

**5TH ANNUAL
ADVANCED PATENT LAW INSTITUTE**

**Co-Sponsored By
The University of Texas School of Law and
The Berkeley Center for Law & Technology,
University of California at Berkeley, School of Law (Boalt Hall)**

**November 16 & 17, 2000
The Four Seasons Hotel
Austin, Texas**

**INVESTMENTS IN CLIENTS:
DANGEROUS LIAISONS
[SLIGHTLY REVISED]**

**Michael Sean Quinn
SHEINFELD, MALEY & KAY, P.C.
301 Congress Avenue, Suite 1400
Austin, Texas 78701
(512) 474-8881
(512) 474-2337 - Fax
E-mail: mquinn@smklaw.com**

**Matthew Baab
SHEINFELD, MALEY & KAY, P.C.
301 Congress Avenue, Suite 1400
Austin, Texas 78701
(512) 474-8881
(512) 474-2337 - Fax
E-mail: mbaab@smklaw.com**

EXHIBIT #3

WORDS OF WISDOM?

People are often reproached for wishing for money above all things, and for loving it more than anything else; but it is natural and even inevitable for people to love that which, like an unwearied Proteus, is always ready to turn itself into whatever object their wandering wishes or manifold desires may for the moment fix upon. Everything else can satisfy only *one* wish, *one* need: food is good only if you are hungry; wine, if you are able to enjoy it; drugs, if you are sick; fur for the winter; love for youth, and so on. These are all only relatively good. . . . Money alone is absolutely good, because it is not only a concrete satisfaction of one need in particular; it is an abstract satisfaction of all.

Arthur Schopenhauer, *Parerga and Paralipomena*, 1851, tr. T. B. Saunders, 1890

INVESTMENTS IN CLIENTS: DANGEROUS LIAISONS

*Michael Sean Quinn
Matt Baab*

Though many lawyers would be loath to admit it, the profession needs gadflies. One indispensable species of such insects are lawyers who sue lawyers.¹ Perhaps the nucleus of the bar--the "best" people--do not need this sort of episodic self-regulation. However, there is evidence that the "Great Unwashed" of the bar need it badly, since the professional is awash in negligence, and the vice of avarice is everywhere exploding.² Indeed, from the point of view of maintaining the integrity of the profession and enforcing minimum standards of competent and fair representation, there is a salutary symbiosis between these attorneys and the bar at large.

The segment of legal community which sues other lawyers regularly has grown in both scale and sophistication in recent years. In earlier times, the few lawyers who took any number of legal malpractice cases pursued them pretty much as they came in. Things have changed. Professional malpractice plaintiff's lawyers are now preparing for cases they don't yet have. They are building readiness archives, banks of expert witnesses, files of citable material, arsenals of arguments. Top-flight lawyers who take plaintiffs cases against other lawyers are now taking a close look at the opportunities they might have for suing lawyers partly because they have substantial investment interests in their clients.

Sometimes, these investment positions come as fees, sometimes as bonuses, sometimes as special investment opportunities, sometimes as simple investments, occasionally as gifts. From

¹Insects have had a bad rap for many generations. This is about to change. N. Lee Goff, *A FLY FOR THE PROSECUTION: HOW INSECT EVIDENCE HELPS SOLVE CRIMES* (2000) is likely to change all that. Goff is a professor of entomology at the University of Hawaii and a professional consultant in forensic entomology. If the Harvard University Press is willing to publish a book about maggots and corpses, the social importance of such activities, we suspect that the designation "insect" is due for better times.

²Robert H. Frank, *LUXURY FEVER: WHY MONEY FAILS TO SATISFY IN AN ERA OF EXCESS* (1999). In our present economy, there are signs everywhere that spending is out of control and savings are dangerously low. Part of the reason for conspicuous over consumption is the desire for relative status. According to Professor Frank, a Professor of Economics at Cornell University, leads us to buy what he calls "positional goods." Since everyone is doing the thing, we all end up treading water with no improvement in our subjective well-being or utility. Nonetheless, as the nationwide 1999-2000 associate pay battle has demonstrated, lawyers and law firms are held sway by the same forces that drive the current economy. See, e.g., *Money Talks: In Order to Compete for Associates, Texas Firms Can't Be Cheap*, 16 TEX. LAWYER 4 (April 3, 2000). But see Macklin Fleming, *LAWYERS, MONEY, AND SUCCESS: THE CONSEQUENCES OF DOLLAR OBSESSION* (1997) (a retired appeals judge) and Lawrence J. Fox, *Money Didn't Buy Happiness*, 57 OREGON STATE BAR BULL. 9 (1997).

the point of view of plaintiffs' lawyers suing other lawyers, it doesn't matter much how target lawyers have acquired interests in their clients.³

No one doubts that sometimes, it is a win/win situation for lawyers to have a stake in their clients. Sometimes, corporate lawyers provide important business acumen to venture capitalists, and the law firm takes stock as fees. The start-up companies have access to legal talent but don't have the money to buy. This is of real value to the issuer of the stock and for the lawyers also: "When the company [in which the lawyer has invested] goes public or its stock otherwise achieves liquidity, the lawyer can then sell his stock, often receiving a phenomenal return. Thus, law firms can make a lot of money by investing in their clients' stock in addition to accepting fees for legal representation."⁴

One wonders, however, whether the possibility of some win/win situations augurs decisively in favor of making substantial equity positions in clients or taking equity as fees. As will be seen, there are substantial down sides. Business acumen is not always what clients need. Sometimes, clients needs purely legal advice. Sometimes legal advice involves telling them not to do what they want to do. Sometimes it involves telling them not to do what would, in the absence of the law, be very sound business strategy. Sometimes, to paraphrase the immortal words of a famous 20th century Wall Street lawyer, it involves telling business clients that they are damn fools not to stop whatever it is they are doing. Sometimes, wearing one's lawyer hat is inconsistent with wearing one's investor hat. It is often difficult for those in independent positions to speak truth to power. It is even more difficult when the oracle is also part of the power structure. To examine how this words in details, one must consult the varied sources of legal authority that circumscribe the lawyer/client relationship.

I. Governing Principles

The law of lawyering is messy. First, there are a few statutes governing lawyers. Mostly they set broad limits. Second, there are disciplinary rules governing grievances.⁵ They also

³There is one exception, as we shall see.

⁴Gwyneth E. McAlpine, Comments: *Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients' Stock?* 47 UCLA L. REV. 549, 558 (1999) (citing a large literature).

⁵This paper will deal with two sets of rules governing grievances against lawyers. First, we will be concerned with the TEXAS DISCIPLINARY RULES OF PROFESSIONAL CONDUCT ("Texas Rules"). Second, we will be concerned with the MODEL RULES OF PROFESSIONAL CONDUCT PROMULGATED BY THE AMERICAN BAR ASSOCIATION ("Model Rules"). The Rules of many states are modeled on the latter. To a considerable degree, so are the Texas rules, but there are significant variations, as we shall see. One should keep in mind the disciplinary rules are designed for processing grievances. They "do not undertake to define standards of civil liability of lawyers for professional conduct. A violation of a [grievance] rule does not give rise to a private cause of action nor does it create any presumption that a legal duty to a client has been breached." PREAMBLE: TEXAS RULES § 15 indeed, "nothing in the [disciplinary] rules could be deemed to augment any substantive legal duty of lawyers or the extra-disciplinary consequences of violating such a

influence civil actions against lawyers. Third, there is the common law, which articulates the law of malpractice and the law of fiduciary duties, among others. The common law is supplemented by such semi-authoritative documents as the RESTATEMENTS OF THE LAW produced by the American Law Institute.⁶ Fourth, there are quasi-authoritative sources, such as opinions written by state bar associations, state attorneys general, and the American Bar Association. These opinions are variously treated in different courts. The most immediately important opinion here is ABA Formal Opinion 00-418, issued July 7, 2000 ("Op-418").

