Connecticut's Take On "Taking a Stake" Part 1

By John D. Moore

Spurred on by reports Silicon Valley lawyers becoming instantly rich, many attorneys followed suit in the late 1990s by taking equity positions, including stock and stock options, in their clients' companies in lieu of a fee.(fn1) In fact, in 2000, the ABA reported that "one in three lawyers representing the more than 500 companies that went public in 1999 held stock in the clients at the time of the offering."(fn2) With the recent economic downturn, and the subsequent drying up of venture capital, clients may feel compelled to offer, and lawyers may be tempted to accept, a piece of the action instead of a more traditional form of payment for legal services rendered. Part I of this two-part series will examine a series of articles and ethics opinions drafted in response to this development. Part II will analyze Connecticut's likely perspective on whether these relatively new payment paradigms are ethically permissible.(fn3).

The Applicable Ethics Rules

From the mid 1990s through the early 2000s, a spate of ethics opinions and professional commentators (collectively "the commentators") weighed in on the rectitude of taking a stake in a client's business.(fn4) These included ethics opinions from the American Bar Association as well as from the bar associations or ethics advisory committees of Mississippi, Utah, Iowa, the District of Columbia, New York City, and Colorado; articles printed in the Minnesota and Illinois bar journals; and a lengthy Texas Law Review piece authored by Professors John Dzienkowski and Robert Peroni. The overwhelming majority of the commentators found the payment of client equity for legal fees to be ethically permissible as long as there was strict compliance with Rules 1.8(a), 1.5(a), 1.7(a) (2) [formerly Rule 1.7(b)] and 2.1. Let us examine the requirements of each of these Rules seriatim.

1. Rule 1.8(a)

Rule 1.8(a) clearly applies to taking equity from a client for a fee.(fn5) The commentators universally agreed that the pre-requisites of 1.8(a) (1)-(3) must be met under these circumstances.(fn6) Rule 1.8(a) was drafted in response to the "business transaction rule" articulated in prior cases discussing business transactions between an attorney and a client. Many of these cases found that such business transactions were "not advisable,"(fn7) subject to the strictest scrutiny,(fn8) and "suspect,"(fn9) and must be "fair to the client."(fn10) One concern articulated in these cases was that the "lawyer's legal skill and training, together with the relationship of trust and confidence required between client and lawyer, create the possibility of overreaching when a lawyer enters into a business transaction with a client."(fn11) Rule
1.8(a)(1)-(3) codified safeguards posited in this case law and Connecticut's Rule 1.8(a) (1)-(3) now reads, after amendments effective January 1, 2007, in pertinent part:

(a) A lawyer shall not enter into a business transaction... with a client or former client, or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client or former client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client or former client and are fully disclosed and transmitted in writing to the client or former client in a manner that can be reasonably understood by the client or former client;  
(2) the client or former client is advised in writing that the client or former client should consider the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in the transaction; [and]  
(3) the client or former client gives informed consent in writing signed by the client or former client, to the essential terms of the transaction, including whether the lawyer is representing the client in the transaction.(fn12)

This rule is as clear as it is mandatory. The use of the word "shall" means that a lawyer is subject to discipline(fn13) when she enters into a business transaction with a client or former client unless (1) the transaction and its terms are (a) fair and reasonable to the client or former client, (b) fully disclosed and transmitted in writing to the client or former client and (c) communicated so that client or former client could reasonably understand them, (2) the client or former client (a) is advised in writing of the benefit of seeking independent legal counsel and (b) is given a reasonable opportunity to do so and (3) the client or former client gives informed consent in writing signed by the client or former client, to the essential terms of the transaction, including whether the lawyer is representing the client therein. Along with the substantive requirement that the business transaction be fair and reasonable, three prerequisites must be evidenced in writing: the terms of the transaction, the advice of the benefit of seeking independent legal counsel and the informed consent of the client. The case law positing these safeguards provided that "lawyer-client business transactions (including equity investments in clients) are presumed fraudulent and improper unless the lawyer has met the burden of showing that" these safeguards "have been satisfied.(fn14)

Several of the commentators added interesting insights to the clearly stated mandates of Rule 1.8(a) (1)-(3) in the context of taking client equity for pay.

