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ABOUT THE JOURNAL

The Wake Forest Journal of Business and Intellectual Property Law is a student organization sponsored by Wake Forest University School of Law dedicated to the examination of intellectual property in the legal context. Originally established as the Wake Forest Intellectual Property Law Journal in 2001, the new focus and form of the Journal, adopted in 2010, provides a forum for the exploration of business law and intellectual property issues generally, as well as the points of intersection between the two, primarily through the publication of legal scholarship. The Journal publishes three print issues annually. Additionally, the Journal sponsors an annual symposium dedicated to the implications of intellectual property law in a specific context. In 2009, the Journal launched an academic blog for the advancement of professional discourse on relevant issues, with content generated by both staff members and practitioners, which is open to comment from the legal community. The Journal’s student staff members are selected for membership based upon academic achievement, performance in an annual writing competition, or extensive experience in the field of intellectual property or business.

The Journal invites the submission of legal scholarship in the form of articles, notes, comments, and empirical studies for publication in the Journal’s published print issues. Submissions are reviewed by the Manuscripts Editor, and decisions to extend offers of publication are made by the Board of Editors in conjunction with the Board of Advisors and the Faculty Advisors. The Board of Editors works closely and collaboratively with authors to prepare pieces for publication.

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INTRODUCTION

CREATIVE CAPITAL: INTELLECTUAL PROPERTY CREATION AND VENTURE CAPITAL

Michael S. Mireles†

This Introduction serves not only as an introduction to the Symposium, “Creative Capital: Intellectual Property Creation and Venture Capital,” held on March 25, 2011, in Winston-Salem, North Carolina, but also as an introduction to the recently renamed and refocused Wake Forest Journal of Business and Intellectual Property Law. Previously known as the Wake Forest Intellectual Property Law Journal, the new Journal has changed its focus from strictly intellectual property law topics to intellectual property law and business-related issues that may involve intellectual property law. Broadly speaking, the Journal will publish articles related to subjects ranging from the burgeoning field of entrepreneurship, business formation, technology transfer, bankruptcy, ethics, intellectual property, and venture capital. The new Journal also aims to provide short and practitioner-focused essays and articles.

† Associate Professor of Law, University of the Pacific, McGeorge School of Law. The author would like to thank the members of the Wake Forest Journal of Business and Intellectual Property Law, especially Emily Cantrell and Dirk Lasater, and Professor Simone Rose for their hospitality and excellent work on the Symposium. The author also thanks the new Board of the Journal for their excellent work on this Symposium issue.

The first Symposium of the *Wake Forest Journal of Business and Intellectual Property Law* was a well-attended and ambitious one. In keeping with the new business and intellectual property concentration, the Symposium was a partnership between the Wake Forest University School of Law, the BB&T Center for the Study of Capitalism, and the Wake Forest University Schools of Business. It included introductions from the Dean of the Law School, Blake D. Morant, and Dean of the Business School, Steve Reinemund. Also, the Symposium was timed to take place the day before the popular Wake Forest University Schools of Business’ Elevator Competition.² This competition draws a large number of venture capitalists to judge the business plans of teams of MBA students from many universities. The keynote speaker for this year’s opening night dinner was Colin Gillespie, a Wake Forest University Schools of Business graduate and Head of Global Online Marketing for LEGO. The competition awards over $40,000 in prizes for teams to commercialize their ideas.

The Symposium examined the role of venture capital and intellectual property law from many different perspectives through two panels and a keynote speech by Bob Young, CEO and founder of Lulu.com and a co-founder of Red Hat. The first panel, “Intellectual Property: From Cradle to Grave,” featured five speakers and was moderated by Professor Simone Rose, Wake Forest University School of Law.³ Robert Rehm, a partner at Smith Anderson, LLP, discussed intellectual property ownership issues from the perspective of a start-up company. The second speaker, Daniel Egger, the CEO of Open Source Risk Management, reviewed issues concerning the use of open source software for start-up and other businesses. The next speaker, Daniel Stell, the Associate Director of the Wake Forest Office of Technology Asset Management, presented several problems confronting university technology managers who evaluate inventions created by university researchers. Mike Mireles, an Associate Professor at the University of the Pacific, McGeorge School of Law, discussed the implications of the *Stanford v. Roche Molecular Sys.*, 

² For information and video concerning the Elevator Competition, see *Wake Forest Elevator Competition*, http://www.elevatorcompetitionlive.com (last visited July 12, 2011).
Inc.\textsuperscript{4} case pending before the United States Supreme Court, which concerns ownership of inventions created from federally-funded research. Finally, Dr. Sibilla Nagel, a partner with Rittershaus in Munich, Germany,\textsuperscript{5} provided a fascinating overview of some issues related to companies with intellectual property that are subject to the jurisdiction of German bankruptcy courts, among other topics.

The next panel, “Financing the IP-based Start-up,” was moderated by Kim Westmoreland, co-founder of KeraNetics, LLC and founder of six start-ups in the healthcare field, and Dr. Stan Mandel, professor at the Wake Forest University Schools of Business and Director of the Angell Center for Entrepreneurship.\textsuperscript{6} The panel included Merrill Mason, a partner at Smith Anderson, LLP; Dr. Sharon Presnell, the Vice President for Regenerative Medicine and Biology for Tengion, a biotechnology company; Therese Maynard, Professor of Law, Leo J. O’Brien Fellow and Co-Director of the Business Law Practicum at Loyola Law School, Los Angeles; and Martin Sinozich, President of Venn Capital. The discussion ranged from the suitability and cost of patents versus trade secrets to the availability of angel financing to the ethical issues related to attorneys accepting stock in their client’s companies in exchange for legal services.

The keynote speaker, Bob Young, discussed a range of issues, and his comments, \textit{Open Versus Proprietary as Business Strategy}, are transcribed and part of this Symposium issue. Some of Mr. Young’s interesting insights included: his views concerning intellectual property law as a tool depending on a company’s perspective; the financing of start-ups by “love money”—money “loaned” by relatives who never expect it to be repaid; the ability of lawyers to get in the way of business—”business” defined as satisfying the needs of customers; and the one issue Mr. Young mentioned keeps him up at

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\textsuperscript{4} Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc., 583 F.3d 832 (Fed. Cir. 2009), \textit{aff’d} 131 S. Ct. 2188 (2011). For the United States Supreme Court’s opinion, see http://www.supremecourt.gov/opinions/10pdf/09-1159.pdf (last visited July 12, 2011).

\textsuperscript{5} Dr. Nagel is currently an attorney with Eder, Zitzewitz and Koll in Munich, Germany.

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night—"the trials of being an owner of a Canadian football team. The most notable aspect of Mr. Young’s comments, which may be hard to discern from the transcript, was his incredible energy. It is difficult to imagine Mr. Young working in a cubicle for some large corporation and, as he noted, if Ritalin® existed when he was a child, he would have received a prescription for it. It was easy to understand why Mr. Young is successful in many start-up ventures after watching and listening to him speak.

As part of this Symposium issue, we also have two thought-provoking and useful essays: Dr. Sharon Presnell’s “Advancing Technology in the Context of the Competitive Landscape: An Industrial Technologist’s Perspective” and Professor Therese Maynard’s “Ethics for Business Lawyers Representing Start-up Companies.” In the first essay, Dr. Presnell takes on the exceedingly difficult and complex questions of how to track and manage new inventions from early-stage research, and when to patent or implement some other intellectual property strategy for that early-stage research in light of the specific product or service market. She argues that preparation and planning are key to commercializing new inventions and provides case studies to illustrate her points. She states that three questions should be asked concerning potential new inventions: first, “is it real?”; second, “is it novel?”; and third, “does the technology have the potential to impact future strategy (beyond existing products and platforms)?”

She emphasizes that answering these questions requires a mix of expertise, whether technical, business, or legal.

Dr. Presnell argues that ongoing research should be carefully observed to ascertain whether there are any new potential patentable or marketable inventions arising from that research, and to analyze those inventions against what is already on the market or published. This observation must be deliberate and careful to avoid missing any new inventions that could be commercialized and to ensure that there is a clear path to commercialization considering the prior art and market need. As part of this process, she proposes the expenditure of capital to reduce the invention to practice early at the concept stage to facilitate the initial drafting of claims that actually cover the (eventually) commercialized product or method if a patent application is filed. Emphasized through a case study, she also warns that early patenting can result in claims that may not cover the commercial device and in a loss of patent term. She also states that an intellectual property strategy should include an evaluation that considers whether

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patent protection or trade secret (or both) is best suited to protect the invention.

