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ETHICS FOR BUSINESS LAWYERS REPRESENTING START-UP COMPANIES

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ABSTRACT

Starting in the 1990s, it became an increasingly common practice for lawyers—particularly Silicon Valley lawyers—to take an equity investment in the business ventures of their new clients. While the practice lulled somewhat in the aftermath of the burst of the dot-com bubble, it is becoming relevant again as the market for stocks of high-tech companies has been gaining strength in the wake of the economic recovery from the recent Great Recession. This Essay explores the ethical issues as well as the general business considerations that arise in connection with the practice of taking stock in lieu of payment of legal fees in cash, which has long been the traditional billing practice for legal services. For reasons that are described in detail in this Essay, many academics and experienced venture capital lawyers believe that taking stock in a client presents significant potential to strengthen the lawyer's relationship with the new business client. At the other end of the spectrum, there are others within the legal community (both academics and practicing lawyers) who just as strongly believe that these equity investment arrangements significantly undermine time-honored ideals that have long guided the legal profession in determining how corporate lawyers should go about fulfilling the ethical and fiduciary obligations that they owe to their business clients. This Essay describes the advantages and disadvantages of these equity fee arrangements in order to address the fundamental public policy concerns presented by the growing practice of taking stock in payment of legal fees—namely, whether this practice serves the client's best interests, and separately, whether these arrangements also serve the best interests of the legal profession.

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I. INTRODUCTION

Starting in the 1990s, it became an increasingly common practice for lawyers, particularly Silicon Valley lawyers, to take an equity investment in the business ventures of their new clients.[1] While the practice lulled somewhat in the aftermath of the burst of the dot-com bubble, it is becoming relevant again as the market for stocks of high-tech companies[2] has rebounded in the wake of recovery from the recent Great Recession. Indeed, the timeliness of this topic is reflected in the focus of this Symposium—venture capital investments in IP-based start-ups.

It had long been the view of the legal community that such equity investments present conflicts of interest between lawyers and their business clients, which would then trigger certain requirements

[1] In 1999, the well-known Silicon Valley law firm Wilson Sonsini Goodrich & Rosati ("Wilson Sonsini") took stock as part of its compensation for legal services rendered in connection with the initial public offering ("IPO") transactions of thirty-three of the fifty-three companies that the firm represented in IPO transactions that year. To illustrate just how lucrative these arrangements can be for law firms (and their owners), it has been reported that Wilson Sonsini's holdings in twenty-four of those fifty-three companies were valued in excess of $1 million *each* at the close of the first day of trading. Debra Baker, *Who Wants to Be a Millionaire?*, 86 A.B.A. J. 36, 37 (2000); Peter D. Zeughauser, *The New Math: Associate Pay Raises Will Have a Domino Effect on the Entire Legal Industry. Clients Will Build In-House Empires, and Many Firms Will Collapse*, 23 LEGAL TIMES, no. 18, May 1, 2000, at 46 ("Wilson Sonsini Goodrich & Rosati's investment partnership took in $88 million in first-day gains on its top three IPOs last year; the average Wilson Sonsini partner owns a $2 million share in the investment partnership."); *see also* Robert C. Kahrl & Anthony Jacono, *"Rush to Riches": The Rules of Ethics and Greed Control in the Dot.com World*, 2 MINN. INTELL. PROP. REV. 51, 54 n.1 (2001); *see also* Sharon Mary Mathew, Comment, *Stock-Based Compensation for Legal Services: Resurrecting the Ethical Dilemma,* 42 SANTA CLARA L. REV. 1227, 1229-30 (2002). This investment practice is not limited to Wilson Sonsini. Indeed, Wilson Sonsini's cross-town rival, Cooley LLP (then named Cooley Godward LLP), also reportedly made lavish returns on its equity investments in law firm clients. *See* Baker at 37. *See generally* Donald C. Langevoort, *When Lawyers and Law Firms Invest in Their Corporate Clients' Stock*, 80 WASH. U. L.Q. 569 (2010).

[2] For purposes of this Essay, I assume that the new business client is to be organized as a corporation, which is the most common scenario likely to be faced by an attorney considering investing in an emerging growth business that will be competing for professional venture capital financing. Although many of the points that I will describe in this Essay will be applicable to an equity investment in a non-corporate business entity, such as a limited liability company or a partnership, any specific discussion of an investment in these other forms of business entities is beyond the scope of this Essay.

under the relevant rules of professional responsibility.[3] While it is widely regarded today that the lawyer's equity investment in the new client can be structured in a manner that is in compliance with the lawyer's professional responsibility requirements, this Essay asks the more profound (and perhaps more provocative) question, namely: Do these equity investments, particularly investments in growth-oriented companies that compete for venture capital financing, in fact present a conflict of interest between the lawyer and the new client corporation?

This Essay explores the ethical issues as well as the general business considerations that arise in connection with the practice of taking stock in lieu of payment of legal fees in cash, which is otherwise the customary billing practice for legal services. As described in more detail below, many academics and experienced venture capital lawyers believe that taking stock in a client presents significant potential to strengthen the lawyer's relationship with the client. At the other end of the spectrum, there are others within the legal community (both academics and practicing lawyers) who just as strongly believe that these equity investment arrangements significantly undermine time-honored ideals that have long guided the legal profession in determining how lawyers should go about fulfilling their ethical and fiduciary obligations to their business clients. This Essay does not take a position on the current practice of taking stock in lieu of fees. Instead, this Essay describes the advantages and disadvantages of these fee arrangements and leaves it to the reader to decide whether the practice of taking stock for fees is in the client's best interests, and in the best interests of the legal profession, and therefore is to be encouraged rather than prohibited.

II. CLIENT SCENARIO

The following passage provides a fairly typical description of a scenario that ultimately leads a lawyer to invest in a new corporate client, thereby providing the reader with a succinct summary of the factual backdrop for the issues to be explored in this Essay:

> An entrepreneur with a promising idea for a high-tech product walks into a [Silicon Valley] lawyer's office [seeking] corporate [legal] assistance. He wants the lawyer to set up a corporation, which will develop

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[3] For purposes of this Essay, I will rely on the ABA's Model Rules of Professional Conduct to provide the relevant guidelines for the lawyer to determine whether the proposed equity investment in the new client corporation is undertaken in a manner that is consistent with the lawyer's professional responsibilities to the new client. *See generally* MODEL RULES OF PROF'L CONDUCT ("Model Rules").

