

NEW HAMPSHIRE BAR ASSOCIATION
Ethics Committee Formal Opinion 1994-95/7
Conflicts of Interest: Obtaining Security for Payment of Attorney's Fees
February 16, 1995

RULE REFERENCES:

- *Rule 1.8(a)
- *Rule 1.7
- *Rule 1.13(d)
- *Rule 1.13 (e)

SUBJECTS:

ANNOTATIONS:

It is generally permissible for an attorney to acquire a security interest on assets of a client so long as the strict mandates of NHRPC 1. 8(a) are followed.

The burden of showing adherence to NHRPC 1.8(a) - including the fairness and reasonableness of the transaction, the proper disclosure of the terms and conditions of the transaction, the opportunity to retain independent counsel, and written consent following full disclosure - shall rest with the attorney.

The evidence does not demonstrate that the terms and conditions of the transaction have been explained to the client offering a security interest, nor does it appear that the client was afforded an opportunity to obtain independent counsel or execute a written consent.

The inquiring attorney should be wary of ethical obligations in the representation of multiple clients such as a corporation and its shareholders.

QUESTION:

May an attorney who is owed money for legal fees or who anticipates being owed money for attorney's fees obtain collateral, such as the granting of a mortgage, to secure payment of such fees, and if so, under what circumstances?

FACTS:

An attorney agrees to represent a close corporation and its two principals, in connection with some costly litigation. As the scope and nature of the litigation are revealed to the attorney, as well as the corporation's income and assets, it is apparent to the attorney that fees will not be paid as they are incurred. Both the attorney and his clients are in agreement as to the amount of the existing fees owed and the estimate of anticipated fees in the future. The attorney would like to continue representation; however, the engagement letter between the clients and the attorney contains no provisions for the granting of security in the event of outstanding or anticipated legal fees or how past due legal fees are to be paid.

As a result, one of the two shareholders offers a mortgage on her residence to be recorded now, to secure the payment of existing and future legal fees incurred in connection with the litigation. The attorney would like to secure his fees with the mortgage, both to protect himself and also because there is a slim possibility that the principals could be held liable if the corporation is adjudged liable. Thus, the mortgage would not only protect the attorney's expectation of being paid, but also its immediate recording would provide the attorney with priority over any court ordered attachment that might be imposed upon the principal's property in the event of an adverse judgment. The attorney and the principals further agree that if a mortgage were granted, the attorney and the corporation will work out an acceptable periodic payment plan in the future to satisfy the then-outstanding legal fees. The attorney has not yet advised the shareholder offering the mortgage to seek independent counsel, nor has he obtained consent to the arrangement in writing from said shareholder. The attorney questions the propriety of accepting a mortgage under the circumstances.

DISCUSSION:

The inquiry raises issues which are founded in and resolved by the principles and professional conduct rules governing conflicts of interest. In this instance, one client - a shareholder - has agreed to come to the assistance of another client - the

corporation - to ensure that legal fees incurred to represent them both (as well as the other shareholder) will be paid. Thus, at least two areas of concern arise:

- (1) Whether it is ethical to accept the mortgage offered by the shareholder-client under these circumstances; and
- (2) Assuming that the acceptance of the mortgage is acceptable, what precautions, if any, the attorney must be wary of, in continuing to represent all three parties.

Acceptance of the Mortgage as Security for Past Due and Future Legal Fees

The offering of collateral to secure the payment of legal fees occurs at a sensitive time in this inquiry. For purposes of this analysis, the Committee assumes that the amount of past due and future fees is not clearly excessive (See NHRPC 1.5(a)) and that the inquiring attorney did not threaten withdrawal or termination of representation at a time or in a manner in which the clients' interests would otherwise be prejudiced if the shareholder in question did not offer the mortgage (See NHRPC 1.16(b)(4). See also *State v. Emanuel, _NH_, 649 A.2d.53 (1994)* discussing unfair prejudice related to withdrawal of counsel.)

There is no doubt that a lawyer may acquire a security interest offered by a client. NHRPC 1.8(a) states clearly that the acquisition of such an interest is permitted. Specifically, NHRPC 1.8(a) provides in pertinent part that:

"A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to the client unless:

- (1) the transaction and terms on which the lawyer acquires the interest are (i) fair and reasonable to the client and (ii) agreed to by the client after consultation;
- (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 to essential terms of the transaction.

