

## Taking Stock In Your Client As Legal Fees Or An Investment

**NHBA Ethics Committee - November 8, 2000**

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Legend has it that lawyers have been taking stock in companies they incorporate in payment of their legal fees for years. They did not view the stock as paving the way to riches because they had no expectation the companies would go public. That has all changed.

In Silicon Valley in the '90's lawyers not only began taking stock in payment of their legal fees, they began investing in their high-tech clients. Some have made out spectacularly. Their success has been chronicled in the press, Dehra Baker, *Who Wants to be a Millionaire?*, 86 A.B.A. Journal, February 2000 at 35, and the practice of taking stock has spread to other parts of the country.

This past July the ABA's Standing Committee on Ethics and Professional Responsibility (hereinafter "the ABA") issued Formal Opinion 00-418 which concluded that taking stock, either in payment of legal fees or as an investment, does not violate the Model Rules of Professional Conduct. The New Hampshire Bar Association's Ethics Committee has had this matter under consideration since last winter. While the Committee agrees with the ABA's conclusion, it believes Formal Opinion 00-418 raises several issues that require further comment. That is the purpose of this Practical Ethics article.

### **Formal Opinion 00-418**

The ABA began by noting that with increasing frequency lawyers are taking stock in start-up businesses in exchange for providing legal services. The practice is seen as a response to client needs as well as to salary competition in the legal marketplace. Start-up clients often are cash poor and claim that giving stock is the only way they can obtain competent legal advice. Further, they view a lawyer's acceptance of stock as a vote of confidence in their business and as becoming "a member of the team." In the legal marketplace, law firms are competing for talent against high paying venture capital and investment firms. Adopting a practice of taking stock in start-up businesses is seen as a way to attract and retain legal talent.

In analyzing the provisions of the Model Rules that apply to taking stock in a client, the ABA used the typical situation in which a lawyer is asked to organize a corporation on behalf of the founding entrepreneurs. Friends and family members probably will invest in the business, and the founders expect the lawyer to introduce them to additional sources of venture capital. Down the road, if all goes well, the lawyer is to perform the services necessary to take the business public.<sup>1</sup>

#### *Compliance with Rules 1.8(a) and 1.5(a)*

A lawyer who takes stock in payment of legal fees or as an investment enters into "a business transaction with a client" and must satisfy Rule 1.8(a). The first requirement of that rule is that the transaction and its terms must be "fair and reasonable to the client." This requirement cannot be taken lightly. The law from which Rule 1.8(a) is drawn makes clear that the lawyer has the burden on this issue and that it is not easily met. When stock is received for legal fees, the lawyer also must comply with Rule 1.5(a), which imposes its own reasonableness requirement that takes into consideration the rule's eight enumerated factors. The ABA, in analyzing how Rule 1.5(a) applies, drew an analogy to determining the reasonableness of a contingent fee. It opined that "only the circumstances reasonably ascertainable at the time of the transaction should be considered." The ABA cited several authorities for this proposition, including the *Restatement (Third) of the Law Governing Lawyers*. However, neither Rule 1.5(a) nor its commentary addresses this timing issue, and there is authority that the reasonableness of a contingent fee should be measured both at the outset of the representation and when the fee becomes quantifiable. *Attorney Grievance Commission of Maryland v. Jill Johnson Pennington*, 733 A.2d 1029 (Ma. Ct. App. 1999); *Matter of Swartz*, 686 P.2d 1236 (Ariz. 1984). The New Hampshire Supreme Court has yet to address this issue.

To minimize the risk that a fee paid in stock will appear unreasonable if the business succeeds, the ABA recommends that the lawyer

establish a reasonable fee for her services based on the factors enumerated under Rule 1.5(a) and then accept stock that at the time of the transaction is worth the reasonable fee. Of course, the stock should, if feasible, be valued at the amount per share that cash investors, knowledgeable about its value, have agreed to pay for their stock about the same time.

If the stock cannot be valued, the ABA suggests that the lawyer agree to take a percentage of the stock to be issued:

the percentage of stock agreed upon should reflect the value, as perceived by the client and the lawyer at the time of the transaction, that the legal services will contribute to the potential success of the enterprise. The value of the stock received by the lawyer will, like a contingent fee permitted under Rule 1.5(c), depend upon the success of the undertaking.

