



# Lawyers' Ethics in Real Estate Transactions

By Roger Bernhardt and  
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In the past few months, two California decisions have made strong statements to lawyers about improper behavior in handling real estate matters for their clients. One such case is concerned with going into business with a client while representing the client and the other case addresses supporting the other side after the termination of the client's representation.

### ***Fair v. Bakhtiari***

In the first of these cases, *Fair v. Bakhtiari*, 125 Cal. Rptr. 3d 765 (Ct. App. 2011), a lawyer who had represented a client for about six months then went into business with him. The two of them made real estate investments together and shared the profits; the client provided the money and the lawyer negotiated and drafted documents. Their enterprise lasted about 10 years (although the lawyer continued to practice at a law firm for the first four years of their joint venture) and ended badly when the client terminated their business relationship. The lawyer filed suit against the client for the value of the lawyer's interest in their jointly owned businesses and for other claims, including assault and battery, and the client cross-complained for, among other things, breach of fiduciary duty. After a bifurcated trial, the court found that the lawyer had violated two California standards. One was California Rule of Professional Conduct 3-300, which, like ABA Model Rule 1.8(a), requires that a lawyer—before entering into a business transaction with a client—advise the client in writing and give the client the opportunity to get advice from independent counsel on the situation. The second was the statutory presumption, found in Cal. Prob. Code § 16004, that the lawyer (or other fiduciary) that enters into a transaction with a client (or

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beneficiary) has the burden of proving that the transaction was fair and reasonable to the client. The lawyer failed to overcome this burden, although the investment venture was very profitable. In light of those findings, the trial court rejected the lawyer's request to amend his complaint to seek a monetary recovery from the client and the businesses on a quantum meruit basis for all the services the lawyer had performed during their shared career (over and above what he had already taken out of the venture as compensation, profit sharing, and benefits). The appellate opinion affirmed that conclusion, holding that the lawyer's misconduct disqualified him from demanding any further compensation from the client.

**Does this decision mean that a lawyer cannot invest in a business deal with his or her real estate client?**

No, but the decision is a cautionary tale about the civil consequences for a lawyer who gets the rules wrong. Because this lawyer failed to meet his burden of showing that the transactions with clients were fair and reasonable to the clients, the lawyer lost his ownership interest in the businesses (a series of real estate investments in which the lawyer was a partner), despite the lawyer's years of work as an active partner in the businesses. He was permitted to retain all of his prior compensation (which the former clients did not seek to recover), but he was denied the right to obtain quantum meruit compensation for the services he had provided to the investment entities.

**Is this a standard peculiar to California?** The rule now stated in Cal. Prob. Code § 16004 has long been part of California statutory law, but it is based on common law considerations that exist even where there is no such codification. For example, the Indiana Supreme Court has stated that "Indiana case law recognizes that transactions entered into during the existence of a fiduciary relationship are presumptively invalid as the product of undue influence. Transactions between a lawyer and client are presumed to be fraudulent, so that the lawyer has the burden of proving the fairness and honesty thereof." *In re Smith*, 572 N.E.2d 1280,

1285 (Ind. 1991), cited with approval in *Liggett v. Young*, 877 N.E.2d 178, 184 (Ind. 2007). See also *In re Disciplinary Proceedings Against McMullen*, 896 P.2d 1281, 1290 (Wash. 1995); Restatement (Third) of the Law Governing Lawyers § 126.

**Suppose the lawyer does not invest funds in the client's project but instead agrees to take a piece of the action in lieu of fees for doing the legal work?** It is widely recognized that the business transaction rules do not apply for either civil or disciplinary purposes when a client hires a lawyer under a traditional hourly, flat, contingency, or mixed fee arrangement. But a lawyer's fee agreement is subject to the business transaction rules when the lawyer obtains an ownership, possessory, or security interest adverse to the client. One example of the rules is the lawyer's obtaining an ownership interest in the client's company or in a client's asset as compensation for legal services. This example is explicit in Restatement (Third) of the Law Governing Lawyers § 126, Reporter's Note, cmt. a, which cites several published appellate opinions to that effect. The same conclusion has been reached in a number of advisory ethics opinions, including ABA Formal Op. 00-418 (July 7, 2000). The *Fair* decision does not rely on any distinction between investing with a client and obtaining an ownership interest in return for providing legal services.

