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Committee on Professional Ethics

Opinion 913 (3/22/12)

Topic: Acceptance of Securities as a Legal Fee

Digest: A lawyer may accept an equity interest in a client if the lawyer complies with the Rule of Professional Conduct governing business transactions with clients and the acceptance does not otherwise create a conflict for the lawyer or result in an excessive fee.

Rules: 1.5(a), 1.7(a), 1.7(b), 1.8(a)

QUESTION

[1] The inquiring lawyer asks whether a lawyer may accept as compensation for legal services a hybrid fee combining a reduction in the lawyer's customary hourly time charges with an equity interest in the client or the client's company. Subject to the caveats below, we conclude that the Rules of Professional Conduct do not invariably proscribe such a fee arrangement.

OPINION

[2] The Rules of Professional Conduct do not confine a lawyer to charging a legal fee based on an hourly rate or other time-based metric. The principal general limit on a lawyer's compensation for legal services is that, under Rule 1.5(a), a lawyer may not accept a fee the amount of which, upon review of the facts, would leave a reasonable lawyer "with a definite and firm conviction that the fee is excessive." Among the facts that Rule 1.5(a) identifies as relevant are the time, labor, and skill required; the novelty and difficulty of the services requested; the lawyer's inability, by reason of the representation, to represent other clients; the amount at stake and the results the lawyer achieves; the fee typically charged for comparable services in the locality where the lawyer practices; the time period in which the lawyer must complete the assignment; the lawyer's experience and reputation; and whether the fee is fixed or contingent. It follows from Rule 1.5(a) that any or all of these factors may properly influence the fee a lawyer charges for legal services. ABA 11-458.

[3] The inquiry poses the question whether Rule 1.5 alone governs when the lawyer's fee consists, in whole or in part, of an equity interest in the client or client's company. Whether a lawyer's acceptance of securities as a legal fee implicates issues under federal or state securities laws or other statutory regimes is a question beyond the scope of this Committee's charter. If a lawyer's acceptance of such consideration as a fee is legally permissible, then in our view it is

necessary to go beyond Rule 1.5. The starting point for analysis is found in Rule 1.8(a), which provides:

A lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise professional judgment therein for the protection of the client, unless:

> (1) the transaction is fair and reasonable to the client and the terms of the transaction are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;
>
> (2) the client is advised in writing of the desirability of seeking, and is given a reasonable opportunity to seek, the advice of independent legal counsel on the transaction; and
>
> (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

[4] Rule 1.8(a) invites a twofold inquiry. The first is whether the transaction itself is one in which the lawyer and client have differing interests *and* in which the client expects the lawyer to exercise the lawyer's independent professional judgment on the client's behalf. If the answers are yes, then, as a second step, the lawyer must assure that the terms are fair and reasonable to the client and fully disclosed in a writing that includes not only the deal's essential terms and the lawyer's role in shaping them, but also the desirability of the client seeking independent legal advice.

[5] The applicability of Rule 1.8(a) to fee arrangements in which a lawyer accepts an equity interest in the client is not self-evident. Every fee arrangement with a client is in a literal sense a business transaction with that client. At the outset of the representation, a prospective client and a lawyer obviously have "differing interests" in negotiating the lawyer's fee. But the second threshold condition of Rule 1.8(a) is less obvious. The language in the New York version of Rule 1.8(a), as in its predecessor DR 5-104, makes its application contingent on the client's expectation that the lawyer is exercising independent professional judgment on the prospective client's behalf in negotiating the lawyer's fee arrangement. For this reason, some authorities opined that Rule 1.8(a)'s predecessor in the Code of Professional Responsibility was not meant to apply to fee arrangements formed at the start of the representation, that is, before an attorney-client relationship formally exists. C. Wolfram, *Modern Legal Ethics* § 8.11.1 at 481-82 (1986) (fiduciary standard arises only after relationship is formed); N.Y. City 88-7 (1988) (establishing the attorney-client relationship is not a business transaction under Code).

[6] Nevertheless, we conclude that Rule 1.8(a) applies to negotiation of a fee in which a lawyer is to receive an equity interest in a client or the client's company. Comment [4C] accompanying Rule 1.8(a) says in relevant part:

> This Rule also does not apply to ordinary fee arrangements between client and lawyer reached at the inception of the client-lawyer relationship, which are governed by Rule 1.5. The requirements of the Rule ordinarily must be met, however, when the lawyer accepts an interest in the client's business or other nonmonetary property as payment of all or part of the lawyer's fee. For example, the requirements of paragraph (a) must ordinarily be met if a lawyer agrees to take stock (or stock options) in the client in lieu of cash fees. Such an exchange creates a risk that the lawyer's judgment will be skewed in favor of closing a transaction to such an extent that the lawyer may fail to exercise professional judgment as to whether it is in the client's best interest for the transaction to close. This may occur where the client expects the lawyer to provide professional advice in structuring a securities-for-services exchange. If the lawyer is expected to play any role in advising the client regarding the securities-for-services exchange, especially if the client lacks sophistication, the requirements of fairness, full disclosure and written consent set forth in paragraph (a) must be met.