Op-418 for the most part endeavors to justify attorney/client equity transactions. Though it recognizes that they amount to business transactions with a client, Op-418 endorses such investments by lawyers in the equity securities of clients to the extent that they meet the minima of reasonableness and fairness to clients mandated by Model Rules 1.8, 1.7 and 1.5. In so doing, the Op-418 sets forth four basic principles for attorneys to follow in establishing the propriety of such transactions: (1) the fee must be reasonable at the time the attorney client contract was formed;⁷ (2) the terms of the transaction must be fully disclosed to the client in a reasonably understandable manner, (3) the client must be afforded the opportunity to seek independent counsel, and the client consents in writing to the arrangement; and (3) there cannot be a material conflict of interest with the client that would preclude representation under Model Rule 1.7. In any dispute, the lawyer must demonstrate each of these propositions. Op-418 derives (1)-(4) from some provisions of the Model Rules.

However authoritative the ABA's imprimatur may sound, it would be high praise to call this opinion perfunctory. The opinion attempts, through mere casual reference to some parts of the Model Rules, to sanitize the burgeoning practice of taking equity interests in clients although it is historically unprecedented and violates long-established norms discouraging attorney involvement in business transactions with clients.. Moreover, its complete inattention to the wide-spread possibilities for conflicts posed by this practice appears hypocritical in light of the bar's rigid, and at times shrill insistence, on the paramount virtue of attorney objectivity and even

duty." Nevertheless, expert witnesses frequently rely on the disciplinary rules to help figure out what the applicable customs are.

⁶RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS (2000). This document has been through repeated drafts for over a decade, and it has been cited by many courts.

⁷The Opinion compares such arrangements to contingent fees insofar as the value of the representation may be entirely impossible to ascertain *ex ante*. However, the assumption that the lawyer is assuming all of the economic risk--and that hence no increase in the value of the stock could be considered when examining the reasonableness of the fee--is itself an unreasonable view. If a lawyer accepts stock as fees at a point and time when the lawyer is justifiably certain that the stock will "take off," then subsequent value of the stock should have some bearing on the reasonableness of the fee.

impartiality in other contexts--for example, in discouraging non-attorney ownership interests in law firms.⁸

However one views this Op-418 however, it is important to recognize that it is not the last word on the propriety of such attorney-into-client equity arrangements. For one thing, it only construes the Model Rules. Actual rules differ among different states: Texas, for example. Op-418 ignores case law and common law principles. Rules of professional conduct such as the Model Rules are only one of the four types of authority governing lawyers. Nor are grievance rules the last word on attorney liability, particularly in the malpractice context, where standards of loyalty to one's clients may be dispositive in spite of an attorney's facial compliance with the Model Rules or their state equivalents. Significantly, the Ethics 2000 Commission has proposed a new model rule--Proposed Rule 1.8(a)--pertaining to lawyer-client business transactions. Since it is discussed in some detail in the paper to which this is Appendix #3, we will pass over it here in silence.⁹

This paper integrates principles from all four areas, describing how they may open up new vistas of liability for lawyers and firms heavily invested in clients. The black letter law will be set forth below in succinct principles, the language of which will be underlined, and the typography of which will be in bold type. After formulating each of these principles, we will comment upon and apply them. Our focus is upon Texas law.

Principle #1: Lawyers are fiduciaries of their clients.

"The relationship between an attorney and his client is highly fiduciary in nature. . ."¹⁰ Indeed, attorneys should be regarded as the trustees of their clients.¹¹ The relationship between a lawyer and her client is one of *uberrima fides*.¹² Thus, a lawyer is charged with *utmost good*

⁸ See, e.g., ABA Formal Op. 95-392 ("[Non-lawyer participation in law firms] poses the possibility of control by the law person, *interested in his own profit, rather than the client's fate.*")

⁹American Bar Association, REPORT OF THE COMMISSION ON EVALUATION OF THE RULES OF PROFESSIONAL CONDUCT 197ff (November 2000).

¹⁰Archer v. Griffith, 390 S.W.2d 735, 739 (Tex. 1964).

¹¹Avala v. Havana Painting Co., Inc. 761 S.W.2d 398, 400 (Tex. App. [14th Dist.] 1948 writ dismissed). (Italics added.)

¹²State v. Baker, 539 S.W.2d 367, 374 (Tex. Civ. App.--Austin 1976 writ ref'd n.r.e.). The Latin phrase *uberrima fides* includes, "[t]he most abundant good faith absolutely on perfect candor or openness and honesty; the absence of any concealment of deception, however slight." BLACK'S LAW DICTIONARY 6th Ed. 1997). Here is what another dictionary says about the phrase "*uberrime fidei*" which is essentially the same phrase." Of the utmost good faith, a term applied to a category of contracts and arrangements where each party must not only refrain from misrepresenting to the other but must voluntarily and positively disclose any factor which a reasonable person in the position of another party might regard as material in determining whether or not to undertake the contract. The

faith. Fiduciary obligations are "the highest order of duty imposed by law."¹³ No higher order of loyalty exists. Pervasive traditions in the law require not only honest but highly honorable conduct. A fiduciary owes his beneficiaries a duty of "undivided loyalty."¹⁴ This requires that the lawyers subordinate their own self-interests to that of the clients. These norms are unbending, inveterate, and uncompromisingly rigid.

In arm's-length relationships, one is entitled to treat one's own interests as more important than those of the people with whom one is dealing, although one is not entitled to break other legal rules, and one is required to observe, for example, the prohibitions of the law of torts. The idea of arm's-length relationships is characteristic of interactions among strangers and normal contracting parties.¹⁵ There are also so-called "special relationships," in which one is obligated to treat one's interest as no more important than the interests of relevant others, but one is entitled to treat them as equally important. A special relationship gives rise to a duty of good faith and fair dealing.¹⁶ Finally, there are fiduciary relationships, in which the fiduciary is entitled to subordinate his interests for those to whom he is the fiduciary. Thus, a fiduciary relation gives rise not only to a duty of good faith and fair dealing, but to a higher level of duty as well.¹⁷

There is no black letter rule, so far as we know, which specifies the degree or extent to which the interests of the fiduciary must be subordinated to the interests of the other party in a fiduciary relationship. One suspects that the interests of the fiduciary must be subordinated a long way, but no more than is reasonably possible for a rational person willing to undertake being a trustee. Obviously this is a flexible standard, to say the least.

Before turning to the next principle, let us summarize the standards against which lawyers are to be judged. Some elements on this list overlap; perhaps a few are redundant:

- The most abundant good faith

requirement applies to contracts of guaranty, insurance, partnership, family arrangements, and certain others, but not such contract as sale." David M. Walker *THE OXFORD COMPANION TO LAW* 1245 (1980).

¹³Roy Ryden Anderson, *The Wolf at the Campfire: Understanding Confidential Relationships*, 53 *SMU L. REV.* 315, 317 (2000).

¹⁴*Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, J.).

¹⁵"[A] business relationship is the antithesis of fiduciary obligation." Anderson, *supra* n.13, at 352.

¹⁶*Crim Truck & Tractor Co. v. Navistar Int'l Transp. Co.*, 823 S.W.2d 591 (Tex. 1992).