When the attorney-client relationship continues, Iowa Opinion 02-01 required that the attorney must, in the event of every new or revived conflict, "provide a fresh, detailed disclosure of the [conflict], and obtain from the client a new consent in writing after consultation and a full disclosure of material facts.(fn15)

The Utah Committee opined that "the lawyer and his firm should take steps to avoid confusion about whether the firm is acting as an independent legal advisor or as a business partner.(fn16)

Professors Dzienkowski and Peroni, in their comprehensive and thoughtful law review article, made several cogent arguments about the operation of Rule 1.8(a). First, they pointed out that the "fair and reasonable" requirement means that a lawyer cannot, in any business transaction with a
client, receive a substantial discount "even if the client consents to the terms of the arrangement.(fn17) In the context of receiving client equity for legal services, it is difficult to ascertain whether the "fair and reasonable" standard has been met because the lawyer receives the equity before the general public, at either the formation stage, with the founders, at the initial funding stage, with the venture capitalists or at the IPO stage, with institutional investors and brokerage houses.(fn18) Second, they explained that providing the information necessary for informed consent is made more difficult by (1) the complexity of the business transactions at issue and (2) the myriad conflicts and potential conflicts for the attorney and her firm.(fn19) Third, they reminded the lawyer that consent from an entity needs to come from those with authority.(fn20) Fourth, they submitted that an attorney seeking consent for such a transaction may have to walk a tightrope between a consent which appears facially to be too general, but which memorializes prior, detailed verbal communications, and an overly verbose and complicated "securities-style letter" that could only be understood by a securities specialist.(fn21) Fifth, they opined that a coercive attempt to mandate that the client pay with equity "violates the consent requirement of Rule 1.8(a)."(fn22) Finally, they suggested that, under certain instances, the "severity of the conflict created by the lawyer's investment" may give rise to a conflict to which the client cannot consent.(fn23)

Several of the commentators have weighed on the disclosures that must be made before the client's consent is sought. The Colorado opinion states that the attorney should disclose that certain conflicts may "require the lawyer to withdraw from the representation" and that "as an equity owner, the lawyer may in the future vote her or his equity interest as she or he sees fit in the lawyer's own self-interest, regardless of the wishes of management of the client."(fn25) The ABA opinion counsels that "full disclosure" should include both "the scope of the services to be performed in return for receipt of the stock or the opportunity to invest," and, if the attorney is to keep "the stock interest regardless of the amount of legal services performed by the lawyer and solely to assure the lawyer's availability, it is important to set forth this aspect of the transaction in clear terms." The ABA opinion, however, posits that compliance with Rule 1.8(a) "does not require reiteration of details that the client already knows from other sources" and that "too much detail may tend to distract attention from material terms."(fn26) Professors Dzienkowski and Peroni soundly criticize this last comment, and state that it is "simply contrary to the literal words of, and policy underlying, Model Rule 1.8(a) (1)."(fn27) They proceed to suggest numerous additional disclosures, including the need to disclose the financial ramifications of the kind of equity to be paid,(fn28) the facts of life concerning the necessary dilution of the founders' interest and control when venture capitalists enter the scene,(fn29) the limitation of the firm's representation to the specific work performed in exchange for the equity received,(fn30) the problem of impeachment of the lawyer's testimony (if compelled) as a result of the equity owned by her(fn31) and the potential for future conflicts with other clients or former clients of the firm.(fn32)

2. Rule 1.5(a)

Another ethical rule with which lawyers must comply when taking stock or options in lieu of other payment is Rule 1.5(a), which requires that a "lawyer shall not make an agreement for, charge, or collect an unreasonable fee..."(fn33) As a threshold matter, it is perfectly acceptable to receive non-monetary compensation in consideration of legal services.(fn34) Difficulties arise
when one attempts to value client equity to see if it is reasonable under 1.5(a). Two commentators suggested referring to the laundry list of factors listed in 1.5(a), and, in fact, several of those factors may be helpful in analyzing the reasonableness of client equity as a fee. Considerations of the time, labor, novelty, and complexity involved could buttress an argument that client equity was a reasonable payment. The factor referred to most often by the commentators is the analogy to the contingent fee. Because an investment in the client may go either boom or bust, many of the authors analogized client equity to the long-acceptable contingent fee. Such a comparison may be helpful in demonstrating that a novel client equity payment is reasonable under 1.5(a), but at least one set of commentators sees limitations to this model. As Professors Dzienkowski and Peroni pointed out, contingent fees work well within the discrete framework of litigation: once the case is settled or judgment entered, the award is split up according to the contingent fee agreement and the parties go their merry ways. However, the dangers for self-dealing only increase when the professional relationship continues indefinitely, especially since the law firm's desire to cash out may run counter to the company's interests.