**Will the Lawyer Always Go Unpaid?**

**Can a lawyer who goes into business with a client obtain compensation for services provided to the client or to the client's business entity?** The opinion in *Fair* provides a starting point for an answer in California. The issue on appeal was whether the trial court abused its discretion in denying the lawyer's motion to amend its complaint to add a claim for the reasonable value of his services. *Fair*, however, does not provide a definite answer to other factual situations that might be raised in later cases. In *Fair*, the appellate court found that under the aggravated factual circumstances presented, the trial court had not abused its discretion

in denying the motion to amend. Among other things, the lawyer failed to document many of the transactions he sought to enforce; the parties had disagreed over time about the terms of their deal. In addition, the lawyer failed to provide any advice to his clients regarding the transactions despite the continued existence of a lawyer-client relationship; and the lawyer had unresolved conflicts. One conflict was that the lawyer represented multiple clients (including the individual client and numerous business entities), and another stemmed from the lawyer's financial interest in the transactions on which he provided legal services. The lawyer failed to comply with the conflict disclosure and consent requirements of California's Rules of Professional Conduct for both sets of conflicts. It is possible that a lawyer might succeed in obtaining compensation in less extreme settings, even if the lawyer fails to meet the burden of showing that the transactions were fair, reasonable, and fully explained to the client. Still, a lawyer seeking quantum meruit compensation will have an uphill battle. The reason is that the court refused to apply the doctrine of severance (a common law principle, codified in Cal. Civ. Code § 1599, that permits a court to sever the invalid part of a contract and enforce the portions that are valid), and accordingly the lawyer's failure to prove that the transactions were fair, reasonable, and fully explained, permitted the clients to void the transactions in their entirety. The trial court's key finding was that all of the lawyer's services were "part and parcel of those unenforceable business transactions." *Fair*, 125 Cal. Rptr. 3d at 783. There might be other situations, however, in which a court would permit a client to void a transaction but nevertheless see at least some of the lawyer's legal or nonlegal services as distinguishable from the void transaction and therefore compensable.

**Is the client's right to void the entire transaction peculiar to California, or will lawyers in other jurisdictions face the same potential outcome?** The client's right to void the entire transaction comes from the common law and

is not unique to California. See, e.g., *DiLuglio v. Providence Auto Body, Inc.*, 755 A.2d 757, 770–71 (R.I. 2000); *Tyson v. Moore*, 613 So. 2d 817, 823–24 (Miss. 1992); and *Security Federal Sav. & Loan Ass'n of Nashville v. Riviera, Ltd.*, 856 S.W.2d 709 (Tenn. Ct. App. 1992). This right of avoidance can be seen as an expression of the norms that a fiduciary ordinarily may not retain any of the profits that arise from a breach of fiduciary duty and that an agent may be required to deliver to the principal any benefit acquired through the misuse of the agent's position. See Restatement (Second) of Torts § 874, cmt. b (1979); Restatement (Third) of Agency § 8.02, cmt. e (2006); and Note, *Sanctions for Attorney's Representation of Conflicting Interests*, 57 Colum. L. Rev. 994, 1004–06 (1957).

**Will lawyers outside of California face the same problem in attempting to obtain compensation for services when a transaction is held to be void?** The authors are not aware of any case from outside California that directly addresses whether a lawyer can secure compensation for services to a joint business with a client when the lawyer cannot otherwise enforce a related transaction. The court in *Fair* viewed the issues from a contract standpoint, but other starting points might be used by different courts. The issue might be viewed from the standpoint of agency, fiduciary duty, or lawyer's conflict of interest.

**Is there any way for a lawyer to safely go into business with a client and enforce the compensation features of the deal?** The safest course is for the lawyer to comply fully with the business transaction rule (Rule 3-300 in California and Rule 1.8(a) under the Model Rules of Professional Conduct). Doing so should allow the lawyer to meet the burden of proving that the transaction was fair and reasonable to the client. Compliance means that (1) the agreement between the lawyer and client is fully stated in writing in a form that the client reasonably should be able to understand, (2) the lawyer advises the client in writing to seek independent counsel and gives the client time to seek that advice, (3) the

client agrees to the deal in writing, and (4) the lawyer provides the client all the advice the lawyer would have given if not a party to the deal. The obligation to competently advise the client about the transaction long has been part of California law and received its most famous statement in *Felton v. Le Breton*, 28 P. 490, 493–94 (Cal. 1892). Accord *In re Disciplinary Proceedings Against McMullen*, 896 P.2d 1281, 1290 (Wash. 1995).