¹⁷*Id.* at 594. ("Although a fiduciary duty encompasses at the very minimum a duty of good faith and fair dealing, the converse is not true. The duty of good faith and fair dealing requires a parties to 'deal fairly' with one another and does not encompass the often more onerous burden that requires a party to place the interest of the other party before his own, often attributed to a fiduciary duty.")

- High level of fiduciary duty
- Complete unconflicted loyalty
- Maximal good faith
- Absolute (perfect) candor
- Absolute openness
- Perfect (absolute) honesty
- The entire absence of any concealment, however slight
- The absence of any deception, however slight
- The absence of any omission to disclose, however slight

These values are not simply ideals. They constitute a part of core rules governing lawyers. They are somehow mandatory.¹⁸

Lawyer-to-client loyalty is at the center of these obligatory values. The Texas rules are perfectly clear on this point. "Loyalty is an essential element in the lawyer's relationship to a client."¹⁹ The Model Rules subscribe to the same view, in the same words.²⁰ (Notice that reciprocal loyalty is not asked of clients, and that is appropriate.²¹)

How might P_i apply to question of whether lawyers should invest in their clients? Of course, a lawyer investing in a client will never been simply an investor. He is always a fiduciary.

¹⁸For further development of these matters, see discussion of the RESTATEMENT under Principle #7.

¹⁹Texas Rule 1.06 Comment #1.

²⁰Model Rule 1.7, Comment #1.

²¹Of course, some states hold clients to high standard independent of any legal duty. *Brown v. Slenker*, 220 F.3d 411 (5th Cir. 2000). (Under Virginia law, legal malpractice cases defeated by any contributory negligence on the part of the client. Interestingly, some commentators believe that "special relationships," which generate duties of good faith and fair dealing are symmetrical. In other words, if *A* is involved in a special relationship with *B*, then *B* is involved in a special relationship with *A*. If that were true, then if *A* owes *B* a duty of good faith and fair dealing, then *B* owes *A* a duty of good faith and fair dealing. Insurance law, where the "special relationship" has been developed substantially in the last decades, it has never been punitively determined whether an insured owes an insurer a duty of good faith and fair dealing, although it is clear that an insured owes an insurer a duty to cooperate, and it is also clear that a reinsured owes a reinsurer a duty of good faith and fair dealing.

He is never simply involved in an arm's length transaction with a client. Perhaps or significantly, at least sometimes, a duty of loyalty running from a lawyer to a client requires that the lawyer maintain his or her credibility. If a lawyer is to advise a client, the lawyer must be believable. Consequently, the lawyer must go out of his or her way to minimize any doubts the client might have about the veracity of statements made or the reliability of judgments conveyed. Surely, substantial ownership positions in a client might have consequences for this implication of the duty of loyalty.

Violations of this rule can cost a lawyer dearly. In *DiLugio v. Providence Autobody, Inc.*,²² DiLugio was a lawyer of some standing, having been the lieutenant governor of the state. He engaged in a complex financial transaction involving a closely held corporation, a majority shareholder, and a parent corporation without making satisfactory disclosures. The trial court found that the lawyer had not represented anyone in the relevant transaction. The appellate court found, as a matter of law, that he had. In addition, the court thought that it might be irrelevant if the lawyer had not actually represented relevant persons or entities in precisely a given transaction, if he represented the persons and entities in related transactions.

The reasoning of the appellate court was perfectly orthodox. The client-attorney relationship, it said, was a relationship of "mutual trust, confidence, and good will." Attorneys in such relationships must exercise "the most scrupulous good faith." Consequently,

[w]hen an attorney takes an ownership interest in a close corporation while simultaneously acting as that corporation's attorney, the attorney owes a fiduciary duty to inform the client corporation, through the board of directors or other controlling party, entity, or representative of the corporation, of the differing interests that exist among the various constituents of the corporate entity and of the existing and potential conflicts of interest that result when an attorney for a close corporation becomes a minority shareholder in that entity.²³

The Rhode Island Supreme Court also recognized that there is no "absolute" prohibition precluding attorneys from entering into business transactions with their clients.²⁴ However, the fact that a unanimous court included the word "absolute" when saying that there was "no absolute bar" suggests that there is a prima facie bar, a conditional bar, a presumptive bar, or something of the sort. Even though there was no evidence that the lawyer took advantage of a client business associate or treated him in anything like bad faith, the court refused to permit the lawyer to receive

²²755 A.2d 757 (R.I. 2000).

²³*Id.* at 769.

²⁴*Id.* at 770.

any financial advantage or profits. In fact, it declared that a business transaction between an attorney and a client

may be voidable at the election of the client, [cite omitted] depending on (1) whether the attorney has made full disclosure of all relevant information in his or her possession; (2) whether the consideration was adequate; and (3) whether the client was informed about the need and then given the opportunity to seek independent counsel before completing the transaction.²⁵

Again, the reasoning of the court is completely orthodox. Since *DiLugio* is destined to become a leading case, it is worth quoting at length:

We hold. . .that when attorneys seek or are asked to take an ownership interest in a close corporation while simultaneously serving as that close corporation's attorney, they must heed the applicable fiduciary duties [including the duties of care and loyalty that shareholders owe one another in close corporations that are akin to those of partners in a partnership and including the duty of utmost good faith and loyalty, as well as] rules of professional conduct concerning an attorney's entry into business transactions with their clients. As a result, they must, among other things, inform their corporate clients (through the controlling person, board, or other managers of the entity) of the existing and potentially differing interests between the lawyer as minority shareholder and the other various shareholders and corporate constituencies (e.g., the managing shareholder(s), creditors, employees), and obey the concomitant rules pertaining to duties of care and loyalty that shareholders in a close corporation owe to one another. [Cite omitted.] When an attorney-shareholder. . .fails to obtain the client's written consent, and/or fails to provide the client with a reasonable opportunity to seek the advice of independent counsel, the attorney's self-interested transaction will be voidable at the election of the close-corporate client within a reasonable time after the client learns or should have learned of the material facts--even if the transaction is economically fair to all concerned.²⁶

²⁵*Id.* at 771-72. The court cites *Tyson v. Moore*, 613 So.2d 817, 823 (Mi. Assess. 1992); *In re Palmieri*, 385 A.2d 856, 860-61 (N.J. 1978), and *Security Federal Savings & Loan Ass'n of Nashville v. Riviera*, 856 S.W.2d 709, 714 (Tenn. App. 1992).

²⁶*Id.* at 770.

Of course, if a client fails to object in a timely manner, he may be estopped from making any further objection.²⁷

Principle #2: Fee contracts between attorneys and their clients are presumptively unfair and hence presumptively invalid.

Fee contracts between lawyers and their clients are presumed invalid. Consequently the burden of showing both fairness and reasonableness falls upon the attorney in case of any dispute.²⁸ If a contract between a lawyer and a client for services sets a fee which is not reasonably proportionate to any mix of the following, the contract will be invalidated:

- The time involved
- The labor involved
- The difficulty of the questions involved
- The novelty of the questions involved
- The skill required to do the job
- The reduction of the lawyer's capacity to take other work
- Usual fees charged
- The amounts at stake
- The amounts obtained
- Time constraints
- The length and nature of the professional relationship between the lawyer and client
- The experience, reputation, and ability of the lawyer
- The nature of the fee, e.g., contingent.²⁹

²⁷*Id.* Probably, courts rule a fair way out of their way to avoid imposing estoppel upon shareholders.

²⁸Archer, 390 S.W.2d at 739-740.