In the second essay, Professor Maynard addresses the ethical issues surrounding an attorney’s acceptance of stock in a start-up, high-technology corporation as payment for legal services. The conflict of interest appears clear: the interests of the lawyer/stock-owner may not always be aligned with the interests of the corporation and, thus, the lawyer’s advice may be skewed to protect his or her own best interests and not the client’s best interests because the lawyer is biased. However, as Professor Maynard notes, there is general acceptance of this practice as long as certain precautions are taken to protect the corporation’s interests, such as compliance with the rules set forth in the ABA Model Rules and comments. In her essay, Professor Maynard analyzes the applicable ABA Model Rules and Comments, and points out issues in complying with the rules. Professor Maynard also analyzes the asserted advantages and disadvantages to continuing this practice. Some of the advantages include the provision of adequate legal representation for clients that otherwise could not afford such advice, advantageous business networking through the attorney for the client, an incentive for attorneys to work efficiently for their clients, and increased loyalty between the client and attorney. Disadvantages may include the attorney taking advantage of the client’s trust by overreaching and advising the client in a way that may not be in the client’s best interests, and a financial risk to the attorney. Professor Maynard concludes, in light of the recent financial scandals, that the issue should be viewed through the lens of the lawyer as the “conscience of the boardroom,” and a lawyer’s independent judgment should be carefully guarded. She astutely asks the reader “What do you think?”

Finally, thank you to all of the hosts, participants, contributors and presenters in the 2011 Symposium for the Wake Forest Journal of Business and Intellectual Property Law.

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KEYNOTE SPEECH: OPEN VERSUS PROPRIETARY AS BUSINESS STRATEGY

Bob Young†

Thank you very much, that is a wonderful advertisement¹, so you now all know where to go to publish all of your great treatises on the law, that are of course all going to become best sellers. When I get introductions like that, it reminds me of a story I had three years ago. I have three daughters. My eldest is now working in New York, but when she was a senior in high school she came into my office at the house, and was asking me about something, and I kept changing the topic, and finally she got exasperated and she stopped me and said, “Dad you’ve got the worst case of A.D.D. of anyone in my high school.” And it was one of these really insightful moments. Had there been Ritalin when I was a kid, I too could have gone to Wake Forest Law School (laughter).

So there’s hope for me yet, for all the Red Hat project, I brought a selection of hats here, just in case we get confused and I switch stories too quickly, I’ll just switch hats so you can stay on topic of which story we’re on. But prior to Red Hat, I actually started two other companies, both of which were in the computer leasing business. One of them is still in business. If you go to Atlanta and try to rent a computer or audio-visual equipment, one of your options will be Vernon computer rentals. They also have an office in Washington, and one in Toronto, and that business was started in our spare bedroom in Toronto.

Red Hat was started in my wife’s sewing closest in Connecticut in 1993, and Red Hat today—I can’t take much credit for

† CEO and Founder of Lulu.com, Co-Founder of Red Hat.
¹ Referring to his introduction by Professor Simone Rose, which detailed the services provided by Lulu.com and Red Hat.
this, this is the smart guys that have been running it since I left—but Red Hat today is a member of the S&P index of the 500 most influential stocks. So if you’re tracking stock market performance and you’re looking at the S&P index, one of the 500 most influential stocks on the planet according to the S&P people, was started in my wife’s sewing closet fifteen years ago. I don’t know about you guys, but this is one that is just . . . the world is just a weird and wonderful place when you realize that is possible.

But coming back to the theme of what keeps me going, besides my A.D.D., and my A.D.D. is a real problem, I tend to bail on projects way too early, I’m not nearly as consistent, I’m not as disciplined, I’m not as organized, and I’m not as committed to my projects as I need to be. So A.D.D. is not a good thing when you leave and you think, “Oh good, I’ll just develop some A.D.D.,” don’t do it. My coping mechanism, which took me a long time to figure out, is to surround myself with people who don’t have A.D.D. Which is why I’m really here recruiting.

But what I thought I’d talk about for a couple of minutes, and then I’d much rather take questions and sort of talk about what you guys want to talk about instead. How many of you guys are lawyers, or aspiring to be lawyers? So basically, all I’ve got for you guys is bad news. (laughter) The world doesn’t revolve around you. In fact, the world operates despite you guys. I’m a card carrying member of William Shakespeare’s line of “first thing we do, we kill all the lawyers”.

So let’s talk a little bit about the context from my point of view, as someone who truly hates lawyers—and don’t take it personally, I don’t hate any one of you guys. I particularly like Kimberly, but I hate the concept of the lawyers. I hate the idea that I have to ask permission before I can do things. I have to think about all the bad things that can happen to my idea before I even take the first step out of my front door. And interestingly enough, I’ve been hugely successful in large part because my A.D.D. precludes me from talking to lawyers before I leave my front door. I’ve been successful in large part because I ignored the law, as much as I can. And I’m not the only one. Bill Gates, Microsoft Corporation, one of the most successful American corporations in the history of American corporations, you know, was found guilty by the US Department of Justice on multiple occasions, precisely because they ignored the law, and they didn’t intentionally break the law. Hold on, this is Microsoft

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OPEN VERSUS PROPERITARY AS BUSINESS STRATEGY

(laughter); most of us don’t intentionally break the law, our focus just is not on the law.

Our focus is on one thing, and for almost all of us successful guys, we prioritize one thing above all else, and it’s our customers. We do what our customers need us to do. You know, if we happen to be selling crack on the streets of Winston-Salem, oh wait, they don’t sell crack here, on the street of . . ., we intentionally break the law in order to do that particular activity serving our customers. But most of us are just busy trying to look after customers, and we only look at the law as an after-the-fact phenomenon. We only look at it if it turns out there is a rule that we’ve been breaking or our customers want us to break, in which case we have to do the old analysis of, ok, do we go to jail, and if we go to jail, for how long do we have to go to jail, cause if it ain’t very long, we might ignore that law.

The other one is: is anyone enforcing the law? And I would argue, that [the laws not being enforced are] the single most common laws that we break. Public servants, whether they’re in Washington, or—I was listening to [a program about] the European experience, and wow, we get a little bit of that in the U.S. I’m Canadian, and a little bit more of it in Canada, where each province in Canada has its own set of laws, but it’s part of a country and they have conferences trying to pull them together all the time, which is a little of what Europe is trying to do right now—but when you elect someone and you send them to Washington, he believes he is there, and I don’t care if he is a Republican or a Democrat, he believes he is there to pass laws to make the world a better place. And what he almost, constantly, and I use “he” in a non-gender specific sense, “they” do, is they lose track of the fact that the world is . . . what’s the expression? “The road to hell is paved with good intentions,” and it’s not any one of the laws that these guys are passing that’s a pain in the neck for us entrepreneurs. It’s the cumulative burden of all these laws that drive you nuts. And it’s why we ignore most of what you guys (lawyers) tell us most of the time. Because if we didn’t, we wouldn’t get out of bed in the morning, because there is, somewhere, a law against getting out of bed in the morning . . . I’m not kidding, the cumulative burden of all the laws.

So Microsoft got into huge amounts of trouble because they recognized that in the technology industry no one was policing all of the antitrust laws that had been developed since the 1930’s, actually before that, and so there were laws that Microsoft was quite clearly breaching with their inclusion of new technologies and their extensions of monopolies they had into new fields, but they go, “this is what our customers want us to do, and no one is policing this thing, why would we obey a law that no one seems to care about in our field?” And for all that, I’m a competitor of Microsoft, and I’ve sort
of lost an admiration about how well run a company they are . . . that is, you know I have a lot of admiration for what Microsoft does, and people in the open source world sort of worry about me when I start talking in admirable terms about the “evil empire.” I go, “Ok, but you have to understand, these are really good guys, they’re trying to look after their customers.” I’ll admit that they do evil things, but what you’re lost in admiration for is they do them so well (laughter), but that’s being mean to the guys at Microsoft, because they don’t mean to do evil things, they mean to look after their customers, and that is their primary goal. If in the process of looking after their customers they end up putting guys like me out of business, is not their business. That’s a little bit sometimes where you guys come in, and that’s where the legal framework is important, that we operate in. So that was the first thought I wanted you to think about: that you guys are not relevant, you may be necessary, but our job is to ignore you guys as much as we can.