A major problem in ascertaining reasonableness, as mentioned in the section on 1.8(a), supra, is that it can be difficult to decide if a fee is reasonable because the law firm often receives the equity before it is available to the general public; in fact, the equity may never have a market value. Several of these commentators felt that the proper time to evaluate the reasonableness of an equity payment is when the contract was entered into, but one disagreed, stating that the proper time to review reasonableness is at the conclusion of the representation. Examining reasonableness at the conclusion of the representation can be problematic itself. If the client concern succeeds dramatically, the client may be tempted to argue that the fee is unreasonable or that the client never gave informed consent, and seek the return of all or part of the value of the equity. Two ethics opinions advocated the return of fees that seem too steep in hindsight. And, of course, if the lawyer is fired or quits, the problem of valuation is exacerbated by the ethical prescription that advance fees should be returned to the client.

3. Rule 1.7(a) (2)

Another rule which applies to attorneys taking a stake in the client enterprise is Rule 1.7(a) (2), formerly known as 1.7(b). 1.7(a) (2) now reads, in pertinent part:

(a) Except as provided in subsection (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

Virtually all the commentators believe that conflicts may very well arise under this Rule because the lawyer's own interest will not, under all circumstances, either be consistent with those of the client entity or may, under many instances, affect the lawyer's professional judgment. Especially if the client equity constitutes a large portion of the lawyer's portfolio, or if the lawyer's shares comprise a significant portion of the client's issued stock, there could be many
situations when the lawyer's personal interests run counter to those of the client. A small
collection of such situations include (1) when the lawyer is asked by the client to draft a
memorandum which reveals adverse financial information and the lawyer believes that such a
disclosure will negatively affect the stock price; (2) if the lawyer, focusing on her
investment, is influenced to urge the client to take a position more or less risky than the
objectively independent lawyer would, such as the timing of the initial public offer-ing; (3)
if the client experiences financial difficulty, causing the investors to request the founders to
dilute their interest, and the lawyer finds herself aligned with the investors and not the
client; (4) if the lawyer were to discover that the founders have misled the investors,
and the lawyer must either disclose this fact, driving the stock price down or keep quiet, and
violate securities laws. (fn51) The heart of the "personal interest of the lawyer" conflict under
1.7(a) (2) or the old 1.7(b) is that "most lawyers acquire stock to dispose of it." (fn52) At some
time, this interest will diverge with that of the client to maintain high-profile investors.

Often overlooked is the fact that a lawyer who invests in one client may end up with a 1.7 (a) (2)
conflict with other past or present clients, if the clients are either competing for venture capital or
for the time and energy of favored professionals in the attorney's office.

If a 1.7(a) (2) conflict arises, 1.7(b) provides that a lawyer may only continue to represent a
client if (1) the lawyer objectively and subjectively believes that the lawyer will be able to give
both "competent and diligent representation to each affected client," (2) the representation "is not
prohibited by law," (3) the representation does not involve direct assertions on behalf of one
client against another and (4) "each affected client gives informed consent, confirmed in
writing." (fn53) Because, however, the lawyer must perform both an objective (that of a
reasonable lawyer) and a subjective analysis of the effect of the conflict on the representation, a
1.7(a) (2) conflict may not be waivable. (fn54)

The New York City opinion suggested that the disclosure required under its version of 1.7(a) (2)
should contain the same information as required under its version of 1.8(a). (fn55) The requisite
information should include: "(1) the risks inherent in representation by lawyer with a financial,
business, property or personal interest in the company, including the possible effects upon the
lawyer's actions and recommendations to the client; (2) the possible conflicts that might arise
between lawyer/shareholder and client or its management and the range of possible
consequences stemming from them; and (3) any potential impact on the attorney/client privilege
and confidentiality rules, particularly in communications between the client and the attorney in
his role as investor rather than as counsel." (fn56)

4. Rule 2.1

Both Rule 1.8(a) and old Rule 1.7(b) addressed the issue of the acceptance of stock for pay
possibly interfering with the independent professional judgment of an attorney. Rule 2.1 requires
that, "in representing a client, a lawyer shall exercise independent judgment and render candid
advice." (fn57) At least 3 of the commentators mandated compliance with this rule when taking
equity for pay, (fn58) and one questioned how independent and honest a lawyer's advice might be
if the business providing payment for work previously performed began to wilt. (fn59) Many of
the concerns articulated above in the discussions of Rule 1.8(a) and 1.7(a) (2) pertain to interference with the attorney's independent judgment.