²⁹Arthur Andersen & Co. v. Perry Equipment Corp., 945 S.W.2d 812, 818 (Tex. 1997). The legal rules are more complex when the fees are quite large. In class actions for example, when contingency fees are involved,

These factors are taken directly from Texas Rule 1.04. Rule 1.04(a) prohibits an attorney from charging or collecting any fee which is *illegal* or unconscionable. According to the Texas Rules, a fee is unconscionable, if, after reviewing the facts, a "competent lawyer could not form a reasonable belief that the fee is reasonable."

If a lawyer takes some sort of an investment vehicle from a client as a fee--whether it be stock, options, warrants, or what have you--an application of P_2 , and other rules will determine whether the lawyer gets to keep the fee. There is a twist here, as we shall see.

Principle #3: All economic transactions between lawyer and client must be fair, reasonable, fully disclosed, understood by the client, and consented to in writing.³⁰

Texas Rule 1.08(a) provides the most important rule for considering the economic transactions between clients and lawyers. It states as follows:

A lawyer shall not enter into a business transaction with 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* in a manner which can be *reasonably understood* by the client;
- (2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
- (3) the client consents in writing thereto. [Italics added.]

Thus, all lawyer-client transactions must be fair to the client, reasonable from the client's perspective, fully disclosed by the lawyer, understood by the client, and consented to by the client in writing.

Texas Rule 1.08 and Model Rule 1.8(a) appear to be narrow since both qualify their scope only to *adverse* interests. At the same time, Comment #1 to the Model Rule 1.8 and Comment #2 to Texas Rule 1.08 both state that "[a]s a general principle, *all* transactions between clients and

sometimes the percentage method of calculation is used, and sometimes the lodestar method is used. Sometimes, both methods are used. *Shaw v. Toshiba Am. Info. Systems, Inc.*, 91 F.Supp.2d 942 (E.D. Tex. 2000).

³⁰Remember Op-418 already discussed?

lawyer should be fair and reasonable to the client." [Emphasis added.] Isn't anything which would create doubt or hesitation in the mind of a reasonable person an adverse something? (It is interesting to speculate what impact the revisions in the ABA's MODEL RULES will have on the Texas rules. Whatever is said, however, is nothing more than guessing. In the past, the State Bar of Texas has often gone its own way.)

Section 207 of the RESTATEMENT, which is entitled "Business Transactions Between Lawyer and Client," is to roughly the same effect, although it exempts routine commercial transactions from its scope. Section 207(2) requires that "[t]he terms and circumstances of the transaction [be] fair and reasonable to the client"; § 207(3) requires that the client be given a reasonable opportunity to seek outside counsel; and § 207(4) emphasizes the importance of written disclosures and written consents, although it does not actually require them. Section 207(1) is slightly different than either the Texas Rule or the Model Rule. It requires that "[t]he client knows the terms of the transaction and the risks presented by the lawyer's involvement in it[.]" The Texas Rule only requires that the lawyer give full disclosure and that the client reasonably understand what the lawyer has said. Section 207 of the RESTATEMENT requires that the client *know* the terms and risks of the transaction. Section 207(1) requires neither full disclosure nor simply a reasonable understanding. If the client gets his understanding from someone other than the lawyer, the lawyer need not make disclosure, under § 207(1). On the other hand, that section is not satisfied if the client merely has a reasonable understanding. Section 207(1) is satisfied only if the client *knows* what's going on. Really knowing--fully and truly knowing--the terms and risks of a transaction means knowing *all* of the terms and all of the risks of a transaction. Moreover, knowing terms and risks presupposes more than a reasonable understanding. It connotes completeness. There is no such thing as "reasonable completeness." Something either is complete, or it is not.

What does P_3 have to do with lawyers' taking investment positions in clients? Obviously, it applies directly when lawyers acquire stock in a client directly from that client. This will be true whether or not the stock acquired was in the client's business or in the business of another.

There are three major problems in thinking about the applicability of P_3 . First, at what point in time must the fairness and reasonableness of the transaction be judged? When should the worth of the asset be measured? Second, what is the proper measure? Because of P_1 , and because of the nature of information passing between clients and lawyers, the market price, if there is one, is probably not adequate. Third, if a lawyer buys shares in a client from a third person, is the lawyer thereafter involved in an economic *transaction* with the client? Some commentators seem to think not.³¹ We are not so sure.

³¹Geoffrey C. Hazard, Jr. and W. William Hodes, THE LAW OF LAWYERING § 1.8:302 (2000).

Principle #4: All economic transactions between lawyer and client during the existence of the relationship are presumptively invalid.

Courts impose a "presumption of fraud" on *all* lawyer-client transactions³²--not just fee arrangements. Moral guilt is not an issue in constructive fraud. The conduct of a lawyer can be constructively fraudulent even though the lawyer "operated completely in good faith during the entire transaction."³³

What does P_4 have to say about lawyers taking equity positions in their clients? One thing is sure, lawyers need to dot their i's and cross their t's when purchasing securities from clients or when taking securities as fees. Many questions are, of course, left unresolved. If a lawyer buys shares in a client from a third person, does P_4 apply? Does the size of the purchase matter? If the company is publically traded, is that important?

Principle #5: The attorney bears the burden of proving that economic transactions with clients are not invalid.

In every economic transaction between a lawyer and a client, the lawyer bears the burden of proving the absence of fraud, the absence of constructive fraud, the absence of any unlawful conduct, and the absence of inequitable conduct. The lawyer also bears the burden of proving complete and total candor, perfect openness, and so forth. In this way all lawyer-client transactions resemble fee transactions.

How does P_5 bear on an attorney taking an equity position in a client, either by purchase or by way of taking a fee? Obviously, lawyers need to anticipate problems and be ready to defend their position.

In Texas this burden need be discharged only by a preponderance of the evidence.³⁴ Presumably, therefore, clear and convincing evidence, which is mandated in some states, is not required in Texas. The relatively low Texas burden of proof is, as a practical matter, raised significantly by the requirements of *complete*-this, *absolute*-that and *perfect*-the-other-thing built into the elements of the substantive rules governing disclosures. Presumptions are of several types: some fly gracefully from the case (as they say) once contrary evidence is introduced, while some stubbornly remain, like dead albatrosses hanging around the necks of the lawyers saddled

³²Books, Tarlton, Gilbert, Douglas & Kressler v. United States Fire Ins. Co., 832 F.2d 1358, 1369 (5th Cir. 1987). The fraud here can be "constructive fraud." Actual, deceptive fraud is not required. Constructive fraud simply means that some legal or equitable duty has been violated, and the law declares the violation fraudulent "because of its tendency to violate confidence, or to injury public interest." Archer, 390 S.W.2d 735, 740.

³³Brooks, Tarlton, 32 F.2d at 1369.

³⁴ *Fossier v. Morgan*, 474 S.W.2d 801, 803 (Tex. Civ. App. – Houston [1st Dist.] 1971, no writ).

with the burden of proof. In this context, it is unclear that a presumption of unfairness evaporates once some evidence of fairness is introduced. The continuing existence of an adverse presumption is very important, because dead birds stink.

Texas Rule 1.06(b) does not appear to be so draconian as *P₅*. In relevant part, it states as follows:

[A] lawyer shall not represent a person if the representation of that person:

- (1) involves a substantially related matter in which that person's interests *are* materially and directly adverse to the interests of. . .the lawyer or the lawyer's firm; or
- (2) reasonably *appears* to be or become[s] adversely limited. . .by the lawyer's or law firm's own interests. [Emphasis added.]

Unfortunately, the concept of *adversity* is nowhere explained. It is probably, therefore, a jury issue. Texas Rule 1.06(b) is limited by 1.06(c):

A lawyer may represent a client in the circumstances described in [1.06](b) if:

- (1) the lawyer reasonably believes the representation of each client will not be materially affected; *and*
- (2) each affected or potentially affected client consents to such representation after *full* disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any. [Emphasis added.]