The other thought talking about intellectual property more narrowly, as it affects open source and all the rest of it, I’ve seen both sides now. I serve as a board member of a medical device company in Raleigh called nContact. If any of you are suffering from A-Fib, arterial fibrillation, or if you have a relative who is, pay attention to what nContact is doing. They have devices that are truly revolutionary in that field. But nonetheless, as a director, I worry more about their patent portfolio and the health and the relevancy of their current patent portfolio than I worry about anything else they do, and yet, with Red Hat, I worried precisely about the opposite. I worried about everyone else’s patent portfolio, and the fact that those patents were going to inhibit our ability to serve our customers.

So one of the thoughts for you [to consider], and why particularly in the technology industry, we try and avoid the law as much as we can, is [that] we move so damn fast. And we’re not moving quickly; [it’s] the demand. You know, the reason technology companies are moving so fast is not because we want to move quickly. We kind of like the world the way it is, like everyone else does. You know you hear all these guys at start-up conferences, saying, “we’re out to change the world,” and I always sort of put my hand up at the back and go, “uh, what if you make the world a worse place?” I’m trying to remind them that their goal is not to change the world; their goal is to make the world a better place. But nonetheless, I subscribe to Adam Smith, the old Scottish philosopher slash economist’s view of life, which is, the invisible hand of the market, [and] the idea that a bunch of businessmen, working in their own self interest, will make the world a better place at a faster clip than the most enlightened monarch, in his day, and today, the most enlightened government.
The reason for that—and this is fundamentally true—and the reason it is true, is that businessmen, unlike the government, are out to look after their customers, and in a free market democracy, the citizen and the consumer are exactly the same person. So you can solve social problems in the marketplace more effectively than you can solve problems anywhere.

So, as an example, and we’ve all sort of read the press, we know how evil Walmart is. The question you want to ask yourself is, “what’s the biggest single factor in the United States, since the second World War, to reduce the disparity between rural poverty and urban wealth?” In other words, what government program has had the biggest impact on raising the standard of living of rural Americans? And I would put it to you that it is Walmart. What Sam Walton recognized was that the cost of consumer goods in rural America was dramatically higher than the cost of the same consumer goods in urban America. He was able both to make his family among the richest families on the planet and solve the societal problem, making rural American’s wealthier by reducing their cost of living in rural America, and that is what drove Walmart’s success. For the first, you know, whatever, thirty to forty years of Walmart’s existence, they stayed in rural America because they knew where the problem was that they were addressing, and rural Americans paid them handsomely. I don’t know if you remember Yakov Smirnoff, the comedian, but you start thinking about this dynamic, and in a free market democracy, our society will pay us—you know as businessmen—it will pay us for making the world a better place. So the more you make the world a better place, the wealthier you get, is this a great country or what!?

So that’s the concept I want to leave you with: that sometimes your advice to your client on intellectual property issues is almost too late, that if you start slowing down and [he] starts patenting his innovations he won’t be serving his customer fast enough, and that was the whole trick behind this Red Hat project. What we recognized was that computer operating systems were one of the fastest moving pieces of technology in technology, with of course, technology being the fastest moving part of our society. So, prior to us and the open source movement getting going, the model for building technology was: IBM built their operating system, and Sun Microsystems built theirs, and Microsoft built theirs, and none of those teams talked to each other, and they all spent more time talking to lawyers than they spent talking to their customers. What we saw as an opportunity was not this sort of revolutionary, you know sort of, mount the barricades thing, it was a very practical business issue. Our customers needed us to evolve the operating system faster than the previous proprietary
binary—only model was enabling those billion dollar competitors to do.

So starting in 1996, Red Hat won the first of five consecutive InfoWorld Product of the Year awards for operating systems. In 1996, when we won the first award from InfoWorld we were as shocked by this award as anyone else in the industry, because we knew that we had a grand total, including you know packaging people in our warehouse, a grand total of fifty employees and the smallest of our competitors was doing $5 billion worth of sales every year. Our competitors were Sun Microsystems, Apple Computers, IBM, and Microsoft, and we were the one that won the Product of the Year award. The reason we won the Product of the Year award is we were able, working with this collaborative model where we could get all of our customers, and all of our partners, and literally the whole world to help us move this technology forward, we were able to do something for customers that our larger competitors could not, and that’s what drove our success. It was not a belief in open source, it was not that every consumer decided they would rather have freedom over tyranny—I mean we all like freedom over tyranny, but none of us are going to pay 10% more to get freedom over tyranny (laughter), so freedom had better deliver something better than tyranny does and it had better be something more valuable than a 10% discount. So that’s what drove the Red Hat success.

With that, I’ll go back to Lulu. I have to put my Lulu hat on, and there’s a reason for this. My colleagues at Lulu say, “Bob, why the hell are you wasting your day going down to Wake Forest to talk to them about intellectual property?” And I don’t really have a good answer other than Kimberly told me I had to, so here I am. Except, so, if I am going to be talking to you, I work on the internet advertising payment model, you know on internet advertising it’s all about number of impressions, so by wearing my Lulu hat, and talking to you redundantly over and over again for the next six hours, I mean how many impressions does that count for? At two cents an impression I should earn, well, you see where I’m going. (laughter) What do you guys want to know instead of what I’ve rambled about? Any questions? Any good ideas? Are lawyers actually relevant?

Q: Can you tell us what intellectual property issues are you facing at Lulu?

Intellectual property issues at Lulu, that’s actually a good one. I’ll admit to when I speak publicly I try and speak in black and white, because it just makes for a more interesting conversation. Of course the world isn’t black and white. The world is full of shades of grey,
but shades of grey get really boring. So I actually do pay attention to intellectual property rules, and Lulu, what we’re trying to do at Lulu is reinvent the concept of publishing. So the publishing industry is one of the world’s oldest. Ever since Gutenberg invented the printing press, and as a result, you talk about law. There is more law in publishing, by jurisdiction; I mean you get different publishing rules in North Carolina than you do in New Jersey, and then you start looking at Albania versus Luxembourg, and some of the laws are really bizarre. Did you realize you are not allowed to discount a book in Germany? Period. No book discounting. When you publish a book you set a price on that book and every bookstore is required to sell that book at that price. Talk about anti-consumer legislation. Every jurisdiction worries about the health of their own publishers because they worry about the health of their own culture, and the connection between publishing and the health of your culture is real . . . I am sympathetic to their desire to do this, I am just astounded by the road to hell being paved with good intentions.

So here’s an interesting one, we run into very few intellectual property issues at Lulu, and the reason we do, is the one thing that trumps intellectual property, patents and copyrights, is prior art. And [we] work in the world’s oldest industry, and everything has been done before. It may not have been done on the internet, but it has all been done before. I work with our printers, we subcontract all of our printing work to a network of printers around the world, and I’ll go and visit them, and they’ll tell me about the coolest new innovation that they’ve just figured out how to use this new Xerox digital printing machine that they spent $5 million setting up the production line around it, and they can use this to do something that no one else on the planet can do, and they’re going to make lots of money doing this, and I go, “yeah, cool, but do you have patents on it?”, and they just look at me funny. In that industry, the thought of trying to patent something with the centuries of prior art, just causes them to not even think about it. They end up using a model back, prior to patents.

So for those of you who haven’t studied the history of intellectual property law, patents were invented precisely to solve the problem of secrecy, of corporate secrets. The way businessmen used to profit from their patents was not to tell anyone about it. So Dresden china was very famous for the whiteness of the china—the clarity—for like 500 years, and the reason no one else could make Dresden china was the guys in Dresden ran a Gestapo service around the idea of not divulging how they got their china as white as they got their china. It was a corporate secret, and so the guild system in many cases was not designed in an open, “we’re trying to educate the next generation of china makers,” it was just the reverse. The guild system was a secret
society, and when you get your guild member card it is because you have proven that you can keep a secret, and so patents were in fact an effort to try and get people to open up and to share their innovations, as opposed to an effort to allow people to profit from their innovations. It is in fact a societal bargain: I will help you profit from your innovation if you share how you did your innovation with me. This is the societal bargain, and we keep losing sight of this one, but the good news for us at Lulu is we don’t have a lot of them. Other questions?