Taking up the other requirements of Rule 1.8(a), the ABA stated that the transactions and its terms must be fully disclosed *in writing* to the client. This requires the lawyer:

- (1) to explain so the client can understand the transaction, its terms, and its potential effects on the lawyer-client relationship;
- (2) to describe the scope of the services to be performed for receipt of the stock, including whether the lawyer may retain the stock if she is terminated before all the services are performed;
- (3) to inform the client that following receipt of the stock matters could arise that would create a conflict between the lawyer's exercise of independent professional judgment and her desire to protect the value of her stock; and
- (4) to advise the client that as a consequence of such a conflict, she might have to withdraw as counsel, or, at the very least, to recommend that another lawyer advise the client on the matter giving rise to the conflict.<sup>2</sup>

The ABA stated that the final steps in complying with Rule 1.8(a) require the lawyer (i) to recommend that the client seek the advice of independent counsel about the transaction and its terms, and (ii) whether or not the client does seek such advice, to obtain the client's written consent. The ABA noted that the lawyer's recommendation to obtain independent counsel should be in writing.

### *Compliance with Rule 1.7*

The ABA concluded that "[a] lawyer's representation of a corporation in which she owns stock creates no inherent conflict of interest under Rule 1.7." Usually the lawyer's representation will complement, and perhaps even enhance, management's role of increasing the business's value for its stockholders. Nevertheless, the ABA recognized there could be circumstances where a lawyer's responsibilities as counsel could conflict with her ownership of stock. The opinion set forth the example of a venture capital transaction in which a lawyer must reveal financial information known to her, yet aware that disclosure might cause the venture capital investor to withdraw. The ABA stated:

the lawyer must evaluate her ability to maintain the requisite professional independence as a lawyer in the corporate client's best interests by subordinating any economic incentive arising from her stock ownership. The lawyer also must consider whether stock ownership might create questions concerning the objectivity of her opinion. She must consult with her client and obtain consent if the representation may be materially limited by her stock ownership.

The ABA also posed an example of a "more severe" conflict that would disqualify the lawyer under Rule 1.7(b). It is where the stock represents "the lawyer's major asset so that the failure of the venture capital opportunity could create a serious financial loss to her." To avoid that situation, the ABA recommends that the lawyer limit her stock ownership "to an insubstantial percentage of stock and the amount invested in any single client to a non-material sum." It also suggested that supervisory responsibility for the client or decisions regarding potential conflicts be made by another lawyer in the firm who does not own stock in the client.

## Issues Raised by Formal Opinion 00-418

### *May a Lawyer Condition Her Services Upon Taking Stock in the Client?*

Some lawyers, according to the ABA, are willing to represent start-up businesses only if they are able to acquire stock in the business. The ABA declined to take a position “on the ethical propriety of this practice.”

While the Ethics Committee is not aware of any judicial decision or opinion by another state ethics committee that has addressed whether this practice comports with the *Rules of Professional Conduct*, the Committee strongly recommends against the practice. In doing so, the Committee recognizes that even though a lawyer may “insist” upon receiving stock, the prospective client remains free to retain another lawyer who would not make the same demand as a condition to representation. Nevertheless, to the extent taking stock in payment of legal fees resembles a contingent fee, the practice runs afoul of the admonition that if there is “doubt whether a contingent fee is consistent with the client’s best interest, the lawyer should offer the client alternative bases for the fee and explain their implications.” Rule 1.5 ABA Model Code Comments.<sup>3</sup> At a minimum, this comment makes clear that it is the client’s interest, not the lawyer’s, that determines the propriety of using a contingent fee. In New Hampshire there is a further consideration. If treated as a contingent fee, the practice would violate RSA 508:4-e,II, which conditions contingent fee arrangements upon the lawyer first “affording the client an opportunity to retain the attorney under an arrangement whereby the attorney would be compensated on the basis of the reasonable value of his services.” Finally, even if taking stock is not considered a contingent fee, to minimize the likelihood that the client will be able to successfully challenge the transaction – in the future when the stock has real value – the lawyer should consider taking stock only if the client suggests it.

