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When Can Law Firms and Lawyers Accept Stocks or Stock Options for Services?

by: Sheldon I. Banoff

With increasing frequency, lawyers and law firms are being asked (or are aggressively seeking) to take equity ownership in their clients. For example, stock or stock options may be received in lieu of all or a portion of the cash legal fees to be received. Alternatively, stock may be negotiated by the law firm as a "premium" for legal services, in addition to its regular cash legal fees. In another scenario, lawyers who serve as members of boards of directors of their clients may receive grants of stock, restricted stock and stock options, pursuant to the company's directors' incentive compensation program. Pursuant to their law firm agreements, such lawyer-directors may be obligated to turn over the equity (and/or the proceeds upon disposition of the equity) to the law firm. (These situations differ from law firms that invest in their clients on the same terms offered to certain other investors.)

Questions

In these stock-for-legal fees scenarios, a number of questions arise:

- Are there legal constraints on law firms owning equity interests in various types of businesses?
- Are there ethical constraints (pursuant to bar association opinions, state court rules or otherwise) which preclude lawyers from accepting stock for fees in certain situations?
- Does the law firm face increased potential legal liability in a malpractice or negligence case?
- How would a jury view a law firm defendant, where the firm has a substantial ownership interest in the client?

- Do the law firm's professional liability insurance policies cover situations involving clients in which the firm also has a substantial economic interest?

Firms that receive stock for services may find themselves holding the equity for the long term. Would the client view the law firm's sale of the stock as a vote of "no confidence" in the client? Is it important to the client that the law firm retain its equity position for business purposes? If a long-term hold is likely, how will the firm allocate the stock ownership among its partners? Should the stock be distributed out to the partners individually? Should the equity be transferred out of the firm and into an investment partnership or fund? What should be done with respect to partners who leave the firm (either voluntarily or involuntarily; by retirement, termination or otherwise) before the stock is ultimately disposed of? Do they retain an economic interest in the stock's value? Must the firm pay the withdrawing partners cash for their interest, even though the firm cannot or will not liquify its investment at that time? What are the firm's exit strategies with respect to the stock received?

Ethical Guidance

Guidance as to the ethical aspects of stock ownership was recently issued by the American Bar Association Standing Committee on Ethics and Professional Responsibility, in Formal Opinion 00-418 (issued July 7). The ABA's ethics panel focused on lawyers and law firms taking an ownership interest in a client, either in lieu of a cash fee for providing legal services or as an investment opportunity in connection with such services.

The ABA Opinion provides favorable guidance in navigating the Model Rules of Professional Conduct, which are the ethics rules adopted by most states. Opinion 00-418 notes that the laws, court rules, regulations, codes of professional responsibility, and opinions promulgated in the individual jurisdictions are controlling on individual lawyers; nonetheless, the ABA opinion undoubtedly will be studied carefully by state bar groups and in appropriate situations applied by courts. Thus, the opinion should be read by all firms considering receiving stock for fees.

Under the ABA opinion, a lawyer acquiring equity ownership in lieu of, or in addition to, a cash fee for services is entering into a business transaction with a client and therefore must meet the requirements of Model Rule 1.8(a). In relevant part, Rule 1.8(a) states that a lawyer shall not enter into a business transaction with a client unless (1) the transaction and terms in which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client 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. (Rule 1.8(a) does not apply when the lawyer acquires the stock in an open market purchase or in other circumstances not involving direct intervention by the client.)

In determining whether the rule's first requirement of fairness and reasonableness to the client is satisfied, the general standard of Model Rule 1.5(a) that "a lawyer's fee shall be reasonable" is relevant. For purposes of judging fairness and reasonableness, the ABA opinion concludes it is incumbent on the lawyer to take account of all information reasonably ascertainable at the time when the agreement for stock acquisition is made.

Reasonable Fee

Determining that the fee is reasonable involves making the often difficult determination of the market value of the stock at the time of the transaction. Investments in startup enterprises face the possibility of both home runs and strikeouts. The stock may increase wildly in value; alternatively, it may become worthless. The ABA opinion notes that the risk of failure and the stock's nonmarketability are important factors to be considered.

The ABA opinion notes that a reasonable fee may also include an agreed percentage of the stock issued or to be issued when the value of the shares are not reasonably ascertainable, e.g., when the lawyer is engaged by founders who are contributing intellectual property for their stock, and the lawyer performs initial services for the corporation, in exchange for shares. In such cases, the percentage of stock agreed on 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.