Q: My question follows from that. How do you balance the countervailing interests between those two: the interest when you’re sitting on Red Hat, less patent, less protection, those types of models, and on the medical device side, with the different interests, how do you balance and find something that encourages innovation, rewards innovation, without stifling it? How do you strike that balance?

So, besides having A.D.D., I’m also schizophrenic, so it depends which Bob Young you’re talking to today! How do we balance it? That’s actually where abstracting away from the specific becomes very valuable. It’s where a good education, you know, if your professors are any good at all, they’re not going to teach you what the laws are. That’s your job, you can look up all that stuff. If they do a decent job, they’re going to teach you why the law evolved the way it did, and how to react to it, which laws are likely to fade away, how to predict the future of the law, and in the end, if I bring anything to my projects, other than finding smart people who make me look good, it is that keenness to abstract away from the details.

So coming back to the specific question about the intellectual property, I think it through from the abstract view of why Jefferson got behind a patent system for the United States. You start going, ok, there are good patents and there are bad patents. If any of you guys actually do aspire to become Supreme Court justices, here’s the topic I want you to take with you and actually solve—and sadly it’s going to take that length of time to solve this one because we’re going to have to get some kid who was educated today in a world of open source to actually get to the Supreme Court, and educate his buddies on how the world actually works with intellectual property. Here is the problem: it is a balance, but our problem with intellectual property is we built all
the rules in an era of mechanical innovations, and we’re now in an era of software and virtual innovations—ideas.

When the original patent acts were applied, both in the U.S. and the U.K., it was specifically articulated that [the act] was [meant] to patent inventions, not ideas. But the problem with patents on things like software is software is simply a form of expression. Ok, the reason we call it software languages—Cobalt is one language, Java is another language—the reason they are languages is they are forms of expression. I’m not kidding you. You go to a software conference, you’ll stand in the hall, there will be a bunch of long-haired guys, hanging around, they’ll be talking to each other in a bunch of gibberish. Finally, one of them will get to the punch line, and go, “slash-dev-null”, and it will bring the room down, (laughter), and that is how you know it is a form of expression. In the same way, if you were in Albania, and you had listened on a street corner to a bunch of Albanians having a heated conversation, and someone got a final sentence and everyone laughed, you would know that they had just told a joke with a punch line. You wouldn’t know what the joke is, you wouldn’t get the joke, but you would trust that they had a form of communication that allowed them to tell a joke. Well, software engineers, when they use computer languages, can use them as a form of expression. They are expressions, and this has actually been tested more than once with our patent office, where some software engineer or another sent in a patent application that was astoundingly obvious in mathematical terms—it was just a relatively sophisticated but well-known mathematical algorithm—that the patent office then issued a patent around, because the patent examiner, was a reasonably bright guy, but was not a software engineer, was not a mathematician. He was neither familiar with this well-known mathematical algorithm nor was he a good enough software engineer to read the code well enough to understand that that’s all it represented. All he saw was a well documented patent, and he hadn’t seen one like that before, ergo he issued the patent.

So, the problem we’ve got is, as a society, in intellectual property, the one that Red Hat helped resolve, or is helping resolve I guess, is it’s like vitamin D. If you don’t have enough vitamin D, you get rickets, and other terrible health diseases, and that’s why we as a society put vitamin D in our milk supply, and other places. However, little known fact, too much vitamin D is highly toxic, it will kill you. So I’m a big fan of both patents and copyrights, I believe in intellectual property, and I always have believed in intellectual property. It’s just like vitamin D, too little of it and we’re not going to be healthy, we’ll have an economy that looks a lot like any of the failed state economies where there is no private property scheme, but
too much vitamin D, and our politicians around the world have come
to associate intellectual property with the health of their technology
industries, so they tend to err on the side of more intellectual property
rules.

As an example, [consider] copyright [laws]. Copyright, up
until about 1977, was twenty years long. At the end of twenty years,
you could use it for whatever you want. Starting in 1977, and I’m not
kidding, most of you probably know this one—when I talk to technical
conferences they don’t know it; they think the term, “the Mickey
Mouse Amendment” in copyright extensions is an insult towards
Disney, but it’s not. It was actually the trigger that got the U.S.
government, Congress, to start passing extensions to copyright
legislation because everyone said, well that’s just not right, that
Mickey Mouse would fall into the public domain. Disney clearly has
invested a huge amount of time and effort building the Mickey Mouse
brand. Why would it fall into the public domain such that anyone
could use Mickey Mouse anytime? So they just kept extending it. My
favorite legislator, a fellow called Sonny Bono, most of you guys are
too young, you know, Sonny Bono, Sonny and Cher, “I Got You
Babe?” The all time great piece of music? Gives you an idea; I’m not
much of a musician, anyway, I would sing it to you if only I really
hated you guys (laughter). When he went to Congress, he actually had
a mission, and his mission was to get copyright extended to an infinite
term. His logic was, if he made a chair, he as the chair maker,
physical property rules were such that he as a chair maker could hand
his chair on to his children, who could give it to his grandchildren,
who could give it to his great-grandchildren, ad infinitum. Why, when
he created a song, could he not do the same thing for his children and
his great-great-grandchildren?

What he completely missed was the difference between
physical property and intellectual property, because in intellectual
property there are only so many tunes that are possible. In an age of
digital technology you can record and keep track of every single tune
ever written. If copyright becomes permanent, at some point, every
tune possibly composed will be copyrighted by sometime, and so the
problem isn’t going to be for us, and our generation, but there will be a
generation, maybe the next one, maybe the one after that, who will
have to ask permission to write any sort of music because every tune
they can think of will have been copyrighted by someone. This public
domain of knowledge, the reason that mathematical algorithms cannot
be owned by anyone, the reason poetry should not be owned beyond a
certain length of time, is the language itself cannot be owned, because
we have to empower our next generation to be as creative and as
inventive as we are. If we don’t do that, there is something wrong
with us. So that is why too much intellectual property is as bad as too little intellectual property. Sorry, that’s my rant on the topic. Other questions?

Q: Other than intellectual property and the law, what is keeping you up at night at Lulu? What are your biggest challenges?

Well, if you run that, and say, what’s keeping me up at night, I get to put on my other hat. I own a—this is a long story, but shortly after I made all my money at Red Hat my favorite football team (I’m from a town called Hamilton, Ontario), it went bust, and a friend up there said, “Hey Bob, maybe it’s time to step up and do your civic duty.” So I bought my hometown football team, the Hamilton Tiger Cats, and as much as I’m a reasonably successful technology executive, I’ve got to be one of the world’s worst sports team owners, judging by our record on the field. So that is actually what is keeping me up at night. (laughter) I’ll let you Google the rest of that story.

At Lulu, it’s relevance, because when you’re on the internet, you’re competing with a whole world of entrepreneurs and people who want to serve your customers better than you want to serve them. So back when I was in the type writer rental business, my first job out of college, it was a nice, slow business. You know typewriters had been around for 80 years, they certainly were improving, but they improved at the rate of an innovation every five years. As we got into personal computers, things sped up a little bit and you had a new computer manufacturer show up every couple of years with a new innovation every couple of years, and now we’re on the f-ing internet, and, you know, you go on holiday for a month, and you come back and, poof, there’s Facebook, and you go on holiday for another month and you come back and poof there’s Twitter. How do you keep up with this crap? This is why you guys are not so dumb at all. Going into law is a lot smarter career move than technology, except that [technology is] good for people with A.D.D., which is why I keep doing it to myself. There was a question over here.

Q: I’m wondering, given your background in open source software and your commitment to the free market, what do you think is the best way to approach net neutrality?