The difficulty of complying with the business transaction rule depends on the nature of the transaction. Imagine, as an example, that a lawyer wants to buy a client's used car for the use of the lawyer's teenager. It would not be complicated for the lawyer to satisfy all of the requirements of the applicable business transaction rule in an isolated transaction of that sort. The documentation would be simple and the fair value of the used car easy to determine. The transaction in *Fair* was at the opposite end of the spectrum. There, the lawyer and the client entered into a real estate investment business. Rather than a simple, isolated transaction, the lawyer and the client entered into a series of complex and interrelated business transactions with one another for which they formed a series of entities over time. In practice the buying, financing, operating, and selling of real estate breaks down into a great number of individual but interrelated transactions. When the lawyer and client work side by side, day after day, in an active real estate investment or development program, a requirement that the lawyer comply with the business transaction rule for each new contract or contract modification would place an extraordinary compliance burden on the lawyer.

### **Quitting as Counsel First?**

**Could the lawyer avoid the business transaction requirements by terminating the lawyer-client relationship before entering into the joint venture?** Although worthy of consideration, this solution has practical problems. The lawyer might have been invited into the real estate project precisely because the lawyer would contribute legal services, as was the case in *Fair*. The client testified that he

agreed to give the lawyer a 30% ownership interest because the lawyer contributed his legal expertise, and the lawyer was found to have represented both the business entities and the individual client after that time.

It would be a significant protective step for the lawyer to clearly and unambiguously terminate the lawyer-client relationship before entering into any business transaction with a client and then to carefully avoid any conduct that the former client reasonably might understand to mean that the lawyer-client relationship had been re-established. By itself, however, termination does not provide the lawyer with immunity. Although the business transaction rule by its terms applies to business transactions "with a client," case law in California has applied this rule to situations in which the relationship of trust and confidence has continued after the termination of the lawyer-client relationship. The continuance of the relationship of trust and confidence is more likely when the business transaction is related to the subject of the former relationship or involves information that the lawyer obtained as a result of the former representation. There is some similar authority on this point from outside California. The application of ABA Model Rule 1.8(a) to transactions with former clients is explicit in the Connecticut version of the rule, and the same result might be obtained through trust concepts. See Restatement (Second) of Trusts § 170, cmt. g.

### **Obtaining "Independent Approval"**

**Can the lawyer in the lawyer-client venture recommend the name of a prospective second lawyer to satisfy the independent approval requirement; would the second lawyer have to be in a different law firm; and who pays the fees of the second lawyer?** Cal. Rule 3-300 and Model Rule 1.8(a) require the lawyer in the lawyer-client venture to recommend that the client seek independent advice and to give the client time to obtain that advice. In a situation of any complexity or magnitude, such as in *Fair*, it would be prudent for the lawyer to refuse to proceed unless the client actually obtains independent legal advice. Model Rule 1.8(a) and Restatement (Third) of the Law Governing Lawyers § 126 do not address the factors that make a lawyer "independent."

Common sense would dictate that the



second lawyer not be in the same law firm with, or be paid by, the first lawyer and should not have a close personal or professional relationship with the first lawyer that might cause independence to be questioned. It is probably best if the client selects the independent lawyer without any input from the first lawyer, but this practice is not required. California's proposed new Rules of Professional Conduct (on which the supreme court has not yet ruled) have the following explanation: "An independent lawyer is a lawyer who (i) does not have a financial interest in the transaction or acquisition, (ii) does not have a close legal, business, financial, professional or personal relationship with the lawyer seeking the client's consent, and (iii) represents the client with respect to the transaction or acquisition." California State Bar, *Petition Request That the State Bar of California Approve New California Rules of Professional Conduct*, Rule 1.8.8, cmt. 13, <http://ethics.calbar.ca.gov/LinkClick.aspx?fileticket=sOY6VmyQx7s%3d&tabid=2669> (last visited Dec. 29, 2011).

