

Taking an Equity Interest in a Client – Is it Worth the Risk?

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There's been a lot of talk (and many misconceptions) lately about lawyers investing in their clients and, in particular, taking stock in lieu of legal fees. Let's examine the issue as it applies to small and mid-sized firms from an economic, ethical, and malpractice standpoint.

The economics

A growing number of clients are insisting that their counsel accept stock options in lieu of legal fees. The practice is most prevalent with start-up companies in the high-tech industry. This presents law firms with the dicey dilemma of either foregoing the legal work or accepting the compensation terms as dictated by the client.

On rare occasions, law firms have reaped significant profits from such arrangements. The recent decrease in tech-stock value, however, reveals the inherent risks in any equity position. In the worst case scenario, the start-up client may never get off the ground, rendering the stock options worthless.

Small firms contemplating an investment in a client should consider whether they can afford to take a total loss on the stock and, in essence, perform the legal work for free. These firms must be financially secure enough to wait for the stock options to be exercised, as opposed to firms that insist on an hourly fee and thus receive payments throughout the representation and have the option of withdrawing if the client stops payment.

That is why a prominent Silicon Valley firm that has invested in its clients for several years has – contrary to rumor – a strict rule against taking stock in lieu of fees. Instead, the firm takes stock in clients strictly as an investment. The reasoning is compelling. Why gamble on a client that doesn't budget for legal fees



Should you take your fee in the form of stock options in a client company? Before you say “yes,” read on.

and hands out stock options like Monopoly money?

The ethics

Putting aside the financial risks, can the investment be made ethically? ABA Formal Opinion 00-418, “Acquiring Ownership in a Client in Connection with Performing Legal Services,” dated July 7, 2000, concludes that the Model Rules of Professional Conduct do not prohibit a lawyer from taking an equity interest in a client so long as the following Model Rules are satisfied: Rule 1.5(a) (the reasonableness of the fee); Rule 1.7(b) (conflicts between the client and the lawyer's own interests); Rule 1.8(a) (business transactions with a client); and Rule 2.1 (lawyer's duty to exercise independent professional judgment and render candid advice). Attorneys considering investments in clients should read this opinion carefully.

The opinion emphasizes the necessity of full and fair disclosure in a manner “that can be reasonably understood” by

the client of the terms of the transaction and the potential conflicts of interest. For example, the ABA suggests that the disclosure include a discussion of

the consequences of any rights by virtue of the lawyer's stock ownership that may limit the client's control of the corporation under special corporate by-laws or other agreements and the possibility that the lawyer's economic interests as a stockholder could create a conflict with the client's interest that might necessitate the lawyer's withdrawal from representation in a matter.

Also, the investing firm must provide the client with a reasonable opportunity to seek the advice of independent counsel regarding the transaction. Lastly, the firm must remain continually vigilant for conflicts of interest that may later arise due to the lawyer's equity interest, thereby requiring withdrawal from the representation.

As illustration, let's assume that Lawyer is asked to draft an opinion or offering memorandum by Client Corporation that would require revealing material adverse financial information that has not previously been disclosed by Corporation. Lawyer believes that the release of the information would have a detrimental impact on the value of Corporation's stock. Let's further assume that Corporation's stock is a major asset of Lawyer and, therefore, a drop in the stock price would cause financial hardship to Lawyer. In such a case, Lawyer's own interests would appear to create an untenable conflict under Rule 1.7(b).

I have often heard lawyers argue that there is no conflict of interest when they invest in clients because both the client and the lawyer have the same goals – to maximize the value of the stock or investment. The above illustration shows the fallacy of that argument.

The malpractice risks

First, there's a well-established presumption of undue influence when lawyers engage in business transactions with clients. It can only be overcome by clear and convincing evidence that (1) the transaction was fair, (2) full disclosure was made to the client, and (3) he or she had the opportunity to seek the advice of independent counsel. If undue influence cannot be rebutted, the transactions is void and the lawyer subject to a breach-of-fiduciary-duty claim.

