PROFESSIONAL LIABILITY FUND

IN BRIEF

MALPRACTICE AVOIDANCE NEWSLETTER FOR OREGON LAWYERS

Issue No. 84 MAY 2001

INVESTING IN CLIENTS

Prior to April 2000, the "New Economy" – with its perceived predominance of emerging growth, high technology, e-commerce and internet companies – provided a particularly fertile arena in which alternative billing arrangements were explored and used. Companies adopted a culture in which equity interests (whether in the form of stock, restricted stock, stock options, warrants, convertible debt, or any combination thereof) were the primary currency and in which the perceived commonality of purpose to increase shareholder value took on emotional, if not moral, overtones. These clients no longer offered stock to their lawyers because they lacked, or more appropriately desired to conserve, cash. Rather, acceptance of such stock by their attorneys was seen as a vote of confidence in, if not a measure of loyalty to, the common enterprise represented by the client's business.

The "bursting of the internet bubble" has led to a world in which many options are underwater and worthless. Corporations are struggling to find a way to reprice their options so as to keep current employees and also avoid variable accounting treatment. Those who exercised their options prior to the market downturn and held onto their stock with the expectation of ever-rising prices and eventual capital gains treatment, must now pay huge taxes on what has become worthless stock.

The realities of today's marketplace have radically changed the economic landscape. Cash is scarcer than ever. Many good companies and good ideas are failing for lack of funding. Stock and options as currency have been demeaned, and all employees, landlords, lenders, and service providers have become much more discerning in their selection of companies in which stock interests are taken.

In this tougher environment, the entrepreneurs need to conserve cash and the measure of loyalty and confidence evidenced by a decision to accept stock in lieu of fees has put different pressures on lawyers and law firms to accept stock in lieu of fees.

The reasons and the source of the reasons for taking equity may have changed, but the risks associated with the decision have not.

These risks are not insignificant and should be considered carefully before a lawyer or law firm makes the decision to take an equity position in a client. This article reviews some of the legal, ethical, and practical issues related to corporate representation and to payment of legal fees through corporate equity interests.

CAN I TAKE STOCK IN LIEU OF A FEE?

Equity positions in clients may be taken either in lieu of or as part payment of the lawyer's fee. In this context, the lawyer must be concerned with 1) the reasonableness of the fee and 2) the lawyer's duties as a fiduciary to ensure that the equity stake is not undermined by the lawyer's interests.

DR 2-106(A) prohibits a lawyer from charging or collecting an illegal or clearly excessive fee. DR 2-106(B) provides factors to be considered in determining the reasonableness of a fee. (See *Tips for Taking Stock in Lieu of Fees*, page 8.) Utah State Bar Opinion 98-13 (1998) suggests that the following additional factors be considered:

- [t]he liquidity of the client's stock, including whether the client's stock trades publicly at the time of the fee agreement and, if the stock is not publicly traded, the risk that the client's stock will not be publicly traded in the future;

- the present and anticipated value of the client's stock, including the risks that a proposed patent or trademark may not be granted, and the necessary government approvals (such as FDA approvals) may not be received;
- whether the stock is subject to restrictions after the law firm receives it that affect the value of the stock to the lawyer;
- the quantity of stock owned by the lawyer and whether the lawyer may exercise ruling control over the client after receipt of the stock; and
- any restrictions placed by the lawyer on the consideration paid for the stock.

Although DR 2-106(B) and the Utah ethics opinion provide some guidance, taking stock of an unknown value in a corporate client as payment for fees raises significant issues relating to reasonableness. The independence and objectivity of a law firm are likely to be substantially affected. For example, if the stock ultimately rises in value, tensions with the client and other stockholders may arise. The corporation may do so well that the fee later appears to be unreasonably large for the work performed. If the equity interest in the company greatly increases, there may even be an obligation to refund some portion of the proceeds of the stock to ensure the fee is reasonable. Factors that enter into this may include, among other things, the length of time that the lawyer holds the stock and whether the value of the stock – actual or potential – was reasonable *at the time of the representation*. On the other hand, the business may falter. The attorney, worried about recovering a fee for work already performed, may be perceived as unable to advise the client with the necessary professional judgment. As the stock fluctuates in value, the attorney may also find law firm financial issues arising.