The lawyer proposing to go into business with the client certainly may provide the client with the names of other lawyers to provide needed advice about the proposed transaction, but the original lawyer should not even appear to have selected the second lawyer. The role of independent counsel is to provide competent and unbiased advice to the client about the proposed transaction. For the second lawyer to counsel the client about the pros and cons of the proposed transaction and the reasonably available alternatives and their pros and cons, the second lawyer will likely want to discuss the situation with the first lawyer to better understand the genesis of the nature and form of the proposed transaction. It also is possible that this discussion will lead to negotiations between the two lawyers about the substance or form of the transaction.

**Should the original lawyer consult with an ethics expert about the proposed deal?** The business transaction rules set out protocols that any lawyer should be able to follow. The greater problem is that the lawyer might not

recognize the need to comply with the rule. Some lawyers may be unable to recognize that they need to comply with the business transaction rule, when their own commercial interests are at risk, though this requirement would have been apparent if they were advising or observing the conduct of another lawyer.

### Further Obligations?

**If a business agreement is ultimately approved by independent counsel, is the original lawyer subject to any ongoing further restraints because of his former status?** The answer depends on the nature of the transaction. If the lawyer had purchased a used car from a client, it is difficult to see how there would be any later interaction between the lawyer and client about that transaction. When a lawyer is in business with a current client, however, the lawyer must be mindful of the business transactions requirements each time the lawyer and the client enter into a new or modified agreement with one another. The lawyer also must be certain that the business relationship and the lawyer's financial interests do not affect the full performance of all of the lawyer's duties to the client and must comply with any other applicable conflict rules.

**Is the relative sophistication of the lawyer and the client important in a business transactions situation?** In determining whether a business transaction is fair and reasonable to the client and therefore is enforceable by the lawyer, there is a long case-law tradition of examining the client's sophistication. The less sophisticated the client, the heavier the burden on the lawyer to demonstrate the procedural and substantive conscionability of the transaction. The lawyer's relative sophistication was mentioned by the court in *Fair*, but the fiduciary nature of the relationship itself creates a presumption of the lawyer's relative sophistication. It is possible the court gave some added weight to the fact that the lawyer was a licensed real estate broker, but it is hard to imagine that the outcome would have been any different if the lawyer had not also been a licensed broker. The decision hinged on the lawyer's status

as lawyer, his lawyer-client relationships with the individual client and the various entities they formed, and the lawyer's failure to meet the burden of showing that the transactions were fair and reasonable and fully explained to the clients.

The obvious civil risks for a lawyer who goes into business with a client are the possible inability to enforce the transaction and the possible inability to be compensated for services to the business. There is also the danger that, when a lawyer obtains an ownership interest in a business, at least in part because the lawyer promises to provide legal services to the business, the lawyer might feel obligated to provide services outside the lawyer's area of experience. The potential for malpractice liability is real in situations of this kind. A lawyer might think of himself only as one of the principals in the business, but he nevertheless owes all of the duties that lawyers owe to clients. Related to this consideration are the questions of whether the lawyer will carry malpractice insurance and whether the insurance will protect the lawyer who is doing business with a client. It also is important to remember that some jurisdictions have malpractice insurance disclosure requirements. One example is California's recently adopted Cal. Rule 3-410, which requires lawyers to tell their clients if they do not have malpractice coverage. The insurance issue easily could morph into a disciplinary issue if this disclosure is not made.

No two lawyer-client business transactions are the same and instead create a wide spectrum of situations. At one extreme is a plain-vanilla transaction, the fairness of which is obvious and in which there may be little or nothing for the lawyer to explain to the client and little civil or disciplinary risk to the lawyer in that kind of situation. The further one moves across the spectrum, the more difficult it becomes for the lawyer to demonstrate, after the fact, that the transaction was fully explained and fair and reasonable to the client—as happens when a lawyer goes into an ongoing real estate development or investment relationship with a client. This presents a real risk to the lawyer

and is something to be taken on—if at all—only with great caution.

