3 voting interest in the venture. Because dismissal of the lawsuit was a condition of the deal, Anne suggested they put the litigation on hold, and Carl agreed. Anne then decided she better put the parties' agreement into writing, so she prepared and signed Articles of Organization naming the joint venture "CAD." Anne then drafted a proposed Operating Agreement which (1) stated she was not representing Carl or Donna on this deal, and (2) advised them both to have the agreement reviewed by independent counsel. Carl took Anne up on her suggestion and hired Indy Counsel.

**Scene 3: Independent Counsel Ends the Deal**

Indy reviewed the draft Operating Agreement and told Carl not to sign it because certain provisions were not fair to him. On May 1<sup>st</sup>, Carl Client and Indy Counsel met with Anne Attorney and Donna Developer. At that meeting, Carl tendered his 1/3 capital investment to Anne and Donna, but did so with a letter stating that he would not sign the Operating Agreement unless changes were made allowing him to exercise control over the parcel with the parking spaces. With Carl's knowledge, Donna signed a purchase and sale agreement on behalf of CAD.

Anne Attorney and Indy Counsel continued to discuss Carl's problems with the terms of the deal, but they could never reach an agreement. Hence, the joint venture unraveled, and Anne substituted out of the prescriptive easement lawsuit. Carl, who still needed the parking spaces for his business, purchased the property with other partners, and dismissed his prescriptive easement lawsuit.

#### **Scene 4: Attorney Sues Client to Recover Her Interest in the Property**

Angry over having lost the investment opportunity, and knowing the purchase and sale agreement had been in the name of the joint venture, Anne filed a suit on behalf of CAD, Donna and herself against Carl and his new partners to establish their 2/3 interest in the property. Carl defended, asserting that the May 1<sup>st</sup> oral joint venture was void because Anne, as his lawyer, had entered into a business transaction with him without full written disclosure and advice, and without obtaining his written consent, all in violation of Rule of Professional Conduct 3-300 and Probate Code §16004.

Anne shot back: "Carl, you never relied on me as your attorney on the joint venture. I told you in writing I was not your lawyer on this deal and that you should hire independent counsel. And you did so! All you are doing is trying to become unjustly enriched at Donna's and my expense. See you in court."

#### **Scene 5: The Outcome According to *BGJ Associates, LLC v. Wilson* (Dec. 2003) 113 Cal.App.4th 1217, 7 Cal.Rptr.3d 140**

What standards apply when an attorney enters into a business transaction with a client? Are those standards altered when the client is represented by independent counsel? Will Anne prevail in her action against Carl? These and other questions were recently addressed in *BGJ Associates, LLC v. Wilson, supra*, where the court began its analysis by looking at Rule of Professional Conduct 3-300.

**Rule 3-300.** Pursuant to Rule 3-300, when an attorney enters into a business transaction with a client, or acquires an ownership, possessory, security or other pecuniary interest adverse to a client:

- i. The transaction must be:
  - (1) Fair and reasonable to the client; and
  - (2) Fully disclosed and transmitted in writing to the client in a manner reasonably understood by the client; and
- ii. The client must:
  - (1) Be advised in writing to seek the advice of independent counsel of the client's choice; and
  - (2) Be given a reasonable opportunity to consult with independent counsel; and
  - (3) Consent to the transaction in writing.

Rule 3-300 was triggered here because Anne was Carl's attorney at the time of the

transaction. However, Rule 3-300 can also be triggered in a deal between an attorney and former client, where the former client trusted the attorney because of the prior relationship. (*Hunnicutt v. State Bar* (1988) 44 Cal.3d 362, 371-372.)

Looking at our scenario, the *BGJ* court determined that Anne failed to comply with the first two requirements of Rule 3-300. First, the court determined that the deal was not fair and reasonable to Carl because: (1) putting Carl's lawsuit for a prescriptive easement on hold benefited Anne and Donna, but did not benefit Carl; (2) the deal required the dismissal of Carl's lawsuit, but never gave Carl the objective of his lawsuit (the parking spaces); and (3) the proposed operating agreement allowed Anne and Donna to override Carl by a simple majority vote.

Second, the court concluded that despite the written Operating Agreement the deal was not fully disclosed in writing, finding: (1) Anne and Carl never reached agreement on a document embodying the essential terms of the joint venture, as the Operating Agreement was never signed; and (2) Anne failed to give Carl advice against herself that she would have given had Carl been coming to her about a deal with a third party.