### *Rule 1.8(a)’s Requirement that the Client be Given the Opportunity to Obtain Independent Advice.*

One of the most troubling issues raised by Formal Opinion 00-418 is giving meaning to Rule 1.8(a)’s requirement that the client have the opportunity to obtain “independent counsel in the transaction.” After all, one of the reasons the client wishes to give stock is because it is “cash poor.” If that is the case, is it realistic to expect the client to seek, and pay for, independent counsel? The Committee believes that the lawyer must urge, in writing, the client to seek independent counsel. In any event, the lawyer must ensure that the written disclosure, see *infra*, is in sufficient detail so the client has a clear basis for concluding that the transaction and its terms are “fair and reasonable.” Since the client is likely to have the most knowledge about the value of the stock, or have access to a valuation from an accountant or financial adviser involved in the transaction, the lawyer should focus the disclosure on what services she will perform, how they are customarily valued, the likelihood that a conflict of interest might develop, and, if one does develop, the financial and other consequences to the client.

### *The Presumption of Voidability*

The ABA noted in passing that if the client challenges the transaction it “remains voidable in a civil suit.” In fact, New Hampshire appears to follow the almost universal rule that establishes a presumption that transactions with clients are voidable. *Whipple v. Barton*, 63 N.H. 613 (1885) (gift). Summarizing the law when a client challenges the transaction, one respected treatise concludes:

The obvious conclusion to be derived from almost two centuries of American decisions is that an attorney rarely can prove there was compliance with the fiduciary obligations in business transactions with the client. The lesson to be learned is that, when the attorney and client become parties to a transaction, the requisite independent advice is best furnished by another unrelated lawyer.

Ronald E. Mallen and Jeffrey M. Smith, *Legal Malpractice* § 14.22 (4<sup>th</sup> ed. 1996). When the transaction is voided, the client may rescind the transaction or recover damages. Courts usually order the remedy that is “most economically beneficial to the client.” *Id.* at § 1423.

### *What the Written Disclosure to the Client Should Contain*

Because the client is not likely to obtain independent counsel to review the transaction, the Committee believes the written disclosure to meet the requirement of Rule 1.8(a) must be comprehensive, explained in plain English, and tailored to the transaction at hand. At a minimum, the lawyer should include:

- (a) The nature of the transaction and each term, e.g.:
  - stock in payment of legal services or as an investment
  - scope and duration of representation: what the lawyer will do, including the performance of non-legal services, such as, finding venture capital financing; and when the engagement will end<sup>4</sup>
  - the amount and value of the stock received
  - what happens to the stock in the event the client or lawyer terminates the representation
- (b) The nature and extent of the lawyer's interest in the transaction, e.g., the type of stock the lawyer will own (common, preferred, etc.); the amount and percentage it represents.
- (c) The ways in which the lawyer's participation in the transaction may affect her exercise of independent judgment.
- (d) The risks and advantages to the client and to the lawyer, e.g.:
  - the client conserves cash
  - the lawyer shares in the risk of success
  - the attorney-client privilege probably will not extend to all communications
  - the lawyer's independent judgment may be compromised, and the client may have to retain other counsel
  - the client likely will be delayed in obtaining financing and put to additional expense, if the lawyer must withdraw because of a conflict.
- (e) The importance of the client obtaining independent advice, including why such advice is in the client's best interests.

### *The Potential for Conflicts*

Rule 1.7(b) prohibits a lawyer from representing a client "if the representation of that client may be materially limited by the lawyer's . . . own interests, unless: (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation and with knowledge of the consequences." This rule poses a serious problem for the lawyer because under Rule 1.8(a) a conflict is presumed when she does business with a client. Further, the ABA Model Code Comments make clear that the lawyer's financial interests are precisely the type of interest that Rule 1.7(b) was intended to guard against. Adding to the lawyer's difficulty in complying with the rule is the standard that will be used to determine whether the lawyer should have requested client consent. The standard the Committee uses is the "harsh reality" test which requires a lawyer to:

ask himself or herself whether . . . a disinterested lawyer . . . look[ing] back at the inception of this representation once something goes wrong, would . . . seriously question the wisdom of the first attorney's requesting client consent to this representation or question whether there had been full disclosure to the client prior to obtaining the consent. . . .

Ethics Committee Opinion 1988-89/24.<sup>5</sup> Three situations likely to arise in a representation which may involve a lawyer's "own interests" and affect her ability to exercise independent professional judgment follow.