It makes sense, therefore, for a lawyer who is considering accepting stock as payment of a fee to take extra care to ensure that the transaction sustains any foreseeable scrutiny. One approach is to obtain an independent evaluation of the present value of the interest. Although the future value of the stock may be considered later by a court or disciplinary body, a present valuation will provide an important baseline that will help to establish the reasonableness of the transaction at the time. The lawyer may also want to make other disclosures to the client about the value. See *Tips for Taking Stock in Lieu of Fees,* page 8.

Whenever an ownership interest is taken as a fee, a lawyer must comply with DR 5-104(A) which prohibits a lawyer from entering into a business transaction with a client if they have differing interests and if the client expects the lawyer to represent the client. The rule allows representation if consent and full disclosure are provided. Full disclosure pursuant to DR 10-101(B)(1) requires a written explanation "sufficient to apprise the recipient of the potential adverse impact on the recipient. . . ." DR 10-101(B)(2) also requires that the lawyer recommend that the recipient seek independent legal advice and contemporaneously confirm the consent in writing. The disclosures should explain the consequences of the conflict in language that is easily understood by the client. The safest approach is to have the client and the lawyer sign the disclosure, after the client has had an opportunity to consult with independent counsel. If applicable, the disclosures should state that the stock acquired by the lawyer will limit the client's control of the corporation.

PLF coverage for claims arising out of business transactions with clients depends on whether the lawyer complied with DR 5-104(A) and DR 10-101(B). (See discussion on page 9 of this article.)

In addition to the duties under DR 5-104 (Limiting Business Relations with a Client), a lawyer also has a duty to fully disclose if the lawyer's professional judgment will be or may be reasonably affected by the lawyer's own financial business, property, or personal interests. A lawyer is prohibited from representing the client in such matters, unless the client consents after full disclosure. DR 5-101(A)(1) (Conflict of Interest: Lawyer's Self Interest).

A lawyer's representation of a corporation in which he or she owns stock is ethically permitted if disclosure and consent is obtained. When drafting a disclosure letter, it is generally a good idea to disclose to the client that events following the acquisition of stock could create a conflict between the lawyer's exercise of independent professional judgment and the lawyer's desire to protect his or her stock value. In some cases, even though disclosure may make it permissible, the lawyer may –

for personal reasons or due to liability exposure – withdraw from representation. See ABA Opinion 00-418. A lawyer who holds stock and continues to represent the corporation may see a wide variety of situations that require consent and disclosure or withdrawal including:

- If the corporation falls on difficult times and asks the lawyer's advice on whether to file bankruptcy.
- If the corporation becomes insolvent and the lawyer's duties flow to creditors.
- If the corporation has the opportunity to be acquired by a larger corporation, and the lawyer would profit from the merger but the founding corporate shareholders do not want to sell. (Whether this presents a conflict depends on who the lawyer represents – see *Corporate Start-Ups – Issues to Consider*, page 4 of this issue of *In Brief*.)
- If litigation arises under securities laws with respect to matters in which the lawyer acted as counsel.
- If the lawyer knows financial or other adverse information that is being withheld from a venture capital investor. (The lawyer may have a duty to instruct the corporation to provide the information even though to do so may cause the venture capital investor to withdraw – thus causing the lawyer a serious financial loss.)
- If the lawyer has material inside information and the lawyer's personal interest will be affected by the disclosure.

Although any of these situations may have been covered generally in the initial consent and disclosure letter provided by the lawyer, the lawyer probably should provide his or her client with an updated disclosure letter specific to events such as these, and obtain consent again.

ABA Opinion 00-418 is a helpful resource on these issues. If you would like a copy, call Reiko Scapple at the PLF 1-800-452-1639 or 503-639-6911 or e-mail her at reikos@osbplf.org.

IF I TAKE STOCK IN LIEU OF A FEE, DO I HAVE PLF COVERAGE?

Whether you have Professional Liability Fund (PLF) coverage for claims by or on behalf of a business enterprise in which you own stock depends on (1) whether you complied with DR 5-104(A) and provided the client with proper disclosures and (2) how much of the business entity you or others own.