> and eventually sell his idea, and to act as its principal counsel. Because the corporation will need large infusions of money for research and development costs, he selected this particular lawyer for his venture capitalist connections; he knows the lawyer will introduce him to potential investors and business advisors. As the lawyer listens to his [prospective] client's proposal, he thinks that it could be very profitable for investors. [The lawyer agrees to represent the new business, at which point the entrepreneur explains that he does not have the cash resources to pay the lawyer's legal fees. Then the entrepreneur asks if the lawyer would be willing to accept stock in the new corporation in lieu of cash payment of legal fees.][4]

While there are many ways in which a lawyer may end up owning stock in a corporate client,[5] this scenario represents a fairly typical recurring situation for lawyers who represent start-up businesses. In this scenario, the lawyer is being asked to take stock in the client as compensation (either in whole or in part) for performing legal services on behalf of the new corporate client, a fee arrangement that is often referred to as an "equity billing arrangement."[6] When faced with such a request, how should the lawyer respond?

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[4] Gwyneth E. McAlpine, *Getting a Piece of the Action: Should Lawyers be Allowed to Invest in Their Clients' Stock?*, 47 UCLA L. REV. 549, 550-51 (1999).

[5] There are other ways in which a lawyer may make an investment in a client. For example, the lawyer may directly purchase common or preferred stock in the client, either as an individual investor, or, alternatively, through the attorney's law firm. The timing of the lawyer's investment may vary as well, in that the lawyer may make the investment at the time of organizing the new business as a corporation, or, alternatively, may make the purchase at a subsequent stage in the life of the company, such as during the course of a subsequent venture capital financing transaction, or even later as part of an IPO. This Essay, however, focuses on the situation where the lawyer acquires stock in the client as part of the lawyer's compensation for performing legal services in connection with the formation of the new corporation, a fairly typical recurring situation in the legal community, especially for lawyers who represent high-tech start-up businesses of the type that are the focus of this Symposium.

[6] This type of equity billing arrangement can take different forms. Among the more common practices, the corporation issues "shares of its stock to the attorney in lieu of payment of cash fees. The issuance may be at the outset of the engagement or [later] in exchange for fees already incurred . . . . [Alternatively, the] attorney [may agree] to defer billing until the client receives its first round of financing, in return for which the attorney receives stock . . . . The stock . . . may be common stock [to be issued] at the founder price or [it may consist of] preferred

At the outset, it is important to remember that the practice of transactional law is itself a business. That is to say, the transactional lawyer will charge a fee for his or her legal services and the client is expected to pay these fees. Until quite recently, the traditional billing practice called for the lawyer to charge an hourly fee that the client was then expected to pay in cash.[7] Before considering the ethical issues that arise in connection with the alternative fee arrangement that is the focus of this Essay, it bears emphasizing that the traditional law firm billing practice is itself fraught with ethical dilemmas,[8] which are, simply put, an inherent and unavoidable part of practicing law. In other words, the lawyer will not be paid if the new corporation does not have sufficient financial resources to pay its bills, including the lawyer's fees for legal services rendered on behalf of the new corporate client. Accordingly, the lawyer, as a prudent business matter, must undertake a careful analysis of the client, its management, and its business prospects in order to decide whether to enter into what amounts to a business relationship by taking on the start-up company as a new client. This is true regardless of the fee arrangement ultimately agreed to by the parties. Therefore, it bears emphasizing that the lawyer enters into a business transaction that places the lawyer in conflict with the client whenever the lawyer decides to accept a start-up business as a new client—regardless of whether the lawyer's fees are to be paid in stock or cash.

These considerations are even more acute where the lawyer is willing to defer payment of legal fees by entering into an equity billing arrangement that calls for the lawyer to invest in the new corporation, the fee arrangement that is the focus of this Essay. Once the lawyer decides to represent the new business based on this type of equity billing arrangement, the lawyer must carefully consider whether such an investment will be consistent with the lawyer's fiduciary duties and ethical obligations to the client, which is the topic of the next section.

III. PROFESSIONAL RESPONSIBILITY AND ETHICAL CONSIDERATIONS

The very essence of the attorney-client relationship rests on the long-standing, fundamental premise that the client depends on the lawyer to provide sound legal advice and independent judgment that is

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stock [which is to be] issued in the first round of [venture capital] financing." Young J. Kim & Jeffrey L. Braker, *Taking Stock in Your Client: Strengthening the Client Relationship and Avoiding Pitfalls*, BUS. LAW NEWS (The State Bar of Cal., San Francisco, C.A.), Issue 1, 2008, at 1, 22.

[7] *See* William G. Ross, *The Ethics of Hourly Billing by Attorneys*, 44 RUTGERS L. REV. 1, 2 (1998).

[8] *Id.*

not tainted by concerns regarding the lawyer's personal financial well-being.[9] As a result, the long-standing practice of lawyers has been to avoid taking stock in their corporate clients in lieu of fees.[10] In fact, until quite recently, even Silicon Valley law firms avoided making equity investments in their clients. One rather high profile example of such traditional reticence to take stock in law firm clients in lieu of fees was recounted by Bill Fenwick, one of the founders of the well-

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[9] The history of billing practices within the legal profession has been succinctly described as follows:

> In early Rome, legal advocates contributed their services free of charge and laws were passed against the peddling of legal services for monetary gain. Even after Emperor Claudius issued a decree allowing for the payment of legal fees up to a maximum amount, an attorney did not have a right to collect those fees if the client declined to pay. Although attorneys' fees in the United States are definitely a matter of course and both blessed and prescribed by law, attorneys, especially attorneys at large law firms, are still loath to discuss the matter of fees with clients. Although most lawyers have new clients sign representation agreements, lawyers prefer not to focus on fee matters when counseling clients, much like a physician treats a patient in an examination room without any mention of the cost of the office visit. Because of the desire to be part of a profession, not a vocation, many attorneys in this century have avoided talking about fees until the end of a representation and then simply have sent a bill for "legal services rendered."
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> In the latter half of [the twentieth] century, hourly billing became the convention among most U.S. attorneys. The practice has been an integral part of life at traditional law firms where leveraged young associates, hoping to one day be partners, used to toil for the benefit of current partners on work steadily and loyally provided by long-term clients.

Christine Hurt, *Counselor, Gatekeeper, Shareholder, Thief: Why Attorneys Who Invest in Their Clients in a Post-Enron World Are "Selling Out," Not "Buying In,"* 64 OHIO ST. L. J. 897, 902 (2003).

