MORE ON TAKING STOCK

by

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Updated 2016

When the stock market was booming and reports of young entrepreneurs striking it rich in the high tech market abounded, disciplinary counsel throughout the country saw a marked increase in ethical issues that arose when attorneys accepted or requested stock in the company as fees for legal services. New start-ups peaked in 2006, but beginning in 2007, when the pendulum swung the other way, falling profits left minority shareholders, regulators, or trustees in bankruptcy looking for someone to blame and lawyers became targets. Given this volatility, lawyers should appreciate the issues that arise when investing in client corporations or businesses.

This article is an update of an article of the same title posted on this website in July 2011. The issue of accepting stock in lieu of legal fees from closely held corporations was also briefly discussed in a Bar Counsel article entitled, "Getting Too Close to a Closely Held Corporation" (June 1998). Since then, as will be explained, amendments to the Massachusetts Rules of Professional Conduct in 2013 and 2015 impose new requirements on fee agreements and conflict of interest waivers. This article will focus on the applicability of Mass. R. Prof. C. 1.5, 1.7 and 1.8 to accepting stock in business entities in lieu of legal fees, illustrate some common problems that arise, and suggest a few policies that might decrease the potential for harm.

Apart from the disciplinary issues, however, it should be noted that there has been much commentary as to the broader policy and business judgment considerations of the practice of taking stock in lieu of fees. Some commentators argue that the practice strengthens the lawyer's relationship and bonding with the client and generally aligns financial interests. Others argue that the practice diminishes a lawyer's traditional fiduciary obligations to provide independent advice and refer to specific situations where the financial interests may not be aligned. A third group, citing to the high failure rate of start-ups, faults the practice as a poor business decision on the part of lawyers, without substantial vetting of the principals and business plan. For an exhaustive exploration of the policy and business judgment issues from the perspective of both the lawyer and start-up, see Maynard, "Ethics for Business Lawyers Representing Start-Up Companies," Wake Forest Journal of Business and Intellectual Property Law (Vol. 11, Number 3, 2010-2011).

The potential problems surrounding taking equity in a company as a fee become clearer when comparing the practice to a standard contingent fee. Normal contingent fees rely on the success of the attorney in a particular suit; but when accepting company equity as a fee, the contingency shifts and the lawyer's economic interest is based on the success of the prospective client's business. See Graham Matthew Cridland and Jacy D'Aiutolo, "When the Lawyer Owns the Client: Equity Interests as Attorney's Fees," 15 Geo. J. Legal Ethics 759, 767-770 (2002). An attorney's professional judgment may as a result be compromised. Id. at 770.

There nonetheless is no per se prohibition on accepting stock in lieu of legal fees as long as there is compliance with certain of the rules of professional conduct. As a starting point, as a result of rules amendments in 2013 and 2015, both the scope of the representation and the basis and rate of the fee must be communicated to the client in writing (Mass. R. Prof. C. 1.5(b)(1)). A fee also cannot be clearly excessive (Mass. R. Prof. C. 1.5(a)). In determining whether the fee is reasonable or clearly excessive, the fee agreement is generally evaluated in light of the factors spelled out in Mass. R. Prof. C. 1.5(a) (1)-(8), including the time and labor required or the skill involved at the time the agreement is made. The fact that the client voluntarily agreed to payment in the form of stock, even with "open eyes," will not necessarily defeat a claim in a civil case that the fee was unreasonable or, in a disciplinary matter, clearly excessive, but the courts will also not take a "second look" at an arrangement made with a sophisticated client who had the opportunity to consult other counsel. See *Rubin v. Murray*, 79 Mass. App. Ct. 64, 73 (2011) (although stock taken as fees appreciated greatly in value over the years, the Appeals Court declined to take a second look with the benefit of hindsight at the reasonableness of the fee in circumstances where the clients were sophisticated, were advised but declined to consult independent counsel, and the original value of the stock was minimal; the court also described policy concerns with taking a second look in these types of cases).