Oh, net neutrality! I love net neutrality questions because I am a bit of a barricade-climbing sort of revolutionary on that one. I’m a huge fan of net neutrality. The reason the internet has gotten to where it is, and this is where, if you do law well, let me take my cynical hat
off for a second, and say this is the value you guys as a group create, and Larry Lessick speaks to this. Larry Lessick runs a project called “The Creative Commons” and speaks to this whole topic. He started as, his area of study was Constitution Law, and so he’s a Constitutional expert. He was asked to go to Eastern Europe after the fall of the Berlin Wall and to consult with some of the countries over there, and his experience as I was chatting to him about this, his experience he said was really interesting because they concluded, coming from an environment that was incredibly oppressive, where there was a law against doing anything, their solution to that was basically anarchy. “Let’s just get rid of all the laws.” and Larry, his mission over there was to say, “Guys, the problem wasn’t your legal system, the problem was you had a really bad legal system.”

You [must] have a framework, and this is where as a businessman, I’m very, very conscious. This is the link between football and business: speaking as a business guy, [and] as a football guy, we have all these rules that we as team owners agree to, and once we set the rules, we punish each other severely for breaking any of those rules. But the rules give us freedom to play the game, and to be creative within that game. The problem with failed states, with those states without a working government, or with a kleptocracy—you know, Rhodesia, or Zimbabwe I guess they are now (I’m showing my age), Zimbabwe where it is a true kleptocracy where the guy running it, Mugabe, he and his family are as bad a governing class as you get anywhere on the planet. The problem with them is no one can actually operate in that environment because they never know if they’re going to own their business, or their chair, or their whatever when they wake up the next morning.

So the internet worked because it was an invention of a bunch of scientist largely funded by the U.S. government. Again, we all tend to be cynical at the expense of our government, only to see every now and again they do really clever things for us, [with] the internet being one of the best ones, and it worked because it was truly neutral. The code ran the internet; there was no human being playing with the rules to benefit him or his own business at the expense of everyone else. They defined the internet within the rules of the code that ran the internet, and any of us, [like] Bob Young, could build Red Hat or Bob Young could go out of business, but I didn’t get to blame Bill Gates for putting me out of business. It was that the customers chose someone else’s solution over mine, but my ability to bring my innovation to market was unimpeded if I played by the published rules of how the code on the internet worked.

For those of you who haven’t been paying attention, the net neutrality debate is [centered around] the big telcos, [who] are looking
at the volume of data they are supplying their customers and they’re going, “Hold on, this makes no sense, our customers are watching Netflix videos, using a huge amount of bandwidth, for which they’re only paying us, the cable provider, trivial amounts of money. Netflix makes good money off of it, and meanwhile the next supplier, eBay, where you’re just downloading images, they provide as much value as Netflix does, but they use a fraction of the bandwidth. We should be allowed to charge more for Netflix bandwidth than for eBay. We should be able to prioritize the people who don’t cost as much money to serve.” That’s their logic. Of course, if you accept their logic, it opens the door for them to be able to say, “Well, Microsoft is paying us a lot of money for our bandwidth, whereas little Lulu doesn’t have the budget to buy our bandwidth, so we will de-prioritize Lulu’s traffic in favor of Amazon’s or Microsoft’s.” Again, it’s not me I’m so worried about because Lulu is doing well enough. We could afford to compete there. It’s all the guys we’re competing with, it’s the next generation of Bob Young’s that we have to worry about, and that is what I worry about. If the cable companies are allowed to set the rules, it’s going to close down what is currently a very, very open and welcoming market for new innovators.

Q: Mr. Young, the focus of our symposium today is IP and venture capitalists, I’m willing to wage that your overhead in your wife’s sewing room was not significant when you started Red Hat. I was wondering though, if you would care to comment on the funding environment today, maybe with some advice on how to get innovation into the marketplace, and maybe some of the ways to overcome some of those hurdles.

Yeah, I’ve got all the scars and the hairline to demonstrate that I’ve had to raise funds before (laughter), and I speak with a lot of passion on this one. There is more than one way to raise money and venture capitalists are only one, and they’re a relatively small one at that, interestingly enough. The vast majority of new businesses are funded through some other method than through a venture capitalist, and just [to name] two of them that I speak to, my favorite being “love money.” Love money falls into the category of—the reason it’s called love money is you’re collecting money for investment from people whose reason for investing in your venture is not because they understand anything about your venture, it’s because they love you, and quite sincerely.
The very first round of Red Hat, other than my and Mark Ewing’s life savings was from a bunch of friends and family who I went around and hit up for a little bit of funding at Red Hat, and my Aunt Joyce put some money into Red Hat. Fast forward six years, and of course Red Hat goes public, and her small amount of money turns into a huge amount of money, and Aunt Joyce being a wonderful human being, gives away like three quarters of it to her local, city-community foundation. It was the largest donation in the history of community foundations in Canada, and as a result got some press, and the journalist sticks a microphone in Aunt Joyce’s face and says, “So Aunt Joyce, when you invested in your nephew Bobby’s little business did you ever think you were going to make this much money?” Without missing a beat Aunt Joyce says, “No, I never thought I’d get my money back” (laughter). That’s the definition of love money.

That’s one, the other one is from your customers. The other biggest, most successful way of funding your business is to go and get a business. Lawyers do this every single day of the week. Most law firms, most new law firms, are funded this way. Has there ever been a law firm funded with venture capital money? Yeah, I don’t think so. Almost all of them are funded by their customers. You build a reputation as a lawyer, and then you hang your own shingle knowing that some of your customers will follow you and they will pay you for starting your own business. But you have to have the credibility, the expertise, and the reputation with your customers.

Your reputation by the way—and this is the one common thing in what I do as a business guy—is it’s all about brand, and brand is nothing more or less than what people think about you. The vast majority of value in all three of the brands that I represent today, the vast majority of that value does not show up on my balance sheet anywhere. When I talk to a venture capitalist, he has no idea what the hell I’m talking about because he wants to study my cash flow and my balance sheet, and I go, “I don’t care about my balance sheet, there’s no value on my balance sheet, my value is all in my customer’s heads,” [and] it’s why it takes five years to establish a business. Most people think [about] Facebook [and say to themselves], “I’m going to be the next Facebook, six months from now I’ll be successful.” The general rule is it takes a minimum of five years to establish a new business, and so if you don’t have a plan for how you’re going to get somewhere from where you started in five years, and the funding, and you know, the Aunt Joyce’s necessary to get you there, you haven’t done your homework. You really just have to work on the assumption that it’s going to take you a good long time to convince, to implant, the Mickey Mouse-like brand in all of our heads.
Talking about intellectual property, that is one of my rants on the topic, it just makes me mad that our copyright rules are so tight, and our fair use rules are not broader. Because what it means is we can’t use Mickey Mouse even in the background of a television show without going to Disney and licensing that [image] from them. Technically, the law says you should be allowed to [under the fair use doctrine], but you ask most judges on the planet and they will tell you to take down that Mickey Mouse sign that you posted on your kindergarten door if it’s a public facing door. It’s so stupid because what is Mickey Mouse? Mickey Mouse is a mental image that Disney Corporation has planted in all of our heads from when we were three years old. It’s just wrong that they both get to build a valuable brand, and we have to pay them every time we represent our life experience in the context of Mickey Mouse because it is part of who we are. We can’t allow [a] corporation to own that. Don’t get me started, buy me a beer and I’ll give you a longer rant about it.

Other questions? Well good we’re right on time, like magic, either that or you all have classes you have to get to, but thank you very much for listening to me this afternoon, it was fun!
ADVANCING TECHNOLOGY IN THE CONTEXT OF THE COMPETITIVE LANDSCAPE: AN INDUSTRIAL TECHNOLOGIST’S PERSPECTIVE

Sharon C. Presnell†

ABSTRACT

An integrated strategy is required to identify, manage, and capture the value from intellectual property that arises in the research environment. Experimental results must be screened routinely to identify potential intellectual property, including novel or improved methods and compositions as well as new or expanded applications. Strategic evaluation of potential intellectual property requires a comparison of the method, composition, or application to existing patents and patent applications, in addition to gaining an understanding of the published literature and other public-domain information. Ultimately, the timing and mechanisms employed to protect intellectual property can play a major role in the success of a product. In this article, specific examples from the medical device and regenerative medicine sectors are utilized to highlight strategic approaches that may be used to effectively understand and navigate the competitive landscape in the pursuit of product development.