[10] *See* John C. Coffee, Jr., *The Lawyer as Gatekeeper: Legal Ethics, Professional Independence and the New Compensation*, COLUM. L. SCH. REP., Spring 2000, at 44 ("For the thirty-odd years that I have practiced law, New York firms have resisted stock as payment for legal services, viewing the practice as suspect at best."), *quoted in* John S. Dzienkowski & Robert J. Peroni, *The Decline in Lawyer Independence: Lawyer Equity Investments in Clients,* 81 TEX. L. REV. 405, 408 n. 10 (2002). It bears mentioning that the same ethical issues arise regardless of whether the ownership interest is acquired directly by the individual lawyer, or alternatively, by the lawyer's firm, or (in taking advantage of an investment opportunity offered to the lawyer) by an investment partnership controlled by the individual lawyer or by members of the lawyer's firm.

known Palo Alto, California, law firm of Fenwick & West, who turned down shares in Apple Computer's IPO:

> [W]e incorporated Apple Computer and represented them exclusively for a number of years. At one point, at a very young point in their development, they wanted us to take $50,000 off of our fees in stock. And, quite frankly, I had come from the East and . . . there are a host of problems you've got to deal with if you're going to do that. Well, that $50,000 that they wanted us to take in stock was worth $12 million when they went public, so that is a pretty humbling experience.[11]

This long-standing perspective on equity billing arrangements began to erode in the 1990s and quickly became the subject of numerous lawyer requests for guidance from their bar ethics committees as to the propriety of such fee arrangements.[12] Ultimately, in 2000, the American Bar Association ("ABA") issued its guidance under ABA Rule 1.8 (the ABA's general rule on conflicts of interest with respect to current clients)[13] concerning equity billing arrangements.[14] Without a doubt, those who object to the use of

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[11] Bill Fenwick, *Remarks at the American Lawyer Media Roundtable: Building a Technology Law Practice: Let's Make This Equitable—How Flexible Must Firms Be on Pricing?* (Aug. 1999), at WL 8/1999 Recorder SF S5, *quoted in* Dzienkowski & Peroni, *supra* note 10, at 413 n. 24. For a more detailed description of equity billing arrangements used by many high profile Silicon Valley law firms, *see* Kevin Miller, *Lawyers as Venture Capitalists: An Economic Analysis of Law Firms That Invest in Their Client*s, 13 HARV. J.L. & TECH. 435 (2000).

[12] *See* Barbara S. Gillers, *Law Firm as Investor: Ethical and Other Considerations*, 1259 Pract. L. Inst./Corp. 457 (2001) (collecting cites to the views of various bar ethics committees); *see also* Dzienkowski & Peroni, *supra* note 10, at 461-77.

[13] For the convenience of the reader, the text of ABA Rule 1.8 is reprinted in the attached Appendix A.

[14] *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 00-418 (2000) [hereinafter 2000 Ethics Opinion]. In its 2000 Ethics Opinion, the ABA observed in a footnote that it was "aware that sometimes the lawyer will ask the corporation to issue her a percentage of the shares initially issued to the founders as a condition to the lawyer agreeing to become counsel to the new enterprise." *Id*. at n. 16. While the ABA declined to opine as to the "ethical propriety of the practice," other bar association ethics committees strongly discourage such practice. *See, e.g.*, *Taking Stock in Your Client as Legal Fees or as an Investment*, 2000 N.H. Bar Ass'n Ethics Comm. Op. 2 [hereinafter NHBA 2000 Ethics Opinion]. This Essay does not address the situation where the lawyer *insists* that the client issue stock in the new

equity billing arrangements largely base their objections on the ethical implications of these fee arrangements.

The ABA's 2000 Ethics Opinion emphasized that, at the very minimum, the lawyer considering taking stock in lieu of fees must ensure that the lawyer's investment in the client complies with the requirements of the relevant professional responsibility rules. Under the terms of ABA Rule 1.8 (as interpreted in the ABA's 2000 Ethics Opinion), the following conditions must be satisfied:

1. The investment and its terms must be *fair and reasonable* to the client;

2. The terms of the investment must be *fully disclosed in writing* to the client in a manner that can be reasonably understood by the client;

3. The client must be advised in writing that the client may seek the *advice of independent counsel* of the client's choice and the client must be given a reasonable opportunity to do so; and

4. The client gives *informed consent in a signed writing* to the essential terms of the investment and the lawyer's role in the investment transaction.

In the Comments to Rule 1.8, the ABA explained the basis for the Rule's requirements by observing that a "lawyer's legal skill and training, together with the relationship of trust and confidence between lawyer and client, create the possibility of overreaching when the lawyer participates in a business, property, or financial transaction with a client." Because of this possibility for overreaching, the courts, as a general rule, will strictly scrutinize the terms of transactions between lawyers and their clients to ensure fairness, with the lawyer usually carrying the burden to demonstrate that the terms of the lawyer's investment in the client is "fair and reasonable" to the client.

Accordingly, under ABA Rule 1.8, there are two main ethical issues that the lawyer must resolve at the outset of a business relationship in connection with a proposed equity billing arrangement. The first is whether the size of the fee is fair and reasonable:

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corporation to the lawyer as a condition to representing the new business as its lawyer.

> Given the variability of future outcomes at the time when the parties agree on a fee arrangement, no simple rules [as to the size of the lawyer's fee] are practical. Hence, the question largely becomes one of informed written consent by the client, which, at the very least, imposes upon the lawyer a duty of candor. When the client is less sophisticated, many of the bar opinions . . . require the lawyer to urge the client to seek separate legal representation about the fee arrangement . . . .
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> The [second] main requirement [that must be satisfied pursuant to Rule 1.8] for representation under an [equity billing] arrangement is that the lawyer must reasonably believe that the fee arrangement will not adversely affect the exercise of his professional judgment.[15]

With respect to the first requirement under ABA Rule 1.8, whether the fee is reasonable to the client, there arises the issue of hindsight bias. That is to say, even though ABA Rule 1.8 requires that the fairness and reasonableness of the transaction between the lawyer and client be assessed *ex ante*—at the time the parties entered into the arrangement and based on the information available to the parties at that time—judges will often take into account the actual large payout to the lawyer *without* also taking into account the extremely low probability of its occurrence.[16] Accordingly, a lawyer may well find that an equity billing arrangement with a client is rendered unenforceable if the lawyer (and his or her law firm) does not strictly comply with the requirements of Rule 1.8. For example, in a rather well-known California case, *Passante v. McWilliam*:[17]

> Passante, a lawyer, arranged for a $100,000 loan that was essential to the survival of his client, the Upper Deck Company. Upper Deck's board of directors

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[15] Langevoort, *supra* note 1, at 571. *See also* Poonam Puri, *Taking Stock of Taking Stock,* 87 CORNELL L. REV. 99, 127 (2001) ("While lawyers who engage in equity billing may expose themselves to discipline by their self-regulatory bodies, the reality is that professional discipline in the context of fee arrangements is very rare, particularly where competent business clients are involved.").