In other words, under Texas Rule 1.06(b), a lawyer may not represent a person if there is a material conflict between the interest of that person and the interest of either the lawyer or his law firm. Texas Rule 1.06(b) is limited by Texas Rule 1.06(c), according to which Texas Rule 1.06(b) is subject to being waived if the client consents to the representation with full knowledge of the actual potential conflict, its nature and extent, and possible implications, and so forth. However, the client's consent will not constitute a waiver, if a reasonable lawyer would not come to the conclusion, under these circumstances, that the client will not be materially affected by the fact that the lawyer has a possibly (somehow) adverse material self-interest at stake.

The Texas Rule is probably more rigorous than Model Rule 1.7. That rule only requires that the client consent after "consultation."³⁵ In the model rules, the term "consultation" is defined so as to denote a "communication *reasonably* sufficient to permit the client to appreciate the significance of the matter in question. [Emphasis added.] Thus, the ABA rule is tied to *reasonable disclosure*, while the Texas rule is tied to *full disclosure*.³⁶ Perhaps this difference is nothing more than a rhetorical difference. Then again, rhetoric matters (sometimes).

How does *P₅* impact lawyer-into-client investments? This is probably an open-ended question. One thing is certain, however. Investing lawyers must be prepared to prove that every aspect of the economic transaction--price, dividends, stock-splits, appreciation, the extent of disclosure, and so on and on--is fully fair, fully reasonable, and fully disclosed. Such disclosure requires not only that there are no absences of disclosure but that there are no false or misleading statements whatsoever of any kind.

Principle #6: A lawyer shall never use privileged information to his own advantage, without an informed client waiver.

The source of this principle is Texas Rule 1.05(b)(4). That principle states as follows:

[A] lawyer shall not knowingly. . . "[u]se privileged information of a client for the advantage of the lawyer or of a third person, unless the client consents after consultation.

The term "consultation" is defined in the Texas rules in pretty much the same way it is defined in the Model Rules. The term "denotes [a] communication of information and advice reasonable sufficient to permit the clients to appreciate the significant of the matters in question." Notice that the Texas Rules add the necessity of *advice* as well as *information* in the definition of "consultation."

The phrase "privileged information" is to be understood as information protected by the rule of lawyer-client privilege set up by Rule 5.03 of the Texas Rules of Evidence or by Rule 5.01 of the Federal Rules of Evidence. Thus, Texas Rule 1.05(b)(4) prohibits the use of virtually any information a lawyer has derived from a communication received from a client, or the client's representative, to buy any asset with might be to his advantage. The rule is limited by the consent of the client, if the client has received information and advice sufficient to inform a reasonable person what the lawyer is doing and of what the client is consenting to.

³⁵ABA model rule 1.7(a)(2).

³⁶Comment #6 to Model Rule 1.7 concerns conflicts between the lawyer's interests and the client's interests. It states, "[t]he lawyer's own interests should not be permitted to have adverse effect on representation of a client. . . a lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed interest." Notice that the concrete instance is only an example.

How does P_6 bear on the lawyer taking an equity position in a client? Does it not require that if a lawyer invests in a client, even by purchasing stock from a third person and even if the position does not materially impact the client, if the lawyer's move is based upon anything the client has told him privately, then the lawyer must antecedently possess an informed waiver from the client in the right form?

Significantly, the Proposed Rules of the Ethics 2000 Commission have a somewhat broader rule. Proposed Rule 1.8(b) states as follows:

A lawyer shall not use information relating to [the] representation of a client with a disadvantage of the client unless the client gives informed consent[.]

Proposed Rule 1.8 is made subject to other components of the MODEL RULES. Notice that the Texas Rule is restricted to privileged information, whereas the ABA Rule--and this is true of both the current rule and the proposed rule--relates to any information at all. ABA rules are not restricted even to confidential information. Thus, the ABA Model Rule is much broader than the Texas rule. At the same time, it is, in another way, narrower. Model Rule 1.8(b), in both its current and proposed forms, relate only to disadvantaging a client, whereas the Texas rule relates to any use at all.

Principle #7: A lawyer may not use confidential information to the disadvantage of a client or former client without a proper client waiver.

This principle is embodied in Texas Rules 1.05(b)(2)-(3). The rule as to current clients, Texas Rule 1.05(b)(2) is as follows:

[A] lawyer shall not knowingly. . . [u]se confidential information of a client to the disadvantage of the *client* unless the client consents after consultations. [Emphasis added]

The rule governing former clients, found in Texas Rule 1.05(b)(3), states as follows:

[A] lawyer shall not knowingly. . . [u]se confidential information of a former client to the disadvantage of the former client after the representation is concluded[,] unless the former client consents after consultation or the confidential information has become generally known. [Emphasis added.]

Notice that Texas Rule 1.05(b)(2) appears to require multiple consultations, at a minimum, whereas Texas Rule 1.05(3) minimally requires only one consultation.

Texas Rule 1.05(a) defines the phrase "confidential information" to include both information which is privileged and therefore also governed by Texas Rule 1.05(b), and "unprivileged client information," which is defined as follows:

all information relating to a client or furnished by the client, other than privileged information, acquired by the lawyer during the course of or by reason of the representation of the client.

Thus, virtually any information a lawyer acquires during the course of representing a client, which pertains to that client and which is not generally known, constitutes confidential information governed by Rule 1.05(b)(3). Comment #8 Texas Rule 1.05, entitled "Use of Information," describes Texas Rules 1.05(b)(2)-(4) as "[f]ollowing sound principles of agency law[.]"

How does P_7 impact the duties of a lawyer vis-a-vis client investments? Obviously, a lawyer may not sell stock if selling it would disadvantage the client and the sale was based on confidential information. Of course, a client could consent to such a disadvantage, but it is difficult to see why one ever would. In fact, is it not a breach of fiduciary duty to ask a client to disadvantage himself? Does that not automatically place the lawyer's interests ahead of those of the client?

Principle #8: A lawyer must provide every client with candid, objective, independent advice.

This principle derives from Texas Rule 2.01, which states as follows:

In advising or otherwise representing a client, a lawyer *shall* exercise independent professional judgment. . . [Italics added].

Model Rule 2.1, which concerns pretty much the same topic, goes on to say that "[i]n rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation." Comments ##2-4 to Texas Rule 2.1 make essentially the same point. According to Comment #5, although "a lawyer is not expected to give advice until asked by the client[.]" if the lawyer realizes that a client's proposed course of action might result in a substantially adverse legal consequence to the client, the lawyer may have a duty to do or say something appropriate. This means that an attorney may have the obligation of provided rights to a client and the client hasn't asked for it, if there is a continuing relationship.

Now, to what kind of advice is a client entitled? Comment #1 to the Texas Rule states as follows:

A client is entitled to straightforward advice expressing the lawyer's *honest* assessment. Legal advice often involves unpleasant facts and

alternatives that a client may be disinclined to confront. In presenting advice, a lawyer endeavors to sustain the client's morale and may put advice in as acceptable a form as honesty permits. However, a lawyer should not be deterred from giving candid advice by the prospect that the advice will be unpalatable to the client. [Italics added.]

Comment #1 to Model Rule 2.1 says pretty much the same thing. The term "honest" in the comments probably means as "up-front as necessary given the circumstances," and not just "nondeceptive." The ABA has remarked that *emotional detachment* is "essential to the lawyer's ability to render constant legal services."³⁷

Section 206 of the RESTATEMENT, entitled "Lawyer's Personal Interest Affecting Representation of a Client," is to the same effect. It states as follows:

Unless the affected client consents to the representation under the conditions and limitations provided in § 202, a lawyer may not undertake or continue to represent a client if a *substantial risk* exists that a financial or other personal interest of the lawyer will materially and adversely affect the lawyer's representation of the client.