### **Oasis West Realty, LLC v. Goldman**

The second recent decision, in *Oasis West Realty, LLC v. Goldman*, 250 P.3d 1115 (Cal. 2011), involved a lawyer who turned against the client on a project on which the lawyer previously had represented the client. In 2004, the client retained the lawyer's firm to obtain all the necessary approvals for a luxury hotel and condominium development in Beverly Hills. In 2006, shortly before the project went before the city council, the firm withdrew from the matter. Then, in 2008, after the council had approved the project, the firm's lead lawyer on the deal joined a citizen's group seeking to overturn the approval, including soliciting signatures for a referendum petition. This conduct led the lawyer and his law firm to be sued for breach of contract and fiduciary duty and for professional negligence by the original client.

The defendants responded with a special motion to strike under California's "Anti-SLAPP" statute, which restricts lawsuits designed to discourage citizens from asserting their rights to petition the government. The trial court denied the motion, holding that the suit was based on claimed breaches of the lawyer's duties of loyalty and confidentiality, but the court of appeal reversed, ruling that the lawyer's actions involved protected petitioning activity and that the client could not show that it was likely to prevail on its claims. The California Supreme Court then unanimously ruled in favor of the client. A presumption of confidential knowledge arose from the existence of the previous attorney-client relationship, and the lawyer's duties of loyalty and confidentiality continued even after representation of the client ended. Those duties were not confined—as the court of appeal had held—to cases involving subsequent representations or employment or the disclosure of confidential information; a breach can be damaging "even if the attorney is not working on behalf of a new client

and even if none of the information is actually disclosed." *Id.* at 1122. An attorney's right to free speech does not include using confidential information to the detriment of a former client.

**Does *Oasis West v. Goldman* advise lawyers whether they can go into business against rather than going into business with a former client?** As a general principle, the duty of undivided loyalty prevents a lawyer from being adverse to a current client on any matter, whether or not related to the subject of the current representation. The opinion in *Oasis West* is a reminder that the duty of loyalty generally ends with the termination of a lawyer-client relationship. What remains after the termination is a prohibition on the lawyer's being adverse to the former client on the subject of the former representation. This is the first California opinion that applies the continuing duty of loyalty to a situation in which the lawyer's conduct was not part of the representation of a new client. Before *Oasis West*, California law previously was thought to be generally consistent with Model Rule 1.9(a), which prohibits a lawyer who has formerly represented a client in a certain matter from later representing another person "in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing."

*Oasis West* also is a reminder that a lawyer may neither use nor disclose the former client's confidential information obtained by the lawyer as a result of the former lawyer-client relationship. The opinion suggests that a lawyer may engage in a business that is competitive with that of a former client, but not if in doing so the lawyer violates either the narrow continuing duty of loyalty or the continuing duty of confidentiality.

**Can the lawyer join a firm that represents a client who is a competitor of the former client?** Yes, but with some important limits. First, without the consent of the former client, a lawyer cannot be adverse to a former client on a matter that is the same or

substantially related to a matter on which the lawyer represented the former client. Model Rule 1.9(a). Second, this is true if the former representation was by the former firm, but not by the lawyer personally, but only if while the lawyer was at the former firm the lawyer obtained confidential information of the former client. Model Rule 1.9(b). Third, the lawyer may not use or disclose confidential information of the former client. Model Rule 1.9(c).

**Must a lawyer advise a prior client about any adverse potential representation in the lawyer's new situation?**

No. There is no general requirement that a lawyer who is leaving a law firm must give notice to or obtain consent from a former client when the lawyer's new firm represents the former client's competitor or is adverse to the former client. Consent from the former client, however, will be needed if the lawyer will be adverse to the former client on the subject of the former representation. Even if the individual lawyer will not be adverse to the former client, the lawyer must be aware that any information held by any firm lawyer is presumed to have been shared with all firm lawyers. This means that if the lawyer has pertinent confidential information, the lawyer's new firm might be subject to disqualification even when the individual lawyer is not adverse to the former client. Applicable state law might permit the lawyer to institute an ethics screen to prevent disqualification of the firm when the migrating lawyer brings pertinent confidential information.

**If a lawyer switches to another firm that presents some potential for conflicts, what steps might be taken to avoid trouble?** The vital first step is to attempt to identify potential conflicts before the lawyer moves to another firm. The lawyer and the new firm must be aware of the conflict to be able to manage it.

### **Conclusion**

The *Fair* and *Oasis West* cases remind lawyers to always consider ethical obligations when moving on to new endeavors. ■