[16] *See* Puri, *supra* note 15, at 138.

[17] Kahrl & Jacono, *supra* note 1, at 60-66; *see generally* Passante v. McWilliam, 62 Cal. Rptr. 2d 298 (Cal. Ct. App. 1997).

> agreed to compensate Passante by giving him three percent of the company's equity. The company became successful and Passante's shares became worth $33 million, but the board refused to honor the agreement. The trial judge set aside a jury verdict of $33 million and the dismissal was upheld on appeal on the grounds that Passante did not advise his client of the need for independent legal advice. The court reasoned that the board might have negotiated a flat finder's fee for Passante had he advised them to obtain independent legal advice.
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> On the issue of independent legal advice, it is significant to note that the ethical rules do not require the client to obtain independent legal advice, only that his lawyer advise him to do so. The reality is that many technology start-up clients are financially constrained from obtaining independent legal advice. If the client does go to another law firm, it will also have to give that law firm equity, creating a never-ending domino effect due to which the client does not actually end up receiving what the ethical rules would consider to be independent legal advice.[18]

To minimize the risk that a fee paid in stock will appear unreasonable if the business should ultimately succeed (and become wildly successful—as in the case of the Upper Deck Company), the ABA's 2000 Ethics Opinion recommends that the lawyer:

> [E]stablish a reasonable fee for her services based on the factors enumerated under Rule 1.5(a) and then accept stock that at the time of the transaction is worth the reasonable fee. Of course, the stock should, if feasible, be valued at the amount per share that cash investors, knowledgeable about its value, have agreed to pay for their stock about the same time.[19]

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[18] Puri, *supra* note 15, at 138-39.

[19] 2000 Ethics Opinion, *supra* note 14, at 4 (citation omitted); *Taking Stock in Your Client As Legal Fees or an Investment*, NEW HAMPSHIRE BAR ASSOCIATION (Jan. 19, 2001), http://www.nhbar.org/publications/archives/display-news-issue.asp?id=82.

This recommendation leads to the rather obvious question—*What if the stock cannot be valued?* In that case, the ABA suggests that the lawyer agree to take a percentage of the stock to be issued by the corporate client and that:

> [T]he percentage of stock agreed upon should reflect the value, as perceived by the client and the lawyer at the time of the transaction, that the legal services will contribute to the potential success of the enterprise. The value of the stock received by the lawyer will, like a contingent fee permitted under Rule 1.5(c), depend upon the success of the undertaking.[20]

While the ABA and other commentators have analogized equity billing arrangements to the well-established lawyer billing practice of relying on contingency fee arrangements in the litigation context,[21] at least one bar association ethics committee has questioned this proposition:

> The ABA accepted without question the proposition that taking stock was like a contingent fee. The Committee is not so sure. A contingent fee in a civil case depends in large measure on the efforts of the lawyer, whereas the value of stock usually depends on the client's efforts and other factors little influenced by the lawyer's work, unless as part of her representation she is to find sources of financing or otherwise contribute directly to the client's financial success.[22]

At the same time, however, equity billing arrangements *do* resemble contingent fee arrangements in that the problems inherent in assessing the reasonableness of an equity-based fee are very similar to the problems in evaluating a contingency fee arrangement.[23] In other words, in the case of both contingency fee and equity billing arrangements, the lawyer stands to collect nothing or to collect a windfall.[24] Today, courts regularly uphold contingency fee arrangements (particularly in connection with personal injury

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[20] 2000 Ethics Opinion, *supra* note 14, at 5.
[21] *See, e.g.*, Puri, *supra* note 15, at 125, 130-31.
[22] NHBA 2000 Ethics Opinion, *supra* note 14, at n.3.
[23] *See* Hurt, *supra* note 9, at 914.
[24] *Id.*

litigation) even though the personal injury lawyer may collect a fee that, with the benefit of hindsight, seems unreasonable.[25]

The ABA's 2000 Ethics Opinion also emphasized that Rule 1.8(a) requires that the transaction and its terms must be *fully disclosed in writing* to the client.[26] According to the ABA, this requires the lawyer to do the following:

1. to *explain* so the client can understand the transaction, its terms, and its potential effects on the lawyer client relationship;

2. to *describe* the scope of the services to be performed for receipt of the stock, including whether the lawyer may retain the stock if she is terminated before all the services are performed;

3. to *inform* the client that, following receipt of the stock, matters could arise that would create a conflict between the lawyer's exercise of independent professional judgment and her desire to protect the value of her stock; and

4. to *advise* the client that, as a consequence of such a conflict, she might have to withdraw as counsel, or, at the very least, to recommend that another lawyer advise the client on the matter giving rise to the conflict.[27]

[25] *Id.* at 943.

[26] 2000 Ethics Opinion, *supra* note 14, at 5-6.

[27] *Id.* (emphasis added). In addition, at least one bar association ethics committee has recommended that lawyers take the following steps (or what are referred to by the committee as "Good Practice" Recommendations) in order to minimize the risks inherent in equity billing arrangements:

(a) Develop a [law firm] policy that addresses the issues raised by [ABA Rule 1.8(a) and other related ABA Rules].

(b) Make certain the client understands those communications that are subject to the attorney-client privilege.

(c) If stock is being acquired in payment of legal fees, keep track of the time spent performing legal services just as though the client were being billed on an hourly basis.

(d) Acquire only an insubstantial amount of the issued and outstanding stock.

(e) If stock is acquired as an investment, it should be an exchange for a cash payment of an amount that, for the lawyer, is non-material.

As a threshold matter, however, some commentators have questioned the effectiveness of requiring that the client be advised—in writing—that the client may seek the advice of independent counsel, at least as applied to the situation where the new corporation proposes to enter into an equity billing arrangement with the lawyer of the client's choice.[28] These commentators point out that, in order for the new company to take advantage of the ABA's recommendation and get *independent legal advice* as to the wisdom of the proposed equity billing arrangement with the *first lawyer*, the cash-starved newly formed company now must be advised to retain the services of yet another lawyer in order to get a *second opinion*.[29] Presumably, the newly formed company cannot afford to pay for the second lawyer's legal services in cash. Most likely, then, the start-up company will have to offer this *second lawyer* stock in exchange for his or her services in rendering an opinion as to the wisdom of entering into an equity billing arrangement with the *first lawyer*.[30] Of course, this will necessitate that the *second lawyer* advise the newly formed start-up company as to the need to seek a *third opinion* before this lawyer can accept stock in lieu of fees, thereby creating this inevitable "domino effect" in order to satisfy the requirements of ABA Rule 1.8.[31]

This "domino effect" ultimately leads many observers to conclude that the practice of requiring the lawyer to obtain *written consent* from the client may not be as meaningful as the ABA's Rules seem to anticipate because the practical reality of the situation is that the typical high-tech start-up business usually has *no* viable option other than to give the required consent.[32] So, if the new client cannot pay in cash and can only pay for legal services in stock, then it would seem that written consent will be easy to obtain from the client but may not serve the purposes intended by the ABA's rules.