[7] In the common situation involving the offer of an equity interest as a legal fee, of which the inquirer is an example, the client is a nascent venture lacking a public market and offering consideration of indeterminate value and liquidity in lieu of cash. In these instances, it is not at all unreasonable to suppose that the client looks to the lawyer for independent judgment. In contrast to the improbable scenario of a sophisticated public-company client offering its openly-traded stock for a fee, the more characteristic offeror is a cash-poor entrepreneur in quest of capital to launch a business. Acceptance of stock as a fee enables the entrepreneur to obtain legal advice for the venture and exhibits the lawyer's confidence in the client's chances. The client may be looking to the lawyer for independent judgment on forming the enterprise with an eye toward an eventual public offering. These are the circumstances in which Rule 1.8(a) plays an important role. *But see* Rule 1.8(a) Cmt. [4B] (the Rule does not apply to "standard commercial transactions between the lawyer and the client for products or services that the client generally markets to others," for instance a lawyer obtaining a mortgage from a bank the lawyer represents on other matters).

[8] Neither the Model Rules of Professional Conduct nor the Rules as adopted in the majority of jurisdictions prefaces the application of Rule 1.8(a) as explicitly as does New York's to those circumstances in which the client expects the lawyer to exercise independent professional judgment on the client's behalf. Still, it matters that every recent opinion to consider the question has said that Rule 1.8(a) or its predecessor, with or without New York's preamble, applies to transactions in which a lawyer accepts an equity interest as part or all of a legal fee. *E.g.,* ABA 00-418; D.C. Opinion 300 (2000); N.Y. City 2000-3 (with some qualification and calling it the "prudent" course in all events); Pennsylvania Opinion 2001-100; Utah Opinion 98-13; *see* II RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 126 cmt. A, at 323 (2000) (more restrictive rules "when a lawyer takes an interest in the client's business as payment of all or part of a legal fee"); I G. Hazard & W. Hodes, *The Law of Lawyering* § 12.5 at 12-15 (2005-2 Supp.) (both Rules 1.5 and 1.8 "are applicable when a lawyer contracts to receive all or part of her fee in the form of an interest in the client's venture"); MODEL RULES OF PROFESSIONAL CONDUCT 1.8, cmt. a.; *cf. Iowa Supreme Court Attorney Disciplinary Board* v. *Kaiser*, 736 N.W.2d 544, 2007 Iowa Sup. LEXIS 93 (2007) (suspending lawyer for acquiring equity interest in client without compliance with DR 5-104 as written in New York).

[9] A recent decision of the Appellate Division in the First Department supports this conclusion. In *Matter of Ioannou*¸ 2011 NY Slip Op 7942, 2011 N.Y. App Div. LEXIS 7792 (Nov. 10, 2011), the Court suspended a lawyer for three months for borrowing money from a former client without heed to the requirements of DR 5-104(a), of which Rule 1.8(a) is a copy. There, the lawyer had represented the client in obtaining a very favorable settlement of a personal injury action. A year later, the onetime client asked the lawyer for some advice about an aspect of the settlement. Two weeks after giving this advice, the lawyer solicited and obtained an interest-free loan from the onetime client. While stressing that DR 5-104(a) (and thus presumably Rule 1.8(a)) does not necessarily "apply to every transaction with a former client," the Court ruled that the "former client's relative lack of sophistication in business matters, the personal nature of the former professional relationship, the importance to the former client of the matter in which the [lawyer] represented him, and the fact that the former client had sought [the lawyer's] advice on a matter related to the former representation only about two weeks before [the lawyer] proposed the transaction" created a reasonable expectation on the former client that the lawyer would be exercising independent professional judgment for the lender in the transaction. *See Schlanger* v. *Flaton*, 218 A.D.2d 597 (1st Dep't 1995) (granting summary judgment for client rescinding equity interests and shareholder agreements that lawyer obtained in violation of DR 5-104(A)).