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I. INTRODUCTION

In any research and development setting (university, small company, large company) discoveries are made that have potential value as products, enabling technologies, or improvements on processes that yield a superior product at a lower cost of goods. The value generated by these discoveries can be harvested ultimately as revenue, providing money to expand universities, create jobs, and fund new pipeline research projects. In an industrial setting, intellectual property (whether patent or trade secret) is the foundation for differentiation among products in the market, and constitutes the battlefield on which market positions are gained and lost based on filing dates and validity.\(^1\)

The Bayh-Dole Act of 1980 fundamentally changed the relationship between industry and academia by enabling non-profits, universities, and small businesses to retain ownership of innovations developed within federally-funded research programs.\(^2\) While the government funding agencies retain “march-in” rights to technologies that they have funded, university-industry collaborations and licensing deals are commonplace, accompanied by a significant expansion in size and scope of the technology management offices that function to capture revenue streams through in-licensing and royalties arising from commercialization of valuable discoveries.\(^3\) After thirty years, the number of patents filed annually in the U.S. has risen over four-fold, from 108,209 in 1979 to 482,871 in 2009,\(^4\) resulting in greater access to federally-funded technologies for commercial application while also creating a more complex competitive landscape for any potentially novel technology.

Intellectual property can arise from pioneering discovery, whereby something new is created in a landscape with no precedent, potentially yielding a novel method to make a new product with an unanticipated application. However, it is more common for discoveries to be made on a foundation of existing knowledge,

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\(^1\) See generally Mark A. Lemley, *The Economics of Improvement in Intellectual Property Law*, 75 Tex. L. Rev. 989, 1066-67 (1997) (arguing control of intellectual property can lead to greater market power).


methods, and products, generating improvements or filling known technological gaps as a routine component of the product development process. Technology managers need sound and consistent strategies for identifying potential intellectual property that emerges from routine experimentation. Integrated management of the intellectual property relative to the competitive landscape and the commercial strategy is essential to ensure commercial success.

II. IDENTIFYING & MANAGING INTELLECTUAL PROPERTY

Build or Buy? Considering the economic realities of both academic and industrial research, the majority of experimentation that is undertaken is aimed at solving a specific problem or filling a known gap in the pursuit of a specific product or product concept. For example, the pioneering use of radioactive seeds to treat prostate cancer (i.e., “brachytherapy”) dates back to 1914-1915. Although the first issued U.S. patent containing “brachytherapy” in the claims was granted in 1985, since that date there have been 217 additional issued patents covering various aspects of brachytherapy, including specialized devices to enable precise delivery of the seeds, methods for imaging the implanted seeds, and improvements in the design of the seeds to provide directional specificity of the radiation delivered to the tissue.

Intellectual Property Generation & Capture. Intellectual property is born of discovery and creativity—two processes that it is tempting to say should not be constrained. However, the practical realities of technology development often lead to discovery strategies that are focused toward solving a particular problem instead of open-ended exploration. A truly effective intellectual property strategy...
lies in the intersection of the technical and business strategies, which together should determine if and when a patent is filed. It can be both expensive and strategically unwise to file patents on concepts alone, because until a technology has been reduced to practice and has demonstrated utility towards its intended use, patent applications tip off competitors while simultaneously creating prior art that could potentially form the basis of rejection later on when the definitive methods and composition of matter are known and are potentially different than anticipated by the theoretical patent application. There are four key steps in the strategic identification and management of intellectual property in the operational laboratory setting:

A. Observation

Frequently, work is initiated in the laboratory to develop a work-around for a particular method, to define a target composition-of-matter, or to develop a new tool where one did not exist before. In these cases, the generation of intellectual property is the driver of the effort and is, therefore, an expected outcome. However, what may appear to be routine work in the laboratory can often harbor hidden intellectual property, such as improvements in manufacturing processes that lower the cost of goods or enhance product performance. Concerted efforts are required to scan, identify, and protect the intellectual property that emerges in the laboratory setting. Witnessing and reviewing of laboratory notebooks, as well

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14 Rubber-Tip Pencil Co. v. Howard, 87 U.S. 498, 507 (1874) (“An idea of itself is not patentable but a new device by which it may be made practically useful is patentable.”).

15 35 U.S.C. § 122 (2006) (providing that, in general, patent applications are published eighteen months from their filing date).

16 35 U.S.C. § 102(e) (2006) (stating that a published patent application that discloses, but does not claim the invention constitutes prior art as of its filing date).

17 Robert A. Matthews, Annotated Pat. Dig. § 1.18 (2011) (“There are three different species of utility patents [under 35 U.S.C. 101]: a patent on the device or apparatus (product patent); a patent on a process or method of creating something (process patent); and a patent on the product that is produced by a patented process (product-by-process patent).”).

as dedicating time to review technical progress and outcomes, is essential for the technology manager charged with gleaning the intellectual property from ongoing work. In environments where key elements of technology development are managed across multiple parts of the organization, additional effort should be put forth to ensure that an integrated approach is taken in the identification and protection of all product-relevant intellectual property. Even at this early stage, it is often beneficial to do a rapid scan of the published literature and patent filings to assess potential novelty.\textsuperscript{19} The time and resources spent confirming and reducing to practice non-novel art may be better expended elsewhere.

\textbf{B. Confirmation}

A small, upfront investment to confirm the initial concepts or observations is worthwhile, compared to the cumbersome practice of amending claims during prosecution to force-fit the technology into the assumptions made based upon initial concepts or preliminary data.\textsuperscript{20} In addition to repeating initial experiments, it is advisable to examine the technology from multiple angles to provide an adequate understanding of the potential scope and value of the intellectual property.

\textbf{C. Reduction to Practice}

Robust enablement of patent claims involves an actual demonstration or a test showing utility in the intended application.\textsuperscript{21} The date on which an invention is conceived is irrelevant unless coupled with the date of reduction to practice.\textsuperscript{22} Actual reduction to

\textsuperscript{19} See generally 35 U.S.C. § 102 (2006) (stating that in order to be eligible for patent protection, patentable subject matter must be novel, useful, and non-obvious).

\textsuperscript{20} See generally 4 PAT. L. FUNDAMENTALS § 15:23 (2d ed.) (indicating that the Patent and Trademark office will reject amended claims that contain new matter or are based on new matter under 35 U.S.C. § 112 for lack of written description).

\textsuperscript{21} 35 U.S.C. § 112, para. 1 (2006) (setting forth the enablement requirement for patentability: “[t]he specification shall contain a written description of the invention, and of the manner and process of making and using it, in such full, clear, concise, and exact terms as to enable any person skilled in the art to which it pertains . . . to make and use the same . . . ”).

\textsuperscript{22} See 35 U.S.C. § 102(g)(2) (2006) (providing that, in a priority contest, the date of invention is the earlier of 1. actual reduction to practice, or 2. constructive reduction to practice).
practice can be accomplished by making a working model,\textsuperscript{23} while \textit{constructive} reduction to practice is accomplished by filing a patent application that is sufficiently disclosing that one of ordinary skill in the art can make and use the invention.\textsuperscript{24} In either case, the refinement and repetition involved in reducing an invention to practice serve to ensure that the design, composition, and/or methods that are claimed are a reasonable approximation of the final process or product.\textsuperscript{25}

Once a patent is filed around a specific method, subsequent changes or improvements may be deemed obvious in light of the previously-disclosed method, thus limiting the potential scope of obtainable patent protection.\textsuperscript{26}