Furthermore, some commentators (and practicing lawyers) have questioned whether strict compliance with the requirements of

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(f) Comply with federal and state securities laws, including determining whether the acquisition of stock will increase or complicate the client's disclosure or licensing requirements.

(g) Obtain approval from the malpractice insurance carrier.

NHBA 2000 Ethics Opinion, *supra* note 14.

[28] *See* Puri, *supra* note 15, at 138-39.

[29] *Id.*

[30] *Id.*

[31] *Id.* (referring to "domino effect").

[32] *See* Puri, *supra* note 15, at 139 ("The reality is that many technology start-up clients are financially constrained from obtaining independent legal advice.").

Rule 1.8 is sufficient to show that the lawyer's investment in the new corporate client is made on terms that are *entirely consistent* with the lawyer's ethical and fiduciary obligations to the client.[33] On the other hand, other observers take the position that "the interests of an attorney who holds stock in a [corporate] client are *aligned* with the company's because both seek to increase the company's value for the shareholders."[34] However, is this always the case? For example, very often the issuance of stock to the lawyer will be contingent on the client obtaining necessary financing.

> In such cases, the attorney will need to be attentive to the possibility that *his [personal financial] interest* in such financing (such as perhaps the attorney's personal interest in 'getting the deal done' and receiving the stock) may cloud his ability to render *independent professional advice* [as to] the requisite disclosure in connection with an investment transaction. It would be prudent for the attorney to describe in his conflicts letter to be signed by his client the various scenarios in which his rendering of legal advice might be construed as less than completely objective and impartial as a result of his holding the stock.[35]

With respect to the extensive disclosure that the ABA Ethics Opinion recommends that the lawyer provide to the client *prior* to entering into any equity billing arrangement, some commentators questioned the effectiveness of such disclosure.[36] For example, just how realistic is it to expect that the lawyer will be able to anticipate (and thus disclose to the prospective client) *all* or even *most* of the scenarios where the lawyer's ability to give independent legal advice *may* be compromised as a result of the lawyer taking stock in the client? Even if it were possible to anticipate (and thus disclose) all such potential situations where the lawyer's independence may be compromised, there still remains the question of whether such disclosure would be sufficient to mitigate the potential adverse consequences of the lawyer's investment so as to fully satisfy the lawyer's ethical responsibilities to his or her client. In the words of one leading criticism of equity billing arrangements:

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[33] *See* Dzienkowski & Peroni, *supra* note 10, at 414-15.
[34] Kim & Braker, *supra* note 6, at 23 (emphasis added).
[35] *Id.* (emphasis added).
[36] *See* Dzienkowski & Peroni, *supra* note 10, at 414.

> How can lawyers exercise independent professional judgment and offer unbiased legal advice to their clients if they have an ownership interest at stake in the venture? How can lawyers fulfill their function as gatekeepers of the securities laws if their personal equity interests in the venture will be injured by disclosure of negative information concerning the client? How can a client exercise its right to discharge a law firm, with or without cause, if that law firm has an investment in the client?[37]

On the other hand, the practical reality for many high-tech, start-up businesses, often with limited cash resources but promising business prospects, is that the only way for these new businesses to access quality legal representation is through an equity billing arrangement that calls for the lawyer to accept stock in the new corporate client in lieu of (or as a supplement to) payment of legal fees in cash.[38] Moreover, some lawyers claim that this billing practice:

> [H]as the potential to strengthen an attorney's bond with the client and can be perceived [by the new client] as a vote of confidence in the client's business prospects. [In addition, there] is anecdotal evidence that attorneys who accommodate their clients by forgoing or deferring legal fees build loyal followings by their clients.[39]

What if the lawyer is skeptical as to the viability of the new client's business prospects? These kinds of reservations on the lawyer's part lead us back to the question that was raised earlier in this Essay, namely: if the lawyer thinks so little of the entrepreneur's proposed business venture, then how can the lawyer take the entrepreneur's money to perform what the lawyer believes is ultimately likely to be fruitless legal work? Does the lawyer owe the prospective client an obligation to disclose his skepticism before taking on the new business as a client? Alternatively, will the client benefit from the lawyer's investment, especially if the entrepreneur does not have the cash resources to pay for the lawyer's services? The next section describes the advantages and disadvantages to the new

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[37] *Id.*
[38] *See generally* Puri, *supra* note 15.
[39] *See* Kim & Braker, *supra* note 6, at 42-43.

client and the lawyer that flow from a decision to enter into an equity billing arrangement.

IV. ADVANTAGES AND DISADVANTAGES OF INVESTING IN CLIENTS

Given the focus of this Symposium, this Section's discussion of the advantages and disadvantages (for both lawyers and their clients) of equity billing arrangements is positioned within the context of lawyers taking stock in high-tech, start-up businesses that plan to obtain venture capital financing. As such, this Essay does not speak more broadly to the propriety of lawyers taking stock in lieu of fees within the context of a new business for which an entrepreneur might seek legal assistance, but where the entrepreneur plans to obtain equity financing from other potential sources such as friends and family, business acquaintances, or angel investors.

The advantage of equity billing arrangements most often proffered by those who support this practice is that these arrangements provide:

> [B]enefits to cash-starved clients by providing them with a way to pay for, and thus to gain access to, premium legal representation otherwise beyond their financial reach. In addition, by associating themselves with prestigious law firms, cash-starved clients effectively rent their firms' reputation and benefit from their firms' business contacts and acumen.[40]

While this is the most frequently cited advantage to equity billing arrangements from the client's perspective, there are a couple of other advantages that are also put forth by proponents of this alternative billing practice:

> Start-up clients undergo a constant search for funding and the lawyer as investor presents an option with low transaction costs. In addition, the lawyer who has a stake in the company may be more likely to share the benefit of his business networking with the client. By involving the lawyer in the company, the client gains a business partner, in addition to a provider of legal services . . . . This arrangement greatly benefits the start-up clients.[41]

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[40] Puri, *supra* note 15, at 103.
[41] McAlpine, *supra* note 4, at 596.