- (1) *Preparing governance and stock purchase agreements*  
The lawyer must consider her status as a shareholder in drafting governance and stock purchase agreements. This is particularly so where the shares held by the lawyer give her a special right or status, such as, special voting rights or rights to acquire additional shares.
- (2) *Preparing opinion letters*  
The lawyer must anticipate that she will be called upon to prepare opinion letters in connection with her client's efforts to secure financing. The lawyer must disclose in an opinion letter her interest as a shareholder, which may render the opinion unacceptable to the potential investor. In this circumstance, financing could be delayed while the client retains other counsel who will have to become familiar with the client's business before giving an opinion.
- (3) *Sales during the pre-public stage*  
During the pre- initial public offering stage it is not uncommon for venture capitalists or other "angels"

willing to provide financing to purchase their shares from the original group of shareholders. If the lawyer is a part of this group and wishes to sell some of her shares, she faces conflicting legal obligations. On the one hand in her capacity as lawyer she must obey the confidentiality strictures of Rule 1.6, while on the other hand she has a duty of disclosure to a prospective purchaser of her shares. To go forward with the sale she will have to obtain client consent. But can she give the client independent advice on the issue of consent? If she stands to make a significant gain on the sale, requesting consent would be a perilous course under the harsh reality test.

### “Good Practice” Recommendations<sup>6</sup>

If a lawyer wishes to take stock, either in payment of fees or as an investment, the Committee recommends several practices to minimize the risks inherent in the transaction:

- (a) Develop a policy that addresses the issues raised by *New Hampshire Rules of Professional Conduct* 1.5, 1.6, 1.7(b), 1.8(a), and 2.1.
- (b) Make certain the client understands those communications that are subject to the attorney-client privilege.
- (c) If stock is being acquired in payment of legal fees, keep track of the time spent performing legal services just as though the client were being billed on an hourly basis.
- (d) Acquire only an insubstantial amount of the issued and outstanding stock.<sup>7</sup>
- (e) If stock is acquired as an investment, it should be an exchange for a cash payment of an amount that, for the lawyer, is non-material.
- (f) Comply with federal and state securities laws, including determining whether the acquisition of stock will increase or complicate the client’s disclosure or licensing requirements.<sup>8</sup>
- (g) Obtain approval from the malpractice insurance carrier.

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<sup>1</sup> This article is based on a “transactional” representation. Thus, it expresses *no opinion* on whether Rule 1.8(j) prohibits a lawyer from taking stock when the lawyer represents the client in a lawsuit over title to the client’s only substantial asset.

<sup>2</sup> The ABA cited with approval a list compiled by C. Wolfram, *Modern Legal Ethics* (1986), which includes the same elements recommended by the ABA but adds a description of “the nature of the respective risks and advantages to each of the parties to the transaction.”

<sup>3</sup> The ABA accepted without question the proposition that taking stock was like a contingent fee. The Committee is not so sure. A contingent fee in a civil case depends in large measure on the efforts of the lawyer, whereas the value of stock usually depends on the client’s efforts and other factors little influenced by the lawyer’s work, unless as part of her representation she is to find sources of financing or otherwise contribute directly to the client’s financial success.

<sup>4</sup> The failure to be precise in outlining the services to be performed for the stock could lead the client to believe it has a “lawyer for life,” particularly if the client goes public and the stock does well.

<sup>5</sup> As one member of the Committee recently put it:

“A lawyer must determine, using the harsh reality test, whether there are facts or circumstances which rise to such a level that the lawyer’s own interest would likely impair the lawyer’s independent professional judgment on behalf of a client with whom the lawyer is contemplating a business transaction.”

Richard Y. Uchida, “Attorneys Investing In and Doing Business With Clients: The Ethical Implications,” *Attorneys Investing in and Doing Business With Clients*, New Hampshire Bar Association CLE Program (November 2000).

<sup>6</sup> For an excellent discussion of the ethical and other issues raised when a lawyer acquires stock in a client, see the program materials prepared for the New Hampshire Bar Association CLE program, “Attorneys Investing In and Doing Business With Clients” (November, 2000).

<sup>7</sup> The Committee notes that depending on the likelihood the client will succeed and go public, even a one percent interest could be a “windfall.”

<sup>8</sup> For example, a lawyer who is not an “accredited investor” under federal securities law may trigger additional disclosure requirements which the client must meet.