

## MORE ON TAKING STOCK

by  
Bruce T. Eisenhut, Assistant Bar Counsel

*updated July 2011*

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. 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. For this reason if no other, lawyers should appreciate the issues that arise when investing in client corporations.

The issue of accepting stock in lieu of legal fees from closely held corporations was briefly discussed in a Bar Counsel article entitled, "Getting Too Close to a Closely Held Corporation" (June 1998), available at the Office of Bar Counsel web site ([www.state.ma.us/obcbbo](http://www.state.ma.us/obcbbo)). This article will focus on the applicability of Mass. R. Prof. C. 1.8(a), illustrate some common problems that arise, and suggest a few policies that might decrease the potential for harm.

There is no per se prohibition on accepting stock in lieu of legal fees. 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, there is the potential for a conflict under Mass. R. Prof. C. 1.7(b). Consequently, the lawyer must obtain client consent after full disclosure by the attorney of the potential impact that the arrangement may have on the attorney's loyalties. See Massachusetts Bar Association, Op. No. 76-16 and Op No. 81-11. See also ABA Formal Ethics Commission Op. 00-418.

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, this position was modified to permit accepting stock in recognition of the fact that the representation of start-ups often requires flexibility with respect to fees and the intense competitive pressure among firms to attract start-up companies without liquid capital. 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 minimize the risk of disciplinary problems and civil claims or liability that flow from these arrangements. See Redding, Brian, J., *Investing in or Doing Business With Clients*, Business and Securities Law Conference, 01-04.04 (MCLE 2000). Reprinted in Muldoon, et al., *Attorney Investments in Clients* (MCLE 2001).

Lawyers should also be aware that accepting stock in lieu of fees may be 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). 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 of the Law Third, *The Law Governing Lawyers*, §207 (2000). (taking an interest in a client's business as payment for all or part of a legal fee is a "business transaction" with the client). This issue was discussed specifically in District of Columbia Bar Legal Ethics Committee Opinion 300 (2000). The opinion reviewed prior commentary on the question, cited to the Restatement of Law Governing Lawyers, and concluded that a stock-for-fee arrangement is subject to Rule 1.8(a).

Mass. R. Prof. C. 1.8(a) requires 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 consent to the transaction in writing. The requirements of written disclosure and written 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).

Furthermore, if deemed a business transaction, 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 heightened duties in light of the heightened risks that the client is taking. 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 (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.

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.

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. 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).

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 (obviously 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.

There are a host of other ethical problems that arise when a lawyer accepts stock for fees in a start-up corporation. See Muldoon, et al., *Attorney Investments in Clients* (MCLE 2001). Given the potential problems particularly in a declining market the potential damage to the client, to the lawyer and to 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.