Therefore, through equity billing arrangements, "the role of the high-tech lawyer often includes being a matchmaker between the client and potential investors or business advisors."[42]

From the client's perspective, the biggest disadvantage to an equity billing arrangement is that the lawyer's personal financial interests will impair his or her exercise of independent professional legal judgment in contravention of the lawyer's ethical and fiduciary obligations, as more fully described in the preceding section of this Essay. There is also the related concern that the "savvy lawyer [will use] his legal knowledge to take advantage of his unsophisticated client."[43] For many commentators, the professional responsibility rules described in the preceding section provide sufficient constraints to ensure adequate protection of the clients' interests.

Notwithstanding these potential ethics concerns, many entrepreneurs also view the equity billing arrangement as making "good business sense."[44] According to this perspective, the new client sees the outside lawyer who invests in the entrepreneur's new business as having the same motivations as the client: to bring the company's goals to fruition.[45] So, in a typical high-tech start-up scenario (such as the one described at the beginning of this Essay), the entrepreneur who contacts the lawyer is indeed the one who started the company and is often the sole owner of the new company. Alternatively, the only other investors at this point generally are "friends and family" of the entrepreneur. In this situation, it would seem that one could assume that the entrepreneur's goals are in fact aligned with the company's goals. From this perspective, having an attorney as an investor in the new company does seem to *align* the attorney's goals with the goals of both the entrepreneur and the company. Indeed, the lawyer's investment may be viewed by the entrepreneur as a vote of confidence in the entrepreneur's new business and may also have the added advantage of signaling to the new client that the attorney is a team player. In fact, these were among the arguments made by many of the Silicon Valley law firms who originally pioneered these equity billing

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[42] *Id.* at 575. It bears mentioning, however, that many practicing lawyers believe that the ethical and fiduciary nature of the attorney-client relationship obligates the lawyer to "share the benefit of his [or her] business network" with the lawyer's client, regardless of whether the client pays the lawyer's fees in cash or stock. If one believes that lawyers' professional and ethical responsibilities to their business clients include this "matchmaking function," then this eliminates this factor as an advantage to equity billing arrangements.

[43] *Id.* at 553.

[44] *See* Hurt, *supra* note 9, at 912-13.

[45] *Id.*

arrangements.[46]

Another way in which lawyers argue that equity billing arrangements *align* the interests of the lawyer and the client is with respect to the lawyer's billing practices.[47] From the client's perspective, having the lawyer take stock in the company alleviates some of the criticisms that many clients have with respect to the lawyers' traditional practice of billing by the hour.[48] Generally speaking, many clients believe that a lawyer who bills by the hour would prefer that legal work for a client fill the lawyer's calendar for a longer time, and thus result in a larger bill for legal services. If the client enters into an equity billing arrangement with the lawyer, the client often perceives that this arrangement will operate to motivate the lawyer to work more efficiently.[49] Since "the [lawyer's] piece of the pie may be worth more as the company is valued more, so the [lawyer] has the same incentive as the client to ensure that the quality of the [legal] services performed . . . is sufficiently high."[50] Moreover, since the lawyer's fee is "fixed," the client does not need to worry that the legal fee is growing excessively large (as it might if the lawyer were to bill hourly).[51]

However, this purported "alignment of interests" of the client and the lawyer must be critically examined by asking two important questions: (1) "Who is the client?"; and (2) "What are the client's true goals?"

> According to ethical rules, the corporate attorney's client is the corporation.[52] The client is not the [entrepreneur who hired] the attorney, . . . [nor is it] the current or future shareholders of the corporation. This concept becomes especially troublesome when considered in the context of a start-up company. At the point at which the attorney is contacted, the [entrepreneur] on the phone and the entity he or she represents seem to be one and the same . . . . [The entrepreneur] is the sole shareholder, the president, and one of the directors. The other officers and directors are [usually] family members [of the entrepreneur]. In

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[46] *Id.* at 930-31.
[47] *Id.* at 931.
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *See* MODEL RULES OF PROF'L CONDUCT R. 1.13 (2007).

> the beginning, the goals of [the new company and the entrepreneur] seem to be perfectly aligned. [The entrepreneur] wants her new attorney to be interdependent, not independent; she wants the attorney to be economically and emotionally invested in what [the entrepreneur] sees as her project.[53]

At the same time, however, the entrepreneur wants to obtain venture capital financing in order to launch the company's new business.

> [So] at some point, the venture capitalists will give the project seed money and become investors. They [will generally] negotiate for slots as members of the board of directors. [Generally speaking, at some point, the entrepreneur's] short-term goals [for] the company [will] become inconsistent with the company's long-term goals. In addition, [the entrepreneur] and other early [friends and family] investors may have goals that are inconsistent with [the venture capital] investors. [All of this growing tension leads to the ultimate conundrum for the lawyer as an investor in the new company:] [w]ith whose goals will the attorney [now] be aligned?[54]

Obviously, this "conundrum" is going to place a significant—if not impossible—strain on the lawyer's ability to effectively represent his or her client—the corporation. At this point, the question becomes: can the lawyer exercise *independent professional judgment* and offer *unbiased* legal advice to his or her client—the corporation—notwithstanding his *personal financial interest* in the corporation? As any experienced venture capital lawyer will attest, these tensions between entrepreneurs and their venture capital investors inevitably will arise at some point during the course of the company's life cycle, and thus the lawyer who enters into an equity billing arrangement almost certainly will find himself or herself confronting this troublesome conundrum at some point during the course of the attorney-client relationship.[55]

Faced with this inevitable conundrum, many lawyers who decide to enter into equity billing arrangements will follow the practice of taking a small percentage interest in the new company,

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[53] Hurt, *supra*, note 9, at 931-32.
[54] *Id.*
[55] *See* Dzienkowski & Peroni, *supra* note 10, at 528-35.

which they plan to hold as a long-term investment, and the size of the equity stake that these lawyers acquire in the new corporate client is not significant in the context of the lawyer's entire portfolio. While this practice may have the benefit of mitigating the lawyer's conflict of interest with the client when the inevitable conundrum arises, it bears emphasizing that the client's stated goal of "aligning the interests" of the new company with its new lawyer will probably not be achieved in any meaningful sense under the terms of this type of equity billing arrangement.[56]

Shifting focus, what are the benefits to *lawyers* who enter into equity billing arrangements with their corporate clients? First, and perhaps most importantly, lawyers "accept stock in technology start-ups because they recognize the moneymaking potential in the arrangement."[57] Another benefit to the equity billing arrangement is that it offers the lawyer "an opportunity to forge longer-term relationships with clients" because lawyers "hope that after their initial representation, clients will use them for subsequent corporate work and transactions," if for no other reason than it would be "costly [for the client] to change law firms."[58]

In addition, many lawyers (and their law firms) "view equity billing [arrangements] as a way to improve associate and partner satisfaction and, in particular, to deal with the high turnover rate of associates."[59] Especially at the height of the dot-com bubble, another reason given by law firms (especially Silicon Valley law firms) for entering into equity billing arrangements was that it was necessary for the law firm to create investment opportunities in order for the law firm to compete effectively in an environment where junior associates, as well as law firm partners, could easily go to work for start-up clients and receive lucrative stock option packages.[60] These lawyers

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[56] *Id.* at 533.