\textbf{D. Formulate a Strategy in Context of Competitive Landscape}

It is virtually impossible to formulate an intellectual property strategy without first considering how a particular method, composition, or utility fits into the competitive landscape.\textsuperscript{27} It is essential to determine whether an element of intellectual property is best protected as a trade secret, or filed as a patent.\textsuperscript{28} For example, in the case of a proprietary manufacturing process that produces a medical device of high quality at a cost well below competitors, it may be wiser to hold the manufacturing process as a trade secret, since the process cannot be revealed by examining or "reverse engineering" the

\begin{footnotesize}
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  \item \textsuperscript{23} Slip Track Sys., Inc. v. Metal-Lite, Inc., 304 F.3d 1256, 1265 (Fed. Cir. 2002) ("In order to establish actual reduction to practice, the inventor must prove . . . that he determined that the invention would work for its intended purpose.") (citing Cooper v. Goldfarb, 154 F.3d 1321, 1327 (Fed. Cir. 1998)).
  \item \textsuperscript{24} See Travis v. Baker, 137 F.2d 109, 111 (C.C.P.A. 1943) (indicating that constructive reduction to practice requires a disclosure of the invention sufficiently adequate to enable one skilled in the art to practice the invention).
  \item \textsuperscript{25} See King Instrument Corp. v. Otari Corp., 767 F.2d 853, 861 (Fed. Cir. 1985).
  \item \textsuperscript{26} See generally 2-5 DONALD S. CHISUM, CHISUM ON PATENTS § 5.03[3][a][i][E] and accompanying notes.
  \item \textsuperscript{28} See, e.g., Robert Graham Gibbons & Bryan J. Vogel, \textit{The Increasing Importance of Trade Secret Protection in the Biotechnology, Pharmaceutical and Medical Device Fields}, 89 J. PAT. & TRADEMARK OFF. SOC’y 261, 262 (2007) ("The importance of properly protecting intellectual property assets as trade secrets either in lieu of or prior to seeking patent protection is garnering the attention and support of audiences beyond in-house and outside counsel in the fields of biotechnology, pharmaceuticals and medical devices.").
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device; placing the manufacturing process in the public domain as a patent filing would teach competitors a proprietary process that they could easily infringe upon with low risk of being caught. However, the risks of disclosure in a patent application have to be balanced against the risks associated with protecting a trade secret—is it possible to contain the trade secret information within the company so that the proprietary methods are not disseminated? What is the likelihood a competitor would file a patent on the same proprietary process? In the sections below, specific theoretical examples will be provided toward the use of comparative analysis tools for the assessment of an intellectual property landscape.

III. PUTTING INTELLECTUAL PROPERTY STRATEGY TO WORK

A. Example 1: Separating a Novel Observation from a Novel Asset

Each of the steps above (observation, confirmation, reduction to practice, and formulation of strategy) plays a role in intellectual property generation; while many observations may be novel, scientific value does not always translate directly into intellectual property value. For example, in 1990, two professors at Wake Forest University invented the VAC technology, which leveraged the observation that wounds or incisions heal better if negative pressure is applied to the wound in combination with a special foam dressing that facilitated wound closure. While the observation that wounds heal faster under negative pressure did not constitute tangibly valuable intellectual property per se, the specific device and methodology that delivered the negative pressure was the subject matter of the patents.

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29 See, e.g., Uniform Trade Secrets Act § 1.4 (defining a trade secret as “information, including a formula, pattern, compilation, program, device, method, technique, or process that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.”).

30 See, e.g., Park & Sons, Co. v. Hartman, 153 F. 24, 29 (6th Cir. 1907) (suggesting that even if a trade secret is not generally known, a third party is free to discover it through its own efforts such as independent development or reverse engineering).

filed in 1991\textsuperscript{32} and subsequently licensed to Kinetic Concepts, Inc. ("KCI"), a prominent wound care company, in 1993.\textsuperscript{33} While the patent estate has been periodically challenged by competitors,\textsuperscript{34} the wound VAC remains on the market at the time of this writing and, according to KCI’s 2010 Annual Report, their Advanced Healing Solutions ("AHS") business based on the negative pressure technology accounted for 70\% of their annual $2 billion in revenue.\textsuperscript{35}

In this case, the stage of discovery and development at which the patent was filed was a key component of the strategy. If the envisioned product that can be sold to generate commercial value is a device or instrument, it may be best to seek intellectual property protection for that device when the design is almost final and the technology as designed has been demonstrated to work in the application for which it is intended, thus providing: 1) the best chance of getting robust coverage of the actual commercial product; and 2) the longest post-commercial duration for protection of the product.\textsuperscript{36} For example, if the scientist who made the novel observation (that accelerated wound healing can occur under negative pressure) had rushed to file a patent on theoretical designs that ultimately did not sufficiently represent the actual device put on the market several years later, the product would have lost several years of commercial patent protection based on the priority date of the original filing. This could have resulted in lost revenue, not only for KCI, but also for Wake Forest University in the form of lost royalties. Furthermore, early conceptual patents can often surface as prior art against subsequent inventions with real commercial potential impacting the ability of scientifically valuable intellectual property to garner tangible financial value.\textsuperscript{37}

\begin{footnotes}
\footnotetext{32}{U.S. Patent No. 5,645,081 (filed Nov. 14, 1991); U.S. Patent No. 5,636,643 (filed Mar. 9, 1993).}
\footnotetext{35}{Kinetic Concepts, Inc., \textit{Annual Report} (Form 10-K) (Feb. 25, 2011).}
\footnotetext{36}{35 U.S.C. § 154 (2006) (generally, the term of a patent is 20 years from the date of filing of the application).}
\footnotetext{37}{35 U.S.C. § 102 (2006) (defining prior art as including the contents of published patent applications).}
\end{footnotes}
As the technology manager scans emerging technical progress for potential intellectual property, there are three key questions to ask. First, is it real? This requires an understanding of the experimental evidence that an observation is reproducible and not due to a phenomenological artifact, and also encompasses the observation and confirmation steps discussed above and can extend to include reduction to practice. The second question is, is it novel? The answer to this question requires an understanding of the discovery in the context of the competitive landscape surrounding the technology, which can be more complex than it may appear on the surface. Many aspects of a technology can be novel and considered intellectual property: the technology itself (a new drug-eluting stent, for example), the process by which something is made (a new process for manufacturing the stent that improves performance or reduces cost of goods), or a new application (taking an existing product and demonstrating utility for that product in an unexpected indication).³⁸

If an initial survey of the competitive landscape indicates the putative intellectual property is novel, the third question materializes: is this invention relevant to the business? The answer to the third question may be ‘yes’ if: 1) the technology is pertinent to the methods of manufacture or the composition of a product; 2) the technology is relevant to the methods or performance of a platform that is used to generate products; or 3) the technology has the potential to impact future business strategy (beyond existing products and platforms). The first question is best answered by the technologists, the second question by the technologists and intellectual property lawyer, and the third question by the intellectual property lawyer and the business strategist. In the following example, a theoretical discovery will be taken through these serial questions, including preparation and analysis of an actual competitive landscape.

B. Example 2: Identifying and Vetting Potential Intellectual Property

Part 1: The Discovery (Theoretical)
Cardiovascular disease is the leading cause of death worldwide, accounting for over 17 million deaths in 2005.³⁹

³⁸ See Matthews, supra note 17; CHISUM, supra note 26, at § 3.01 (2011) (discussing the novelty requirement).
Consequently, with the emergence of the stem cell and regenerative medicine fields, much effort has been dedicated to the discovery and development of cell-based technologies to address this large unmet medical need and market.\textsuperscript{40} For example, Ohio-based Athersys, Inc. and its partner Angiotech Pharmaceuticals plan to initiate Phase II human clinical trials in 2011, on the foundation of a Phase I clinical trial that demonstrated safety of the company’s proprietary MultiStem® cell-based technology in patients with acute myocardial infarction.\textsuperscript{41} Consider the following theoretical example, whereby scientists at a small biotech company focused on the development of cell-based therapeutics have made an unexpected discovery:

\textbf{Observation:} In a set of experiments, specific cells derived from the blood are delivered systemically to an animal model to test whether they will improve recovery and survival after acute exposure to a toxin that causes kidney failure. A significant improvement in kidney function was not detected. However, post-injury survival was better in animals that received the cells compared to those who received a placebo. Surprisingly, follow-up analyses revealed that the toxin also induced severe damage to the heart muscle, which was significantly reduced in the cell-treated group. Furthermore, the cells were found in the heart muscle in the damaged area, indicating they may have played a direct or indirect role in cardiac regeneration.