Anne did satisfy the next requirements of Rule 3-300, as she notified Carl in writing of his right to independent counsel and gave him an opportunity to do so. However, she failed to comply with the Rule's final requirement, obtaining Carl's written consent.

Although Anne did not formally comply with each and every one of the specific requirements of Rule 3-300, she argued that because Carl was actually represented by Indy Counsel in connection with the transaction, her non-compliance should be excused. In this regard, Anne claimed that Indy gave Carl all the advice against Anne that he needed. Carl, on the other hand, argued that strict compliance with the letter of the Rule is required.

The *BGJ* court resolved this dispute by holding that: Even if a client entering a business transaction with a lawyer is represented by independent counsel, the lawyer must still satisfy all of the elements of Rule 3-300. As the rule contemplates a situation where a client **both** consults with independent counsel, **and** consents in writing to the terms of the agreement, both are required. [Accord, *Chambers v. Kay* (2002) 29 Cal.4<sup>th</sup> 142, a fee splitting agreement could not be upheld under Rule 2-200 without written consent even if the lawyer provided written disclosure.]

As Anne violated Rule 3-300, Carl asserted the case was over. However, the *BGJ* court found that while the violation meant Anne had committed a disciplinable offense, it did not automatically render the transaction void or voidable. Noting that in addition to the rules of professional conduct, statutes and principles generally governing fiduciary relationships help define the fiduciary duty of attorneys, the court turned its analysis to Probate Code section 16004(c).

**Probate Code §16004(c).** Pursuant to Probate Code §16004(c) a transaction between a trustee and beneficiary occurring during the relationship that is advantageous to the trustee is **presumed** to be a breach of fiduciary duty, and to have been entered without sufficient

consideration and under undue influence. The presumption affects the burden of proof.

Although section 16004 expressly applies to the relationship of trustees and beneficiaries, it also applies to the relationship between attorneys and clients. In fact, since the 19<sup>th</sup> century, transactions between attorneys and clients have been “scrutinized . . . with jealous care, and . . . set aside at the mere instance of the client” unless the attorney has overcome the presumptions by showing, through extrinsic evidence, that:

- The client acted with full knowledge of the facts;
- The client fully understood their effect;
- The deal was fair and just; and
- The client was fully advised, which means that the attorney must prove that he/she gave the client all that reasonable advice against the attorney that the attorney would have given the client against a third party. (*Felton v. Le Breton* (1891) 92 Cal. 457, 469.)

In analyzing our scenario, the *BGJ* court pointed out that the deal was not fair and just, citing the same facts upon which it concluded the deal was not fair and reasonable under Rule 3-300. The court also noted that Anne never fully advised Carl against herself, as she never informed Carl: (1) whether he was better served through the joint venture or prosecuting his easement action; or (2) of the value of his easement lawsuit to the joint venture. Hence, Anne could not overcome the presumptions that she breached her fiduciary duty to Carl, provided insufficient consideration and exercised undue influence.

The net result of Anne’s inability to overcome the presumptions of Probate Code 16004(c) was that the transaction between Anne and Carl was voidable at Carl’s election. As a result, and based upon Carl’s legal challenge, the joint venture between Carl, Anne and Donna was deemed void, and all of the claims advanced by Anne and the CAD joint venture, including their claim of unjust enrichment, failed.

### **Scene 6: Does a Third-Party Investor Fall with the Attorney?**

But what about Donna Developer’s claims inasmuch as she was not an attorney and had no obligations under Rule 3-300 or Probate Code §16004? In answering that question, the *BGJ* court stated that Donna lost all of her rights in the transaction as well because she stood to benefit from the unfairness of the deal. In other words, Donna’s fates were tied to, and fell with Anne’s claims. What are the ramifications of that finding? Anne’s next risk: A malpractice action by Donna asserting that Anne should have explained that if Anne became a member of the joint venture, Donna’s interest was at risk of failing with her own.

### **Epilogue:**

While attorneys are not prohibited from entering into business transactions with clients,

they must proceed cautiously and in recognition of the risks of State Bar discipline, losing all interests or gains from the transaction, becoming responsible for all losses, and even exposure to malpractice claims by other parties to the transaction whose fates are tied to those of the offending lawyer. The mere fact that a client is represented by independent counsel in connection with the transaction does not eliminate the lawyer's obligations pursuant to Rule of Professional Conduct 3-300 and Probate Code §16004. Any attorney contemplating a business transaction with a client should therefore carefully study the legal principles applicable to the transaction and seek objective advice with regard to the disclosures being made.