[57] Puri, *supra* note 15, at 110 (noting many lawyers are likely "motivated by greed"); McAlpine, *supra* note 4, at 551 (In addition to the substantial profit that can be made if the new company is successful, some lawyers may also be "motivated" to take stock in lieu of fees because they know that the lawyer "will negotiate the financing with the venture capitalists, [and therefore] can make sure the terms of the stock purchase are favorable to [the lawyer and] his firm for the initial [shares] and for investment in later financings. As corporate counsel, [the lawyer] can also advise the client in a manner that protects his shareholder interests and his lucrative return."). To the extent that this is the motivation for the lawyer to enter into an equity billing arrangement with a new client, this almost certainly seems to run afoul of the ethical considerations imposed on lawyers pursuant to the requirements of ABA Rule 1.8, as discussed in the prior section of this Essay.

[58] Puri*, supra,* note 15, at 110-11.

[59] *Id.* at 111; *see also* McAlpine, *supra* note 4, at 581-82.

[60] *See* McAlpine, *supra* note 4, at 581-82.

were "quick to point out that other advisors to the corporation, such as investment bankers, routinely take equity in clients."[61] Indeed, very "often the entire investment bank[er]'s fee will be contingent on the closing of the transaction."[62] The obvious response to this justification is that it has *nothing* to do with whether the equity billing arrangement promotes the clients' best interests, nor does it have any bearing on the ethical and fiduciary responsibilities of lawyers as a profession. I have long told my law students that the analogy to investment bankers is fundamentally misplaced because investment bankers, unlike lawyers, do *not* owe fiduciary duties and ethical obligations to their clients.

These advantages to law firms need to be balanced against the disadvantages associated with equity billing arrangements. First and foremost is the financial risk of taking stock in lieu of payment of legal fees. Start-up companies have a notoriously high rate of business failure which means that, if the business fails, "not only does the law firm fail to make a profit, but it will have provided free legal work."[63] In addition, there is a reputational risk to the lawyer. Some commentators have argued that lawyers who routinely represent start-up companies (and invest in these new companies) run the risk of being perceived as too closely affiliated with their clients and thus "could be placing their own reputations on the line. However, it would appear that [lawyers and their] law firms could minimize this reputational risk by engaging in greater scrutiny of the client's business plan and management team" before taking on the new business as a client.[64]

All of this leads me to the final and very personal concern that I want to raise regarding equity billing arrangements—and this concern goes to the very heart of why I decided to become a corporate lawyer. As I repeatedly emphasize to my students, I truly believe that the lawyer is the "conscience of the boardroom," and that is true regardless of whether the company is a small start-up company or a large publicly-traded corporation. To be able to meet professional obligations as a lawyer, I believe it is vitally important that the lawyer always maintain his or her independence. In the aftermath of the recent financial scandals, I believe it is more important than ever for lawyers to maintain their independence, and thus it is more important than ever for the legal profession to examine just how closely connected lawyers should be to their corporate clients. This has been made all the more important in the wake of the Great Recession as the

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[61] Hurt, *supra* note 9, at 950.
[62] *Id.*
[63] Puri, *supra* note 15, at 113.
[64] *Id.* at 115.

general public has begun to question the activities of lawyers (as well as other professionals such as auditors[65] and financial analysts) that have been perceived as being too close to their corporate clients. The legal profession must decide what is the proper role of a corporate attorney. Since I decided to go to law school because I truly believe that the law is a noble profession—a profession that requires its members to have the courage to be the conscience of the boardroom and thereby promote good corporate governance practices—any activity that calls into question the independence of the lawyer in the practice of his or her profession needs to be examined very seriously in order to protect the future of the legal profession as a "noble calling."[66]

V. CONCLUSION

It is certainly clear today that lawyers can invest in their clients in a manner that satisfies their obligations under the professional responsibility rules that govern lawyers' ethical obligations to their business clients. Indeed, many lawyers view these arrangements as having significant potential to strengthen the bond between lawyer and client and are often perceived as a vote of confidence in the client's business prospects. In addition, there is anecdotal evidence that attorneys who accept stock in lieu of fees (or defer legal fees) actually build loyal followings by their clients. Finally, with respect to start-up businesses with limited cash resources but a promising future, taking stock in lieu of fees (or alternatively, as a supplement to the payment of reduced legal fees in cash) may be the only way for these new businesses to access quality legal representation. On the other hand, there are many experienced lawyers who view these arrangements with great suspicion and as inherently presenting conflicts of interest that disable the lawyer from being able to practice law according to the highest ideals of professional ethics and fiduciary obligations. These commentators believe that it is simply unrealistic to believe that lawyers will be able to exercise independent judgment and give advice to their clients without this advice being unduly influenced by their

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[65] For an interesting analysis of the difficulties that ensnared the accounting profession in the 1990s when they expanded their business model to include an ever-expanding array of consulting services, *see* Hurt, *supra* note 9, at 950-53; *see also* Comments of Karl Groskaufmanis, *Corporate Citizenship: A Conversation Among the Law, Business and Academia,* 84 Marq. L. Rev. 723, 754-58 (2001).

[66] Hurt, *supra* note 9, at 929 ("Independence of the attorney is critical to the [lawyer's] gatekeeping function."); *see also* Dzienkowski & Peroni, *supra* note 10, at 479-84.

own personal financial well-being if the lawyer is also an investor in the corporate client. Dear reader, what do you think?

VI. APPENDIX A

SELECTED PROVISIONS - ABA'S MODEL RULES OF PROFESSIONAL CONDUCT (2004)*

Rule 1.7 Conflict of Interest: Current Clients

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

(1) the representation of one client will be directly adverse to another client; or

(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.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing

COMMENT

GENERAL PRINCIPLES

[1] Loyalty and independent judgment are essential elements in the lawyer's relationship to a client. Concurrent conflicts of interest can arise from the lawyer's responsibilities to another client, a former client or a third person or from the lawyer's own interests. For specific Rules regarding certain concurrent conflicts of interest, see Rule 1.8.

* In 2002, the American Bar Association amended its Model Rules of Professional Conduct to reflect the recommendations of the so-called "Ethics 2000" commission, which was officially known as the Commission on the Evaluation of the Model Rules of Professional Conduct [and which was chaired by former Chief Justice of the Delaware Supreme Court, Norm Veasey]. Among the various changes that were implemented in 2002 the ABA amended Rules 1.7 and 1.8 and deleted former 2.2, entitled "Intermediary."