In addition, any time a lawyer gains a financial interest in a client's business, there is the potential for a conflict under Mass. R. Prof. C. 1.7(a)(2). Consequently, each affected client must give informed consent, which, as a result of the 2015 amendments to the rules, must be confirmed in writing. "Writing," "confirmed in writing" and "informed consent" are now defined terms under Mass. R. Prof. C. 1.0. Informed consent is defined in Mass. R. Prof. C. 1.0(f) as the "agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanations about the materials risks of and reasonably available alternatives to the course of conduct." Obtaining informed consent generally requires an affirmative response from the client or other person whose consent is being obtained and that consent generally cannot be assumed from silence. (Rule1.0, Comment 7) Informed consent is "confirmed in writing" under Rule 1.0(c) either with the client's written consent or the lawyer's prompt written transmittal confirming oral informed consent. "Writing," defined in Rule 1.0(q), includes any tangible or electronic record of the communication and a "signed" writing includes an electronic signature or other process intended as a signature. An email from the lawyer to the client can thus be a written confirmation. Another article on this website, "Conflict Resolution: Informed Consent to Conflicts of Interest under Mass. R. Prof. C. as Amended" (November 2015), discusses these changes in more detail. See also, ABA Formal Ethics Op. 00-418.

The degree of specificity required for informed consent when taking stock as a fee is unsettled. However, certain written disclosures appear minimally necessary. How the stock is to be valued at various times is one example. The determination of value at the outset has particular significance for a start-up company or when there is in initial public offering (IPO) for an existing company. Stock for an IPO or start-up has the inherent potential for an increase or decrease in market price not supported by traditional price-to-earnings ratios or other objective criteria. This volatility can result in a windfall to the lawyer. But also not uncommonly, as recent history has proven, the stock of an IPO may fall precipitously (after an initial surge), subjecting the company (and possibly its lawyer) to civil claims from other stockholders, such as a failure to make full disclosure in the offering documents. If the stock dives, the lawyer also may feel cheated or the client may perceive (rightly or wrongly) that had the lawyer been more diligent, things could have turned out differently.

For these reasons, the Attorneys' Liability Assurance Society, Inc. (ALAS) had recommended to its member law firms that there be a ban on any lawyer in the firm accepting stock in an IPO, or private start-up companies, in lieu of legal fees. In 2000, in recognition of the fact that the representation of start-ups often requires flexibility with respect to fees and of the intense competitive pressure among firms to attract start-up companies without liquid capital, this position was modified to permit accepting stock. There may also be pressure within firms to take stock in lieu of fees or risk losing partners or associates. ALAS has published suggestions to its members to minimize the risk of disciplinary problems and civil claims or liability that flow from these arrangements.

ABA formal ethics opinion 00-148 suggests that the written disclosure of the potential for conflicts should explain what will happen if the lawyer is terminated or permissibly withdraws before the representation has ended. And, of course, there must be clarity as to the scope of the representation. Rule 1.5(b)(1). The lawyer may also wish to provide written examples of where the lawyer's personal financial interest may differ from the interests of the other shareholders or the business entity, such as the propriety or details of obtaining financing from venture capitalists or nontraditional sources, where the initial benefit to the value of stock may be offset by negative long-term consequences.

The ABA opinion also takes the position that accepting stock in lieu of fees should be construed as entering into a business relationship with a client within the meaning of Rule 1.8(a), detailing restrictions on entering into "business transactions" with clients and requiring certain specific writings and consents. Thus, Mass. R. Prof. C. 1.5, comment 4, states that a fee paid in property instead of money may be subject to the requirements of Rule 1.8(a) because such fees often have the essential qualities of a business transaction with the client. See also, the *Restatement (Third) of the Law Governing Lawyers*, §206 (2000). (setting forth limitations on when a lawyer may participate in a financial transaction with a client, including when a lawyer takes an interest as payment of part or all of a legal fee, similar to Rule 1.8). This issue was also discussed specifically in District of Columbia Bar Legal Ethics Committee Opinion 300 (2000). The opinion reviewed prior commentary on the question, and concluded that a stock-for-fee arrangement is subject to Rule 1.8(a).