Even if the lawyer can overcome the presumption of undue influence, he or she might be sued by third-party investors or lending institutions that have lost money in the client's venture. Although the complaints can take many forms, the general allegation is that the lawyer conspired with or otherwise assisted his or her client in defrauding third parties by, for example, understating the client's debts or similar misrepresentations.

In hindsight, the lawyer often appears to be a self-serving investor who assisted in the client's fraud to save his or her own investment. Additionally, it may be difficult to persuade a jury that the lawyer had no knowledge of the client's fraud when the lawyer had a financial stake in the client from day one.

To complicate matters, start-up companies rarely carry directors-and-officers liability insurance. Think about it. A client that had enough capital to pay for D&O coverage wouldn't be twisting counsel's arm to take speculative stock options instead of cold hard cash. As a result, the lawyer's trusty legal-malpractice policy is one of the only deep pockets available.

This situation creates a major incentive for the plaintiff's counsel to draft counts in the complaint alleging both fraud and legal malpractice by the start-up's legal counsel. Most legal-malpractice policies contain an exclusion for fraudulent or intentional conduct.

Most also exclude claims by entities in which the insured is an "owner." Thus, even if the carrier has a duty to defend, the lawyer may be on the hook personally for an adverse verdict.

Guidelines for those who must

From an ethics and malpractice perspective, it is always safer for a lawyer to wear only his or her legal hat and avoid business transactions with a client. Small and mid-sized firms that decide to accept the risks of an ownership interest in a client may want to establish a few basic guidelines first. The following guidelines apply not only to firms contemplating taking an equity position in a client but to those considering any type of ownership interest, including an interest in a real-estate limited partnership.

1. Screen the clients in whom you invest. Are the major players long-time clients you know and trust or newcomers with whom you are unfamiliar? Do they enjoy a good business reputation? Are the decision-makers conservative, or are they risk-takers willing to cut corners? Is the client requiring you to take stock options because it cannot afford to pay your legal fees or is your investment strictly optional? A little due diligence goes a long way.

2. Require each investment to be approved by all of the partners in a small firm, or in a mid-sized firm, by the firm's "new business" or "conflicts" committee. This precaution serves two purposes. First, it guarantees that no one partner can expose the firm to the additional risks of an equity interest without the knowledge and consent of the others. Second, as with any potential conflict of interest analysis, the decision whether or not to proceed with the investment should be made by someone other than the firm member who has the most to gain or lose. Impartial partners can also ensure that the investment meets any other guidelines that have

been established by the firm.

3. Have the client sign a detailed disclosure statement. A generic, one-size-fits-all conflict of interest waiver is insufficient. The disclosure statement should cover all of the points discussed in ABA Formal Opinion 00-418 mentioned above.

4. Don't take stock options or other ownership interests in lieu of fees. As discussed above, this type of investment carries the greatest financial, ethical, and malpractice risk. Instead, just make a straight investment in the client.

5. Set a limit on the amount of each investment. The best approach is to prohibit large investments. For example, the firm may decide to restrict investments to no more than a 5 percent ownership interest in any single client.

6. Consider requiring investments to be made as a firm rather than individually. It may be more difficult for a claimant to allege that a lawyer's judgment was compromised by a firm-wide investment than by his or her personal investment. For the same reason, some firms prohibit any lawyer providing legal services to the client from individually investing in that client. Other firms create separate investment entities through which the firms invest. (Carefully review the securities laws before establishing any type of investment vehicle.)

7. Require the investment to be held for a minimum period. This will avoid the prospect of a lawyer selling the stock the day after the initial public offering at a significant profit.

8. Review your legal malpractice policy. Is there a safe harbor for ownership interests below a certain percentage?

If you decide to gamble and invest in a client, you can at least improve the odds a bit by establishing sensible guidelines for those investments. Personally, it's just not a bet I'd be willing to take. ■