Section 202(1), which is entitled "Client Consent to a Conflict of Interest," is this:

A lawyer may represent a client notwithstanding a conflict of interest prohibited by § 201 if each affected client gives informed consent to the lawyer's representation. Informed consent requires that the client have adequate information about the risks and advantages of such representation to that client.

Section 201, entitled "Basic Prohibition of Conflict of Interest," says this:

Unless all affected clients consent to the representation under the limitations and conditions provided in § 202, a lawyer may not represent a client if the representation would constitute a conflict of interest. A conflict of interest exists if there is a *substantial risk* that the lawyer's representation of the client would be *materially and adversely* affected by the lawyer's own interests. . . .

³⁷ABA Com. on Ethics on Prof. Resp., Formal Op. 92-364 (1992).

The general point of §§ 201, 202, and 206 is that "when lawyers have substantial personal interest at stake, their representation of clients may well be compromised." Comment *b* to § 206 contains this remark: "Personal interests of a lawyer that are inconsistent with those of a client may significantly limit the lawyer's ability to pursue the client's interest." Lawyers are not always able to subordinate their substantial personal interests to the interests of their clients. Even if they could, it would be difficult to know when they had done so.

How does P_g impact a lawyer investing in a client? We are inclined to think that P_g is pivotal. Any time a lawyer takes a substantial position in a client, the client will ask himself,

Why am I receiving this advice? Is it because the law says thus-and-such? Or is it because it is in my lawyer's interest?

In our opinion, no commentator up to now has taken P_g seriously enough, and we level this charge with particular alacrity at Op-418.

The italicized question is inevitable, to some degree, under all circumstances. People always ask this question about other people, as well they should. However, the question becomes particularly trenchant and very difficult to answer when the lawyer has a substantial economic interest at stake. Further, if a question is difficult to answer, it becomes even more difficult to appreciate a correct answer, because of doubts and suspicions generated by economic interests. For this reason, at least, the idea that when lawyers invest in clients, their self-interests are aligned with the client's self-interests.³⁸ This is right, in a way, and wrong, in a way. This is one of the ways that it's wrong. A principal function of lawyers is to speak truth to power. Truth is not always consistent with self-interest. It is even more often inconsistent with short-ranged self-interest. Also, in larger companies, the self-interest of managers and the self-interest of stockholders sometimes diverge, as may the self-interest of different classes of stockholders. Besides, the self-interest of lawyers has several dimensions: there is economic self-interest (the most easily recognizable brand), but there is also professional self-interest. When a person becomes a lawyer, he makes commitments to the ideals of a profession. He has an interest in emulating those ideals and not falling short. He has an especially strong interest in not betraying those ideals. Finally, there is a sense in which these are both legally and morally wrong to suggest the self-interest of lawyers and the self-interests of clients should be aligned. Since lawyers are fiduciaries, they are obligated to place the interests of their clients ahead of their own. This automatically means that for every representation by every lawyer of every client their interests *cannot* be aligned. To try to do that would be a violation of the fundamental principles of being a fiduciary.

³⁸Kevin Miller, *Lawyers as Venture Capitalists: An Economic Analysis of Law Firms that Invest in Their Clients*, 13 HARV. J. L. TECH. 435 (2000).

Principle #9: Lawyers shall not bring, continue, or defend frivolous claims.

This rule derives from Texas Rule 3.01, which states as follows:

A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless the lawyer reasonably believes that there is a basis for doing so that is not frivolous.

Model Rule 3.1 says more or less the same thing. Comment #1 to Texas Rule 3.01 states that lawyers have "a duty to use legal procedure for the fullest benefit of the client's cause, but also a duty not to abuse legal procedure." The Comments to Texas Rule 3.01 make it clear that the following are frivolous:

- Pleadings with statements in them known to be false
- Motions with statements known to be false
- Other court papers containing statements known to be false
- A filing or assertion made primarily for the purpose of harassment
- A filing or assertion primarily for the purpose of maliciously injuring someone.
- A position for which a reasonably articulate lawyer cannot make a good faith argument for the position.

No doubt other things count as unlawful frivolity.

One form of frivolous claim is a claim which is filed simply to impose costs, burdens, or delays. This corollary principle is embodied in Texas Rule 3.02, which states as follows:

In the course of litigation, a lawyer shall not take a position that unreasonably increases the costs or other burdens of the case or that unreasonably delays resolution of the matter.

Presumably, this rule includes the filing of a lawsuit merely for the purposes of delay. The formulation of the Texas rule is explicit and clear on this point, and so this Model Rule 3.2 which states that lawyers "shall make reasonable efforts to expedite litigation consistent with the interests of the client." Expediting and unnecessary delay are contradictory ideas. Hardly anyone doubts that this rule is intended to include the filing of pleadings, even though it refers only to what

happens during the course of litigation, i.e., after pleadings are filed.³⁹ There are limits on the extent to which our legal system is capable of cabining what has been described as the propensity of attorneys for "shoveling smoke."

What does P_9 have to do with lawyers who have invested in clients? Obviously, it applies only in litigation contexts. In that situation, P_9 creates something of the same problems that P_8 creates. If frivolous litigation will enhance the lawyer's economic position, how can the client be sure that he is getting sound advice?

Principle #10: Lawyers shall not fund, or acquire an interest in, any contested matters they are handling.

This principle is entailed by Texas Rule 1.08(d), and that rule states as follows:

A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation or administrative proceedings[.]

This rule is subject to two exceptions. First, under Texas Rule 1.08(d)(1) a lawyer may file a contingency fee lawsuit, and this may include "reasonably necessary medical and living expenses[.]" Second, under Texas Rule 1.08(d)(2), lawyers representing indigent clients may pay court costs and expenses of litigation.

The Model Rule is narrower than the Texas Rule. Model Rule 1.8(e) only prohibits providing financial assistance in connection with "pending or contemplated litigation[.]" There are two exceptions similar to the Texas exceptions, but Model Rule 1.8(e)(1), concerning clients who are not indigent, is somewhat narrower than the Texas exception.

It would look like the Texas Rule forbids lawyers from providing clients money for research and development, if some sort of intellectual property administrative proceeding is underway. Presumably, the enforcement of this rule would ignore corporate formalities, and would ignore the various oblique ways in which investors can provide money to economic entities. One would think that the same kind of rule would apply to providing business entities, such as corporations, with money for performing various activities if lawyers providing the money are also handling the relevant litigated matters for the business entity.

Sometimes, the situation can become a little tricky. One of the responsibilities of lawyer is to make a patent idea clear enough to survive the scrutiny of the Patent Office. Sometimes, the opponents of a patent have argued the lawyer is in fact the inventor and that the putative inventor is not the real one. This argument is likely to fail under most circumstances. Nevertheless, a

³⁹American Bar Association, ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT 308 (4th Ed. 1999).

lawyer who has technical prowess is working on a contingency fee may, sometimes, come close to a problematic line.⁴⁰

What does P_{10} have to do with lawyers investing in clients? Can a patent lawyer invest in a prototype? Can a lawyer purchase stock in a startup company where the money will be used to create a prototype? When a lawyer is helping to create a startup company, isn't acquiring shares in that company the same as acquiring an interest in a matter that is being handled? Of course, P_{10} applies only to contested situations. But don't those come up often enough?