Accepting security from one's own client has been problematic for some courts in the past because of the fiduciary obligations that an attorney has to a client. In *Goldman v. Kane*, 3 Mass.App.Ct. 336, 329 N.E.2d. 770 (1975), cited in the New Hampshire comments to Rule 1.8, a Massachusetts appeals court, relying on similar provisions to NHRPC 1.8(a) outlined in the Code of Professional Responsibility, upheld a damage award against an attorney (Kane) after he sold assets at a profit owned by a law school graduate who had granted the attorney a security interest in them. In the case, Kane advised the graduate not to grant him the security interest and fully disclosed that he was over-collateralizing the loan to protect his own interests. Unfortunately, Kane did not advise the graduate that he should seek independent counsel or obtain the graduate's consent to the transaction in writing. The court stated:

"When an attorney bargains with his client in a business transaction in a manner which is advantageous to himself, and if that transaction is later called into question, the court will subject it to close scrutiny. In such a case, the attorney has the burden of showing that the transaction was in all respects fairly and equitably conducted; that he fully and faithfully discharged all his duties to his client, not only refraining from any misrepresentation or concealment of any material fact, but by active diligence to see that his client was fully informed of the nature and effect of the transaction proposed and of his own rights and interests in the subject matter involved, and by seeing to it that his client either had independent advice in the matter or else receives from the attorney such advice as the latter would have expected to give had the transaction been one between his client and a stranger. (Citation omitted).

It is interesting to note that the lawyer did, in fact, advise the law school graduate not to grant the security interest - and thus, in substantial part, fulfilled his duty to offer such advice as the (lawyer) would have expected to give had the transaction been one between his client and a stranger . (Citation omitted). Yet, in the court's eyes, this was not enough. Imposing strict scrutiny upon the transaction, the court found that Attorney Kane did not act ethically in accepting the collateral as security.

The case above involved a business transaction. However, for two reasons, the language of the case should be well-heeded. First, the Committee offers the caution that a modification to a previously-established fee agreement may, under the

circumstances, constitute a business transaction under NHRPC 1.8(a). Second, there is no distinction under NHRPC 1.8(a) between the scrutiny a lawyer must undergo in advising a client in an attorney-client business transaction or accepting a security interest as anticipated under the Rule. Not only must the transaction be "fair and reasonable", but the terms and conditions must be placed in writing and must be agreed to after consultation, including communication of all risks and consequences of the transaction, disadvantageous to the client. Moreover, the client must be given the reasonable opportunity to seek advice from an independent attorney, and must consent in writing if the client chooses to proceed with the offering of such an interest.

In the present inquiry, there are several shortcomings in satisfying NHRPC 1.8(a). First, the transaction is unlikely to be fair and reasonable or fully and fairly explained if the parties have yet to agree on repayment terms. In fact, the parties intend to have no writing that defines the underlying debt obligations of the clients other than the mortgage. Second, it does not appear that the shareholder-client offering the mortgage has been advised to seek independent counsel. Third, there is no evidence other than the mortgage itself, that the shareholder-client has consented in writing to the granting of the mortgage. Thus, under the circumstances, it is unethical to accept the mortgage in this case. Outside of the ethical concerns, there is even some doubt about the enforceability of the mortgage since the parties have not agreed and will not reduce to writing the clients' debt obligations which the mortgage secures.

Moreover, the Committee notes that even if the inquiring attorney adheres to the requirements of NHRPC 1.8(a) and subsequently obtains a mortgage to protect the payment of his fees, the burden will be on the attorney to prove that each of the protections imposed by the Rule has been satisfied, however reasonable the transaction may ultimately have been.

Continued Representation of All Clients.

Although not raised by the inquiring attorney, it bears stating that if the attorney is able to successfully charter his way through NHRPC 1.8(a) and obtain the mortgage, he must be careful to adhere to the mandates of NHRPC 1.7. That is, although the lawyer has secured his fees through the acquisition of a mortgage from one shareholder-client, neither the existence of the mortgage nor the generosity of the shareholder-client granting the mortgage may affect the duties of allegiance which he owes to the remaining shareholder or the corporation. The impact of the litigation on each of the clients must be measured against the dual representation provisions outlined in the Rule on a continuing and on-going basis. See also NHRPC 1.13(d) and (e) concerning dual representation of an organization and its members and explanations concerning the identity of the organization as a client.