Mass. R. Prof. C. 1.8(a) requires that the terms of a business transaction with a client be fair and reasonable to the client and further requires that the transaction and terms be fully disclosed to the client in writing in a manner that the client can reasonably understand. The client must be given the opportunity to consult with independent counsel and must give informed consent to the transaction in writing signed by the client. The requirements of written disclosure and written informed consent are not technicalities, nor excused due to the sophistication of the client or the type of business. See, *Rubin*, *supra* at n. 8 (court stated that 1975 agreement, entered into after the representation commenced, to accept stock in payment of earned fees complied with the disciplinary rules as then in effect but would not pass muster under current Mass. R. Prof. C. 1.8(a) because of the lack of both written disclosure and the client's written consent to the conflict created by the lawyer's and client's differing interests).

That the transaction shall be fair and reasonable is an independent threshold requirement, regardless of written disclosure and informed consent. See, Mass. R. Prof. C. 1.7(a)(2). Furthermore, a strict fiduciary standard would apply to any review of the fairness and propriety of an arrangement in which a lawyer accepted stock in lieu of legal fees. A business transaction between attorney and client requires a "conspicuous degree of faithfulness." The attorney is required to meet the burden of showing that the transaction was in all respects fairly and equitably conducted and that the client received independent advice in the matter or else received from the attorney such advice as he would have been expected to give had the transaction been one between his client and a stranger. See *Goldman v. Kane*, 3 Mass. App. Ct. 336, 341 (1975). In other words, the burden of proof is on the lawyer to prove that the transaction was fair and the client was adequately informed. ABA Opinion 00-418. For an extreme example see *Passante v. McWilliam*, 53 Cal. App. 4th 1240 (1997) (lawyer required to disgorge equity interest in a corporation worth 30 million dollars).

Assuming the above standards are satisfied, the acceptance of stock in lieu of fees may nevertheless have unintended consequences. ABA Opinion 00-418 describes events following a stock acquisition that could create a conflict between the lawyer's exercise of independent judgment and the lawyer's desire to protect the value of the stock. The opinion states that this possibility must be disclosed to the client at the outset.

Attorneys should also consider the possibility of individual liability or damage to their practice from acquiring an interest in a client's business. Some start-up corporations will market stock through private placements. In such a situation, if the attorney's holding is substantial, the promotion may use the attorney's well-earned reputation in the community to market the shares. This will potentially harm the reputation of the lawyer or her firm if the business begins to fail, is subject to litigation or is the subject of investigation by regulators or taxing authorities. A lawyer whose name is used in marketing may also be drawn into a regulatory investigation or litigation if persons who were solicited feel betrayed. The holding of stock may also be included as evidence of "business connections" between the lawyer and client sufficient to provide ammunition to a potential claimant trying to drag an attorney into the alleged wrongful conduct. Holding stock may be only one fingerprint, but in combination with entanglements in the business of the corporation, an attorney may find it difficult to convince a trier of fact of the lawyer's lack of participation in, or knowledge of, the alleged wrongful conduct. ALAS reports that these types of cases are difficult to defend and, although the number of claims is small, the monetary awards have been substantial.

If, despite the above problems, a lawyer decides to accept stock in lieu of fees, there are practical steps that may be taken to reduce the likelihood of problems resulting. One possibility is to require the company to have independent advice as to the terms of a written fee arrangement. The arrangement may be reviewed for fairness by an outside attorney who will not participate in the client's representation. Another suggestion is to include in the fee agreement a minimum/maximum loss benefit formula that places a floor and ceiling on the legal fee. Some law firms have limited their exposure to conflict-of-interest concerns by limiting the percentage of stock in a start-up that can be accepted in lieu of legal fees (the smaller the percentage, the less potential for divided loyalties), requiring that the stock portion of the fee represent a minimal percentage of the entire fee and prohibiting the representation of any direct competitor. Finally, some firms do not permit the firm or members of the firm to hold stock in client companies or, if stock is accepted, it is held in a firm-wide independent pooled investment vehicle.

The above are just some of the issues that may arise when a lawyer accepts stock for fees in a start-up corporation. Given the potential problems, the potential damage to the client, the lawyer and the legal profession may outweigh the benefits of such a fee. Lawyers and firms should carefully craft written policies and carefully review each decision to accept stock or other equity positions in client companies.