Another way for the lawyer to minimize risk on reasonableness of fees is to establish a reasonable fee for his or 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.

The ABA ethics panel observes that sometimes a lawyer will ask the corporation to issue a percentage of the shares initially issued to the founders as a condition to the lawyer's agreeing to become counsel to the new enterprise. The ethics panel takes no position on the propriety of this practice. However, the panel cautions that in this situation, especially if the cash value of the shares is not reasonably ascertainable, the lawyer should take special care to be in a position to justify the reasonableness of the total fee should it be questioned as a violation of Rule 1.5(a).

Full Disclosure and Transmittal of the Transaction

In addition to the stock transaction and its terms being fair and reasonable to the client, compliance with Rule 1.8(a) also requires that the transaction and its terms be fully disclosed and transmitted in writing in a manner that can be reasonably understood by a client. Thus, the lawyer must not only set forth the terms in writing, but also clearly explain the transaction and its potential effects on the client-lawyer relationship. For example, if the lawyer's stock acquisition will create rights under corporate bylaws or other agreements that limit the client's control of the corporation, the lawyer should discuss with the client the possible consequences of such an arrangement.

Possible Conflicts of Interest

At the outset, the lawyer also should inform the client that events following the stock acquisition could create a conflict between the lawyer's exercise of his or her independent professional judgment as a lawyer on behalf of the corporation and his or her desire to protect the value of his or her stock. The lawyer should also advise the client that as a consequence of such a conflict, the lawyer may feel constrained to withdraw as counsel for the corporation, or at least to recommend that another lawyer advise the client on the matter regarding which he or she has a personal conflict of interest.

Full disclosure also includes specifying in writing the scope of the services to be performed in return for receipt of the stock. If the client's understanding is that the lawyer keep the stock interest regardless of the amount of legal services performed by the lawyer solely to assure his or her availability, it is important to set forth this aspect of the transaction in clear terms. Otherwise, the equity acquisition may be viewed by a court as being in the nature of an advance fee for services and require part of the stock to be returned if all the work originally contemplated as part of the services for which the stock was given has not been performed.

The client also must have a reasonable opportunity to seek the advice of independent counsel in the transaction and must consent in writing to the transaction and its terms. The written documentation of the transaction should include the lawyer's recommendation to obtain such advice. (Actual consultation by the client is <u>not</u> required.)

The ABA opinion expresses the view that a lawyer's representation of a corporation in which he or she owns stock creates no inherent conflict of interest under Model Rule 1.7. There may, however, be circumstances in which the lawyer's ownership of stock in his or her corporate client conflicts with the lawyer's responsibilities as the corporation's lawyer. For example, the lawyer might have a duty when rendering an opinion on behalf of the corporation in a venture capital transaction to call on corporate management to reveal material adverse financial information that is being withheld, even though the revelation might cause the venture capital investor to withdraw. In such circumstance, the lawyer must evaluate his or her ability to maintain the requisite professional independence as a lawyer in the corporate client's best interest by subordinating any economic incentive arising from his or her stock ownership. The lawyer also must consider whether his or her stock ownership might create questions concerning the objectivity of his or her opinion, and must consult with the client and obtain consent if the representation may be materially limited by his or her stock ownership.

KMZ Rosenman
KATTEN MUCHIN ZAVIS ROSENMAN

www.kmzr.com

525 West Monroe Street
Suite 1600
Chicago, IL 60661-3693
Tel 312.902.5200
Fax 312.902.1061

575 Madison Avenue
New York, NY 10022-2585
Tel 212.940.8800
Fax 212.940.8776

2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
Tel 310.788.4400
Fax 310.788.4471

1025 Thomas Jefferson St., N.W.
East Lobby, Suite 700
Washington, DC 20007-5201
Tel 202.625.3500
Fax 202.298.7570

401 South Tryon Street
Suite 2600
Charlotte, NC 28202-1935
Tel 704.444.2000
Fax 704.444.2050

260 Sheridan Avenue
Suite 450
Palo Alto, CA 94306-2047
Tel 650.330.3652
Fax 650.321.4746

One Gateway Center
Suite 2600
Newark, NJ 07102-5397
Tel 973.645.0572
Fax 973.645.0573