II. Summary

How would a lawyer bring a case against another lawyer partly based on the fact that the lawyer had invested in the client contrary to the foregoing principles? What would be the key evaluative phrases the lawyer would use in formulating the complaint and in driving the case home to the jury?

- Unyielding Loyalty: lawyers must be completely loyal to their clients at all times.
- Fiduciary: lawyers are the fiduciaries of their clients.
- Trustee: Lawyers are trustees of the clients and of their clients' interests.
- Perfect Communications: All relevant communications from lawyer to client pertaining to any business the lawyer is doing with the client must be complete. Nothing potentially relevant must be left unsaid. Nothing relevant may be said obscurely.
- Perfect Communications: All relevant communications from the lawyer to the client must be completely error free. The slightest error vitiates the transaction and renders it invalid.
- Privileged Information: Lawyers may not profit from privileged information they may receive from their clients, without fully informed waivers.
- Other Confidential Information: Lawyers may never disadvantage their clients or former clients on the basis of confidential information they have, without fully valid waivers.
- Fees: The fees must be fair and reasonable, as well as based on full disclosure.

⁴⁰Solomon v. Kimberly-Clark Corp., 216 F.3d 1372 (Fed. Cir. 2000).

- Burden of Proof. Lawyers bear the burden of proof with respect to virtually everything, if they have profited from a lawyer-client relationship.

With respect to virtually all of this, the lawyer, who may be the defendant, bears the risk of non-persuasion. From a plaintiff's point of view, unless the lawyers can demonstrate that they were not just "good scouts," but "superlative super-scouts" in every respect, the plaintiff should win.

Not only must lawyers prove that they have been fair, equitable, forthcoming, honest, and so forth, they must prove that they have been *perfect* with respect to these values in every respect. This is an onerous burden. In the context of malpractice cases or breach-of-fiduciary-duty cases there will also probably have to be proof of causation. Arguably, this is not true in the context of dealing with grievances. It is not entirely clear who bears the burden of proof here. Probably, under Texas law, the parties suing the lawyer will have to prove, by a preponderance of the evidence, that the unacceptable conduct of the lawyer caused some injury. Almost always, of course, there will be an injury. Proving the injury will usually not be a problem.

The only problem will be connecting the misconduct (with respect to which the lawyer must prove that it did not happen) and the injury (which will usually be fairly obvious). It is entirely unclear how the requirement of causation will work when a lawyer has utilized privileged information to his advantage--without the consent of the client--when the client was not disadvantaged. Forfeiture seems to be an appropriate remedy, but if the money goes to the client, the client will be unjustly enriched. Perhaps the substance of Texas Rule 1.05(b)(4) should be used in civil actions only where causation can be proven. Perhaps its substance should, in the absence of proof of causation, be used only in grievances.

III. Plaintiff's Cases

Does not the plaintiff who is suing the lawyer begin with a substantial advantage? Not only does the party suing the lawyer have a rhetorical advantage and the advantage of some societal skepticism (perhaps even, cynicism) about lawyers in general,⁴¹ but the plaintiff has a huge arsenal of causes of action: breach of fiduciary duty, negligence, negligent misrepresentation, violations of the state deceptive trade practices act, breach of contract in some jurisdictions (though not Texas), securities violations, RICO violations, and others as well. With respect to causation, the lawyer's conduct will look improper. The key to these cases is demonstrating that the lawyer has taken some sort of advantage of the client or has illegitimately used the information which belonged to the client. Plaintiffs can be counted on to find accounting, financial, or business experts who will support a submission of causation.

⁴¹If depth psychologies, like those of Freud or Jung, have any validity at all, it is to be found in the mantra: *Jokes have a point.* There are simply too many lawyer jokes around to ignore. The thrust of lawyer jokes is that lawyers are liars, cheats, scoundrels, rascals, and worse.

The theme of the plaintiff's case will always be the same. Lawyers have illegitimately feathered their own nests. In some civil suits, it will be necessary to prove that they did this at the expense of their clients possibly when privileged information is involved, proving injury to the clients might but not be necessary, although this eventuality seems unlikely. Plaintiffs' cases against investing lawyers can present themselves in many ways. Lawyers might be accused of pulling punches in giving advice, because they wanted to create time in which to sell off their stock. Lawyers might be accused of exaggerating the significance of positive news in order to cause things to happen which would be to their benefit. (Such acts might also benefit the business entity client, but not as much, or the benefit to the business client might be short lived and eventually turn to ashes. Or, it might be unlawful.)

The remainder of this paper will consider a number of these problems. They will be discussed in no particular logical order. Nevertheless, here it is: reasonable fees, acquiring an interest in a corpus, investments in competing clients, getting truly independent advice, and some problems having to do with full disclosure.

A. Reasonable Fees⁴²

Under Model Rule 1.5(a) legal fees must be *reasonable*. Under Texas Rule 1.04(a), legal fees may be neither *illegal* nor *unconscionable*. The same section in the Texas rules goes on to say a legal "fee is unconscionable if a competent lawyer could not form a reasonable belief that the fee is reasonable." Notice this is not the definition. The statement does not formulate a necessary condition for permissibility of a fee. All it does is formulate a sufficient condition for impermissibility of a fee. It does not say that a fee is conscionable (not unconscionable) if a competent lawyer could form a reasonable belief that the fee is reasonable.⁴³

One significant issue involved in determining the unconscionability of a legal fee would be the point in time focused upon by the evaluation of a reasonable lawyer. One commentator has suggested that the temporal focal point should be the point at which the contract is formed.⁴⁴ Klein's basic argument is that we have always evaluated the fairness of legal fees at the time of contract formation. After the lawyer has agreed to receive stocks as compensation, any increase in the price of stock (and hence its value) are to be attributed to the lawyer's willingness to bear

⁴²This is the exception mentioned in note 2 above at p. 2.

⁴³Remember Model PR-1.5(a)(8) changes the current rule somewhat.

⁴⁴Jason M. Klein, *No Fool for a Client: The Financing Incentives Behind Stock-Based Compensation for Corporate Lawyers*, 99 COLUM. BUS. L. REV. 329 (1999).

risk, and to nothing else.⁴⁵ To be sure, historically, fairness of legal fees has been evaluated at the time the fee is agreed upon.⁴⁶

The difficulty in the standard view of when and how to judge the fairness and reasonableness of fees suffers from another deficiency. The argument we are about to give is partly conjecture, but it is plausible, and most every lawyer will recognize its key premise would probably prevail in court. Suppose a client sues a lawyer for disgorgement of a fee on the basis of some prohibited conduct. Let us suppose that the lawyer took 100 shares in the client corporation, and that those shares were worth \$100 apiece at the time of client-lawyer contract formation. Let us suppose that the price of the stock has shot up, say, by a factor of 100, and that the stock has split several times. Let us suppose that the aggregate value of all the stock is now \$600,000. "Now" is one year later, plus one day.

Could the lawyer make the case go away by simply offering to return \$10,000 in cash, plus interest, or return \$10,000 worth of the stock, measured at current ("now") prices? The answer is almost certainly a resounding *No!* The client would expect to receive all the stock. A court would probably order such a disgorgement. How is this possible if only that fraction of the stock corresponding to its value at the time of client-lawyer contract formation constitute the fee?

If this argument, or any more sophisticated variant of it, has any merit, then the entire corpus constitutes the fee. If so, then clients can complain if, in a relatively short period of time, the value of stock paid as fee goes through the roof. It is simply false that the lawyer has accepted all the risk of appreciation or depreciation. The probability of appreciation is part of the fee--as is the appreciation itself.