5. Cautionary Tales and Pragmatic Advice

Not surprisingly, given the complicated legal and ethical issues involved, the articles and opinions reviewed present many cautionary tales and warnings and dispense some practical advice. Several commentators discuss the case of the lawyer for Upper Deck trading cards who took a 3 percent stock interest in consideration for providing his client with a "Hail Mary" start-up loan. Even though the court found that the underlying transaction was fair to the client and even suggested that the loan was necessary for the company's survival, the court held that the attorney had failed to comply with the prerequisites of the lawyer client business transaction rule by neglecting to advise his client's board to seek separate counsel and by failing to inform the client about potential conflicts. As a result, the lawyer forfeited his entire equity interest, valued at nearly $33 million. This case is no aberration, as many states recognize a presumption of undue influence in any attorney client business transaction.

Along with loss of the value of the equity, other bad outcomes may include being sued by either the client (or other clients, alleging divided loyalty) for legal malpractice or breach of fiduciary duty or by third parties who relied to their detriment on documents drafted or reviewed by the attorney. While there is a split of opinion as to "whether equity investments expose law firms to greater civil liability," civil cases against lawyers can succeed more easily or with higher damages if the client can prove a motive behind the lawyer's allegedly negligent behavior in a legal malpractice case or the lawyer's failure to use display the acme of good faith, in a breach of fiduciary duty case. The lawyer's personal equity interest can provide a handy motive to convince a jurist to find liability or to inflame a jury to increase the damages awarded. Moreover, the finder of fact may not be persuaded that a lawyer was an innocent if the lawyer had a financial stake in the client from the start of the enterprise. Compounding this problem is the very real danger that either allegations of non-negligent conduct or specific exclusions may preclude coverage for such lawsuits.

At least two representatives of insurance carriers have advised against taking stock or stock options in lieu of fees. Anne Thar, then the vice president and general counsel of ISBA Mutual Insurance Company, stated that this kind of investment carried not only ethical, but also financial and malpractice risk and counseled her readers to refrain from taking stock for pay. If so inclined, she believed that a lawyer could, however, make a "straight investment in the client." The Attorneys Liability Assurance Society ("ALAS") opined that lawyer-client business transactions were a threat to "become an unmanageable crisis within the legal profession [because of the] risk that the lawyer's independence, objectivity and judgment will be compromised."

Anne Thar provided a helpful list of practice pointers for those lawyers who feel drawn to investing in their clients. Her hints include: careful screening of potential clients in which to invest, requiring each investment to be approved by all partners or a committee, having the client sign a detailed disclosure and consent statement; setting a limit on the amount of each investment, considering all investments to be made by the firm as a whole and not by individual
lawyers, requiring the investment to be held for a minimum period of time and reviewing your legal malpractice policy for coverage. (fn69)

Notwithstanding all preventive measures, however, the most critical of the commentators reviewed, Professors Dzienkowski and Peroni argued persuasively against investing in a client, and even believe that there should be a presumption against it. (fn70) They articulate several reasons for this conclusion.

Professors Dzienkowski and Peroni felt that the opinions granting an ethical imprimatur on client investment in lieu of payment are too naive. According to them, opinions such as ABA Op. 00-418 ignore both the presumption against attorney-client business transactions found universally in the case law and the harmful remedies a court can fashion against the lawyer for even the most isolated and technical non-compliance with Rule 1.8(a) or the common law prerequisites of the business transaction rule. (fn71) Further, these two believed that such ethics opinions understate the complexity, including the nature of extent of actual and potential conflicts, involved with the financial transactions at issue. (fn72) None of the ethics opinions, according to this article, give comprehensive consideration to the kind of consent document a client must sign for such a document to be effective. (fn73) The professors stated further that many of the ethics opinions do not take into account the fact that lawyers will only want client equity if they acquire it at less than public market value. (fn74)

On one hand, the opinions of Professors Dzienkowski and Peroni appear to be informed by a cynical view of private practitioners. (fn75) In their conclusion, they speak in negative absolutes about the lawyer's inability to give independent advice when her personal financial interest in the client equity may be harmed thereby. In arriving at this conclusion, the professors ignore the fact that, since time immemorial, lawyers have managed to offer independent advice even when doing so might jeopardize their financial well-being, such as when a lawyer gives an unwanted opinion to a major client. On the other hand, the other commentators have not thought through the factual complexities of taking client equity with anywhere near the level of detail as have the professors. Many of the ethics opinions and other articles are superficial by comparison and the skeptical reader may wonder if they felt compelled to give their imprimatur to this practice since so many brothers and sisters at the bar had already engaged in it.