[10] We therefore join other ethics committees and authorities in concluding that a lawyer who wishes to accept an equity interest in a client must comply with the provisions of Rule 1.8(a). This means that the terms of the transaction must be fair and reasonable to the client, fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client, with the client being advised of the desirability of seeking independent legal advice and given a reasonable chance to do so, and the client signing a writing that describes the transaction and the lawyer's role in the deal, including whether the lawyer was acting for the client in the matter.

[11] Whether particular terms are "fair and reasonable" to the client is a fact-specific inquiry for which general rules are of limited aid. If there is a market for the stock, be it public or private, the market may offer a fair and reasonable measure. In some instances, comparisons may offer guidance if other professionals are providing so-called "sweat equity." In the absence of some third-party yardstick, some of the criteria set forth by the Utah Ethics Committee, in its Opinion 98-13, may usefully influence the fairness and reasonableness of the transaction, among them the liquidity of the stock or the risks that the stock may remain illiquid for the foreseeable future; the present and anticipated value of the stock, including the value of any intellectual property that the enterprise may own or control and the risks of adverse regulatory or judicial rulings affecting those values; any restrictions placed on the securities by law or contract; the percentage ownership of the enterprise that the securities now or in the future (*e.g.*, if the currency is warrants or options) may represent; and, as a related matter, whether the lawyer's stake in the company is passive, the opportunities for control or participation in management, and the structural restrictions on such matters. To these must be added the factors, listed above, identified in Rule 1.5(a).

[12] Whether a transaction in securities may be deemed "fair and reasonable" under Rule 1.8(a) is analytically distinct from whether the fee may be "excessive" under Rule 1.5(a), *see* Rule 1.8(a) Cmt. [4F], though in the end the relevant considerations are substantially similar. Unless some obvious metric exists to assess the fairness and reasonableness of a securities transaction as a legal fee, the resolution of that issue is unlikely to be amenable to any fixed determination. We agree with the ABA that, "[f]or purposes of judging the fairness and reasonableness of the transaction and its terms," the controlling consideration should be "the circumstances reasonably ascertainable at the time of the transaction." ABA 00-418. The same is true of any assessment of whether the fee may be considered "excessive" under Rule 1.5(a). "An equity stake in a corporation that turns out to be successful might seem excessive in relation to the services rendered if the value is determined only after the success is achieved." N.Y. City 2000-3. "But to make the evaluation at that end point – and with the wisdom of hindsight – would not value the fee that the client agreed to pay or the lawyer accepted, because it would eliminate the risk that the lawyer undertook that the venture would fail and the securities, *i.e.*, the fee, would have little or no value." *Id.* For this reason, we believe that whether a fee is excessive under Rule 1.5(a) is an assessment about the value of the fee at the time the fee is set. *Accord* I RESTATEMENT § 34 cmt. c at 250; *id.* § 126 cmt a.

[13] Another separate but very important question is whether the business transaction involving the acceptance of an equity interest as a legal fee occasions a conflict of interest between the lawyer and the client. Rule 1.7(a) prohibits a lawyer from undertaking an engagement if "a reasonable lawyer would conclude" that there is a "significant risk that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other personal interests." Rule 1.7(b) qualifies this prohibition by allowing to proceed if the "lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation." *See* Rule 1.8(a) Cmt. [4D] (explaining reasons for concern about conflicts arising from equity interests). Rule 1.7(b) requires also that the lawyer obtain the client's informed consent, which may involve information beyond that required by Rule 1.8(a). *See* Rule 1.8(a), Cmt. [4E].

[14] Subject to this proviso, if the lawyer concludes that the lawyer may competently and diligently represent the client in the matter, then the lawyer may do so upon the client's fully informed consent. We believe that this informed consent requires disclosure of, among other things, the risks inherent in the representation of a client by a lawyer with a personal financial stake at risk, including the chance that the financial interests could affect the lawyer's judgment; the conflicts that could emerge from the possible tension between lawyer as counselor and lawyer as stockholder; and the risks that privileges could be in jeopardy unless the communications between the two concern confidential legal advice.[1]

[1] The foregoing analysis is intended to apply only to the negotiation of the fee arrangement at the outset of the representation. There may be other considerations that must be brought to bear in negotiations over the modification of a prior arrangement during the course of the representation. The current inquiry does not raise these issues. *See* N.Y. State 910 (2011).

CONCLUSION

[15] In sum, a lawyer may accept an equity interest in a client or a client's company if the terms and conditions of the business transaction are fair and reasonable to the client, fully disclosed to the client in a writing the client may readily understand that advises the client of the desirability of seeking, and gives the client the reasonable chance to seek, independent professional counsel, and the client consents in a writing signed by the client that fully discloses the terms of the transaction and the lawyer's role in the matter.

(29-11A)