B. An Interest in a Corpus

P_{10} prohibits lawyers from providing financial assistance to clients in connection with pending matters which are involved in administrative proceedings. If a patent lawyer invests in a client, either directly or indirectly, the lawyer may be doing just that and thereby violating P_{10} . It seems to us that this is a particularly acute problem in thought up situations involving a single, extremely valuable, patented asset. It seems to us that this is a particularly vexing problem for intellectual property lawyers.

⁴⁵Id. at 336.

⁴⁶RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS (3) § 207, Comment e (1998). See also ABA Formal Op. 924-389 (1994 on contingency fees.)

C. Interest In Competing Clients

It is not uncommon for firms specializing in the corporate, securities, and intellectual property affairs of start-up companies, which are also high tech companies, to represent a large number of them, all at once. It is also not uncommon for these companies to compete against each other. We are familiar with situations--yes, right here in [Colorado] River City--in which quite large and apparently respectable law firms have utterly failed to advise their clients properly in accordance with P_3 . In that very situation, several of these clients competed against each other. Now, consider the problem of C_1 and C_2 , both high tech, startup companies both being represented by the same law firm, which owns as stock in both of them. If the leadership of both C_1 and C_2 wants "business acumen" from its lawyers, there may be "adversity" and therefore an insurmountable conflict of interest.

D. Lawyerly Independence

P_8 requires that lawyers provide every one of their clients with candid, objective, and fully independent advice. P_1 requires that the lawyers put themselves in situations both where they are actually trustworthy and where they appear to be trustworthy. A real concern is that lawyers who have a substantial economic interest in a client which they advise cannot be independent, cannot subordinate their own interests to that of their client, cannot be completely objective, and cannot generate an aura of trustworthiness.

ABA Formal Op. 00-418 posits that "a lawyer's representation of a corporation in which [the lawyer] owns stock creates no inherent conflict of interest[.]" We are not so sure this is realistic if the lawyer has anything in the nature of a substantial holding. Material interests undermine impartiality.⁴⁷ Expectation of gain breeds partiality. Hopes for profit reduce objectivity.

E. The Paradox of Full Disclosure

Unquestionably, the Texas Rules require that a lawyer *fully* disclose every even marginally relevant aspect of a transaction with a client to a client. Now let us suppose that the transaction goes "south." Let's suppose that some client capitalists wish to sue their investor-lawyers either for malpractice or to recover sums of money the lawyers made when they sold their stock.

The Texas Rules require *full* disclosure. The plaintiff's lawyer representing the client-investees will take this requirement quite literally and will present it that way to the jury. The lawyer is likely to succeed in this effort. She will get favorable jury instructions. After all, the law frequently distinguishes between things being fully done and things being substantially done. The law distinguishes between something being reasonably correct and it being perfectly correct.

⁴⁷See Brian Barry, JUSTICE AS IMPARTIALITY (1995).

The rules governing lawyers in Texas, do not use the language of *reasonable*-this or *substantially*-that. They use the language of *fullness* and *completeness*.

For every respect in which a transaction runs amok, there is likely to be *something* which was not disclosed or which has somehow misdisclosed. Indeed, from the benefit of hindsight, it will always be possible to find such things and to formulate a plausible hypothetical disclosure such that, if the client had been told precisely that, the client never would have consented. Thus, the requirement of consent is so high for attorney investments in clients that if a deal goes south, it will *invariably* be possible to find something which the lawyer failed to disclose or find something formulated in such a way that the client will say that had he known that he never would have consented to the deal. Also invariably, it will be possible (more or less) reasonably to attribute causation, in part, to that failure in proper disclosure.

Now for the paradox itself. If a lawyer succeeds in making absolutely full and complete disclosure at the level of perfection, the disclosure will be so technical and so detailed that no client will be able to understand it, and the price a client will have to pay to another lawyer for sorting out the disclosure and explaining will render the flame unworthy of the candle. There are also practical problems associated with full and complete disclosure. Lawyers are addicted to form disclosures. Predictably, there will pages upon pages of boilerplate caveats in any disclosure. Many of them will be inapplicable to the case at hand. Plaintiff's lawyer will have field day with such disclosure documents.

Now we have the paradox. Either, a full-blown disclosure will be less than full, hard though it tried to be full, or it will be defective for being overly technical and too long to be palatable.

It is important to notice that the "Paradox of Full Consent" is actuated only in the most difficult cases. There will be many, many less difficult cases to be brought against lawyers. (1) Frequently, the disclosures by lawyers will contain really material misrepresentation. They may not be deliberate, but that fact does not matter. (2) The disclosures may be so badly written that no one can understand them. (3) They may be so voluminous that nobody could really get through them. (4) The client may not be given a sufficient opportunity to consult with other counsel. (5) The lawyer may have a hand in picking other counsel, and that can be made to look terrible. (6) The written consent signed by the client may actually be written by the lawyers to whom the consent is given, and that too will be made to look wretched.

IV. Conclusion

We have not suggested that the bar should promulgate rules prohibiting investing in clients, although such a course is probably the prudent one, nor have we suggested that lawyers should always refrain from investing in clients, although that too is prudent. Instead, we have simply

suggested that, frequently, if a lawyer invests in a client and the deal comes apart, the client goes bankrupt, or something of the sort, lawyers should expect litigation and expect to lose.

Lawyers should consider carefully whether investing in their clients makes sense from the point of view of the long-held ideals of the legal profession. Even when they are advising clients, lawyers are officers of the legal system; they are public citizens; they have a special responsibility for the quality of justice; they are guardians of the law; and they "play a vital role in the preservation of society."⁴⁸

Lawyers would also do well to consider another practicalities of investing in clients. Under some circumstances, the investing lawyer may become an officer, director or partner of the entity in which she invests. If this happens, the lawyer may find herself without malpractice insurance. Frequently, such policies exclude coverage when the lawyer is too wrapped up in a business organization.⁴⁹

Do the investor role and these other roles are suppose to play really fit together? Insofar as lawyers are lawyers, they are suppose to be figures of not only confidence and respect but nobility.⁵⁰ Moreover, although lawyers are to zealously pursue their client's interests,⁵¹ they are not required to disregard their interests entirely. As a people, as well as lawyers, lawyers should be prudent.

We regard investing in clients as imprudent. We think that commentators who believe that law firm investments in venture capital firms are hunky-dory are riding the crests of a soaring economy and are substantially underestimating the risks should the economy ever plunge. Lawyers, it appears, have no longer memories than anyone else. Texas lawyers who are enamored with investing heavily in start-up clients will do well to review what happened to law firms in Texas in the 1980s, when the S&L disaster struck.⁵²

⁴⁸Texas Rules: Preamble § 1.

⁴⁹Coregis Ins. Co. v. Larocca, 80 F.Supp.2d 452 (E.D. Pa. 1999).

⁵⁰Id. at § 9.

⁵¹Id. at § 3.

⁵²To invert the Cole Porter song, *Let's don't do it!* After all, accountants don't. See Miller supra n. ___ at 446.

EXHIBIT A

MONEY

Money is a kind of poetry.

Wallace Stevens

Money, the long green,
cash, stash, rhino, jack
or just plain dough.

Chock it up, fork it over,
shell it out. Watch it
burn holds through pockets.

To be made of it! To have it
to burn! Greenbacks, double eagles,
megabucks and Ginnie Maes.

It greases the palm, feathers a nest,
holds heads above water,
makes both ends meet.

Money breeds money.
Gathering interest, compounding daily.
Always in circulation.

Money. You don't know where it's been,
but you put it where your mouth is.
And it talks.

Dana Gioia, *The Lions of Winter*, 1991