For former client conflicts of interest, see Rule 1.9. For conflicts of interest involving prospective clients, see Rule 1.18. For definitions of "informed consent" and "confirmed in writing," see Rule 1.0(e) and (b).

[2] Resolution of a conflict of interest problem under this Rule requires the lawyer to: 1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentable; and 4) if so, consult with the clients affected under paragraph (a) and obtain their informed consent, confirmed in writing. The clients affected under paragraph (a) include both of the clients referred to in paragraph (a)(1) and the one or more clients whose representation might be materially limited under paragraph (a)(2).

[3] A conflict of interest may exist before representation is undertaken, in which event the representation must be declined, unless the lawyer obtains the informed consent of each client under the conditions of paragraph (b). To determine whether a conflict of interest exists, a lawyer should adopt reasonable procedures, appropriate for the size and type of firm and practice, to determine in both litigation and non-litigation matters the persons and issues involved. Ignorance caused by a failure to institute such procedures will not excuse a lawyer's violation of this Rule....

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Identifying Conflicts of Interest: Material Limitation

[8] Even where there is no direct adverseness, a conflict of interest exists if there is a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests. For example, a lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer's ability to recommend or advocate all possible positions that each might take because of the lawyer's duty of loyalty to the others. The conflict in effect forecloses alternatives that would otherwise be available to the client. The mere possibility of subsequent harm does not itself require disclosure and consent. The critical questions are the likelihood that a difference in interests will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.

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[33] Subject to the above limitations, each client in the common representation has the right to loyal and diligent

representation and the protection of Rule 1.9 concerning the obligations to a former client. The client also has the right to discharge the lawyer as stated in Rule 1.16.

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Rule 1.8 ***Conflict Of Interest: Current Clients: Specific Rules***

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

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and 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.

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COMMENT

[1] A lawyer's legal skill and training, together with the relationship of trust and confidence between lawyer and client, create the possibility of overreaching when the lawyer participates in a business, property or financial transaction with a client, for example, a loan or sales transaction or a lawyer investment on behalf of a client. The requirements of paragraph (a) must be met even when the transaction is not closely related to the subject matter of the representation, as when a lawyer drafting a will for a client learns that the client needs money for unrelated expenses and offers to make a loan to the client. The Rule applies to lawyers engaged in the sale of goods or services related to the practice of law, for example, the sale of title insurance or investment services to existing clients of the lawyer's legal practice. See Rule 5.7. It also applies to lawyers purchasing property from estates they represent. It does not apply to ordinary fee arrangements between client and lawyer, which are governed by Rule 1.5, although its requirements must be met when the lawyer accepts an interest in the client's business or other nonmonetary property as payment of all or part of a fee. In addition, 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 example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has no advantage in dealing with the client, and the restrictions in paragraph (a) are unnecessary and impracticable.

[2] Paragraph (a)(1) requires that the transaction itself be fair to the client and that its essential terms be communicated to the client, in writing, in a manner that can be reasonably understood. Paragraph (a)(2) requires that the client also be advised, in writing, of the desirability of seeking the advice of independent legal counsel. It also requires that the client be given a reasonable opportunity to obtain such advice. Paragraph (a)(3) requires that the lawyer obtain the client's informed consent, in a writing signed by the client, both to the essential terms of the transaction and to the lawyer's role. When necessary, the lawyer should discuss both the material risks of the proposed transaction, including any risk presented by the lawyer's involvement, and the existence of reasonably available alternatives and should explain why the advice of independent legal counsel is desirable. See Rule 1.0(e) (definition of informed consent).

[3] The risk to a client is greatest when the client expects the lawyer to represent the client in the transaction itself or when the lawyer's financial interest otherwise poses a significant risk that the lawyer’s representation of the client will he materially limited by the lawyer's financial interest in the transaction. Here the lawyer's role requires that the lawyer must comply, not only with the requirements of paragraph (a), but also with the requirements of Rule 1.7. Under that Rule, the lawyer must disclose the risks associated with the lawyer's dual role as both legal adviser and participant in the transaction, such as the risk that the lawyer will structure the transaction or give legal advice in a way that favors the lawyer's interests at the expense of the client. Moreover, the lawyer must obtain the client's informed consent. In some cases, the lawyer's interest may be such that Rule 1.7 will preclude the lawyer from seeking the client's consent to the transaction.

Rule 1.13 *Organization as Client*

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if

(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

(f) In dealing with an organization's directors, officers, employees, members, shareholders or \other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule

1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

COMMENT

THE ENTITY AS THE CLIENT

[1] An organizational client is a legal entity, but it cannot act except through its officers, directors, employees, shareholders and other constituents. * * * The duties defined in this Comment apply equally to unincorporated associations. "Other constituents" as used in this Comment means the positions equivalent to officers, directors, employees and shareholders held by persons acting for organizational clients that are not corporations

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[3] When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. Paragraph (b) makes clear, however, that when the lawyer knows that the organization is likely to be substantially injured by action of an officer or other constituent that violates a legal obligation to the organization or is in violation of law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. As defined in Rule 1.0(i), knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious.

[4] In determining how to proceed under paragraph (b), the lawyer should give due consideration to the seriousness of the violation and its consequences, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant considerations. Ordinarily, referral to a higher authority would be necessary. In some circumstances, however, it may be appropriate for the lawyer to ask the constituent to reconsider the matter; for example, if the circumstances involve a constituent's innocent misunderstanding of law and subsequent acceptance of the lawyer's advice, the lawyer may reasonably conclude that the best interest of the organization does not require that the matter be referred to higher authority. If a constituent persists in conduct contrary to the lawyer's advice, it will be necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization. If the matter is of sufficient seriousness and importance or urgency to the organization, referral to higher authority in the organization may be necessary even if the lawyer has not communicated with the constituent. Any measures taken should, to the extent practicable, minimize the risk of revealing

information relating to the representation to persons outside the organization. Even in circumstances where a lawyer is not obligated by Rule 1.13 to proceed, a lawyer may bring to the attention of an organizational client, including its highest authority, matters that the lawyer reasonably believes to be of sufficient importance to warrant doing so in the best interest of the organization.

[5] Paragraph (b) also makes clear that when it is reasonably necessary to enable the organization to address the matter in a timely and appropriate manner, the lawyer must refer the matter to higher authority, including, if warranted by the circumstances, the highest authority that can act on behalf of the organization under applicable law. The organization's highest authority to whom a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation.

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