Part II of this series will consider when, and under what circumstances, Connecticut courts and disciplinary bodies will align themselves more closely with those who criticize and caution against taking client equity for pay, or with those who give it the seal of approval, as long as the lawyer complies with the applicable ethics rules.

Footnotes:

1. Stephen L. Sapp, "Legal and Ethical Considerations of Investing in Your Client," 14th Annual Intellectual Property Law Course, 3/3/01 ("Sapp"), p. 1 (Accessed 5/1/09). [Author's Note: Citations of works printed from the Internet will reflect the page citations as printed and the date they were so accessed.]

3. This article shall not discuss either the application of securities laws to the payment of client equity for legal services or discuss the situation governed by Rule 1.8(i) in which the property acquired is the subject matter of litigation.


5. See, for example, ABA 00-418, p. 3, and fn. 7. This footnote cites other sources, such as the 1998 proposed official draft of the Restatement (Third) of the Law Governing Lawyers, Section 126 comment a.; G.C. Hazard and W.W. Hodes, *The Law of Lawyering* (2d ed. 1998) Section 1.8:202 et seq. and C. Wolfram, *Modern Legal Ethics* (1986) Section 8.11.2 for the proposition that "Rule 1.8(a) applies when a lawyer accepts an interest in the client in connection with a fee for legal services."


7. NYC 00-3, p. 4.


9. DC Op. 300, p. 3.

10. Id.

12. Rule 1.8(a) (1)-(3), Connecticut Rules of Professional Conduct ("Conn. RPC"). "Reasonable" or "reasonably" are defined in the Rules, when referring to a lawyer's conduct as "the conduct of a reasonably prudent and competent lawyer;" Rule 1.0(i); and "informed consent" is defined as "the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of action." Rule 1.0(f).

13. Scope, Conn. RPC.


17. D and P, pp. 32.

18. Id., pp. 32-33.

19. Id., pp. 33-34.

20. Id., p. 34.

21. Id., p. 35.

22. Id.

23. Id., pp. 16-17.


25. ABA Op.00-418.

26. Id.


28. Id.

29. Id., p. 34.

30. Id.
31. Id., p. 41.

32. Id., p. 42.

33. Rule 1.5(a), Conn. RPC.


35. NYC 00-3, p. 7; DC Op. 300, p. 2.

36. In relevant part, (1) the time and labor required, the novelty and difficulty of the legal issues and the requisite skill, (2) the possibility, if communicated to the client, that the particular employment will preclude work, (3) the customary fee, (4) the amount in question and the results obtained, (5) time limits of the client or from the circumstances, (6) the nature and length of the relationship with the client, (7) the experience, reputation and ability of the lawyer doing the work and (8) whether the fee is fixed or contingent. Rule 1.5(a) (1)-(8).

37. Sapp, pp. 1-2 for examples.

38. ABA 0018, p.5; NYC 00-03, p. 8; DC Op. 300, p.2 and D and P, p. 32.


40. DC Op. 300, p. 5.

41. Sapp, p. 9; ABA 00-418, p. 5 (which suggest separate evaluation performed at this time of both the stock and the work to be performed); Col. Op. 109, p. 4 and D and P, p. 36.

42. Iowa Op. 02-01, p. 2.

43. Id., Col. Op. 109, p.3.

44. Id., p. 4; D and P, p. 37; NYC 00-3, p.8.

45. Rule 1.7(a) (2), Conn. RPC.

46. ABA 00-418, p. 10.


50. Id., p. 40.
51. *Id.*

52. *Id.*, p. 23.

53. Rule 1.7(b), Conn. RPC. "Reasonable believes" denotes "that the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable." Rule 1.0(j).

54. ABA Op. 00-418, p. 10.

55. NYC 00-3, p. 6.

56. *Id.*

57. Rule 2.1, Conn. RPC


59. ABA Op. 00-418, p. 6.


61. Thar, p. 2.

62. D and P, pp. 43-44.

63. *Id.*

64. *Id.*

65. Thar, p. 2.


69. Thar, p. 2.


71. *Id.*, p. 22-23.

72. *Id.*, p. 23.
73. Id.

74. Id.

75. In fact, Professors Dzienkowski and Peroni go so far as to say that, "lawyer investments in client equity have been driven by lawyer greed and receive client 'consent' because of a perceived value of being as sociated with a major Silicon Valley law firm." D and P, p. 48.