Section I.3.h. of the PLF Coverage Plan provides that there is no coverage for claims based upon or arising out of business transactions subject to DR 5-104(A), unless disclosure in the form of DR 5 (which is attached as Exhibit A to the Plan) has been properly executed and other notice requirements are met. The details of this section are contained at page 93 of the 2001 Oregon State Bar Membership Directory. In addition, section I.3.f. excludes coverage for any claim on behalf of any business enterprise:

> **f.** This Plan does not apply to any CLAIM by or on behalf of any business enterprise:
>
> **(1)** In which YOU have an ownership interest, or in which YOU had an ownership interest at the time of the alleged acts, errors, or omissions upon which the CLAIM is based, or
>
> **(2)** In which YOU are a general partner or employee, or in which YOU were a general partner or employee at the time of the alleged acts, errors, or omissions upon which the CLAIM is based, or
>
> **(3)** Which is controlled, operated, or managed by YOU either individually or in a fiduciary capacity, including the ownership, maintenance, or use of any property in connection therewith, or was so controlled, operated, or managed by YOU at the time of the alleged acts, errors, or omissions upon which the CLAIM is based.

The comment to PLF coverage plan I.3.f. explains that ownership interest for the purposes of I.3.f.(1) does not include an ownership interest "now or previously held by you solely as a passive investment so long as you, those you control, your spouse, parent, child, or any member of your household, and those with whom you are regularly engaged in the practice of law, collectively now own

or previously owned an interest of 10 percent or less in the business enterprise." Therefore, if your spouse owns more than 10 percent of the business enterprise and you do legal work for the business, you do not have coverage for claims arising from your representation of the business enterprise. Similarly, if your law partner owns more than 10 percent of a business enterprise, you do not have coverage for claims arising from the business enterprise. This is true even if your partner owns the interest in the business enterprise, and you or someone else in the firm does the work. The PLF Excess Plan has similar exclusions.

For these reasons, it is important to know whether your partners have a business interest in clients of the firm. If you are accepting stock in lieu of fees, be certain to comply with the disclosures required by DR 5-104 and be certain that your "ownership interest" (as defined in the PLF coverage plan) is 10 percent or less.

VOTING RIGHTS AND OTHER CHALLENGES OF OWNING STOCK

Lawyers who are contemplating accepting stock in lieu of a fee must also give some thought to:

- What will be the firm's policy on investing in an initial public offering (IPO) if the firm acted as counsel to the issuer or underwriter of the offering?
- How and by whom will the stock be owned?
- Will departing or retiring members be allowed to continue to own stock?
- Will the stock be held by the individual partner(s), the firm, an investment fund or some other entity?
- Who will decide when and under what conditions the stock will be converted to cash or distributed?
- If the stock is converted, to whom will the money be distributed?
- How much stock of a particular company is appropriate for the firm (or its collective partners) to own?
- How much of the firm's assets is the firm willing to place in equity interests of clients?
- Who will oversee the firm's investments in clients?
- Will the stock voting rights be retained by the firm, the individual lawyer, or returned to the client's Board of Directors?
- Will the firm defer fees and accept founder's stock or some other arrangement?

The answers to these issues will vary from firm to firm, depending on the firm philosophy and politics. Many of the issues will require an analysis of the potential conflicts of interest and an analysis of the tax implications.

CONCLUSION

Lawyers are permitted to acquire stock interests in client companies in lieu of fees provided 1) the lawyer's fee is reasonable, 2) the lawyer specifies for the client how the lawyer's representation may adversely impact the client, and 3) the lawyer discloses if his/her professional judgment may be compromised. Only after receiving this information can the client evaluate whether he or she wants to proceed. Only by providing this information can the lawyer fulfill his or her fiduciary obligations.

Bradley F. Tellam
Barran Liebman, LLP

Donald W. Douglas
Miller Nash LLP

Barbara S. Fishleder
Professional Liability Fund

Our thanks to Peter R. Jarvis, Stoel Rives LLP, and Robert J. McGaughey for their assistance with this article and the related sidebars.