\textbf{Confirmation:} Two series of experiments were conducted; in the first set of experiments, \textit{in vitro} cultured heart cells (herein “cardiomyocytes”) were exposed to the toxin to induce cell death in the presence of the blood-derived cells or placebo. Cardiomyocyte cell death was reduced by 50\% when the blood-derived cells were present. Furthermore, the response was dose-dependent, showing that an increase in the relative proportion of blood-derived cells translated into a further reduction of cardiomyocyte cell death. In a second set of experiments, delivery of the blood-derived cells in another animal model of acute cardiac damage reproduced the observation—the blood-derived cells improved post-injury survival and multiple measurable cardiac functions.

At this point, the first question posed above comes into play: is it real? Clear observations were reproduced in two animal models as well as a set of \textit{in vitro} studies. Given the consistency and reproducibility, paired with the fact that the company is focused on the

\textsuperscript{40} \textit{Id.}

development of cell-based products, the technology warrants further analysis. In part 2 (below), the actual competitive landscape is considered for cell-based therapeutics intended for the treatment of cardiac injury.

Part 2: The Competitive Landscape

Conducting a preliminary assessment of the competitive landscape at this point in the process is time well spent. Assuming novelty and deploying resources toward reduction to practice and advancement of the technology without consideration of the landscape could result in the development of a great technology with no real path to commercialization. Existence of prior art, especially in high-interest fields such as heart failure and regenerative medicine, is almost guaranteed; there can often be a path, albeit complex, to steer a new technology through the myriad of existing methods, compositions, and uses.42 Furthermore, it is important to consider that patents are often available for licensure, or may expire prior to the anticipated date of commercial launch for the new technology.43 The competitive landscape is not a still snapshot, but is more akin to a dynamic moving picture into which it is often feasible to introduce an additional character or alter the backdrop. Once the initial landscape is created for a specific area, routine updating is essential to ensure that the product remains relevant within the context of the evolving landscape.

For the purpose of this example, the following search was initiated on the United States Patent & Trademark Office: ACLM/((cell or cells) and (heart or cardiac or cardiovascular) and (repair or regenerate or engineer)), which identified a total of 57 issued patents and 468 patent applications. Screening of the 57 issued patents identified 11 issued patents with independent claims involving the use of cell-based products for repair or regeneration of cardiac tissue.44 The specific attributes of the blood-derived cells used in this example should be compared to any general or specific cell types identified in the “composition” column of Table 1, realizing that if overlap is suspected, a more detailed analysis of the claims, specification, and examples provided in the patent will be necessary. If intellectual

42 See 1 CHISUM, supra note 26, at § 3.02 (discussing prior art and the anticipation standard).
44 USPTO PATENT FULL-TEXT AND IMAGE DATABASE, http://patft.uspto.gov/netalhtml/PTO/search-adv.htm (in the field marked “Query,” enter ACLM/((cell or cells) and (heart or cardiac or cardiovascular) and (repair or regenerate or engineer)); see also Table 1.
property protection is sought on the cells alone, independent of method or application, an additional search should be conducted based on the defining attributes of the cells.\textsuperscript{45} For example, many issued patents in Table 1 name general or specific cell types that are not claimed as composition of matter in the listed patent; in some cases, the cell type is too general to warrant patent protection (the ‘stem cells’ of 7,548,780) and in others the cells are protected as composition of matter by another patent (the mesenchymal stem cells of 6,387,369 and the “spore-like cells” of 7,060,492).\textsuperscript{46} In contrast, some patents define the cells very specifically with a set of genotypic or phenotypic markers (the “unrestricted somatic cells” of 7,556,801).\textsuperscript{47} Independent of composition of matter, methods and use claims that are not dependent on a specific composition should also be considered. For example, patents 6,514,515, 6,671,558, 6,696,575, and 7,338,657 contain claims that involve the seeding of cells (specific or general) onto specific biomaterials or devices for delivery; thus, if the blood-derived cells that are the subject of this analysis are delivered by these methods, the specific claims may be relevant.\textsuperscript{48}

Analysis of the pending patent applications (from 2002–2010) identified by the initial search is more cumbersome and speculative, because the patents are still under active prosecution where claim amendments and cancellations are commonplace.\textsuperscript{49} However, any patent application, whether claims are ultimately granted or not, becomes a public-domain document six to eighteen months after filings, depending on whether or not a provisional patent was filed in advance of the utility patent.\textsuperscript{50} Thus, patent applications can contain subject matter (in claims, specification, or examples) that can be used

\textsuperscript{45} For a discussion of the patentability of stem cells, see Allen K. Yu, \textit{Within Subject Matter Eligibility-A Disease and a Cure}, 84 S. CAL. L. REV. 387, 414-15 (2011) (defining the question of stem cell patentability as “[w]hen does the extraction, purification, and preparation of naturally occurring products render the resulting products different enough to be considered man-made?”).


\textsuperscript{49} See generally 37 C.F.R. § 1.121 (2010) (allowing patent owners to amend and cancel pending patents).

\textsuperscript{50} See 35 U.S.C. § 122 (2006) (stating patent applications must be published promptly after the expiration of a period of eighteen months from the earliest filing date of the application with several exceptions).
as prior art in the prosecution of a subsequent patent.\textsuperscript{51} It is often helpful to screen the patent applications at this stage of analysis to evaluate the total number of pending patents, the filing trends over time, and the general subject matter. Figure 2 highlights the 102 patent applications that contain independent claims around cells themselves (for cardiac indications), biomaterials or devices combined with cells (i.e., a product in which cells are a component), and broad claims that include cardiac regeneration in a long list of therapeutic indications.\textsuperscript{52} Notable trends revealed by Figure 2 are a peak in filings in 2005, and resurgence in 2008-2010 of cell-specific filings. It is recommended to populate the competitive matrix (Table 1) with relevant patent applications as well and conduct regular updates to monitor prosecution of applications and identify new relevant art.

The competitive matrix tool facilitates the answering of the second question: is it novel? Multiple opportunities exist for novelty in this theoretical example. The cells themselves may be novel, or novel in the context of use in cardiac therapy.\textsuperscript{53} If the cells are not novel alone as a composition, there may still be opportunity to seek compositional coverage with the cells as part of a more complex formulation or as a component of a device.\textsuperscript{54} Methods related to delivering the cells to the heart or preventing toxin-induced cardiac damage may also be patentable.\textsuperscript{55} Finally, because the cardiac results were unexpected, therapeutic use of the cells for cardiac injury may constitute a novel application, even if the base cellular composition is not novel.\textsuperscript{56} If commercial application of the technology is feasible and aligned with business strategy, the investment of resources into reducing the invention to practice and optimizing the technology toward commercial development are justified.

In Example 2, the refinement that occurs naturally during the development process serves to solidify methods, composition, delivery strategy, and scope of therapeutic use. As the product and the competitive landscape evolve, it is advantageous to apply more

\textsuperscript{51} See 35 U.S.C. §§ 102, 103 (2006) (excepting from patentability inventions either anticipated or rendered obvious by prior art).

\textsuperscript{52} See Figure 2.


\textsuperscript{54} See id. (defining machines and articles of manufacture as patentable subject matter).

\textsuperscript{55} See id. (defining processes as patentable subject matter).

\textsuperscript{56} See MPEP § 2145 (8th ed. Rev. 8, July 2010) (discussing the use of evidence of unexpected results to rebut prima facie cases of obviousness under 35 U.S.C. § 103).
rigorous mapping of the technology against the competitive landscape; heatmapping strategies provide an information-rich and highly visual means for tracking the positioning of a product within the competitive landscape. The near-commercial version of a product has typically undergone significant modification from its original form, which underscores the importance of formulating a strategy.

Part 3: Formulating a Strategy

The key elements of intellectual property strategy are mechanisms of protection and timing. In Example 2, assume that the cells (which are novel) are combined with a hydrogel (which is not a new invention), and efficacy in the cardiac application requires delivery of the cells + hydrogel to the heart using a new device that had to be developed specifically for the application. What is the product? Cells + hydrogel loaded into a device for delivery to the heart—that is what will be packaged, sold, and put into the hands of the clinician who will administer it to the patient. It is useful to consider: 1) each component separately (cells, hydrogel, device); 2) the methods of manufacturing each component; 3) the composite product; and 4) therapeutic use(s) of the product. Unless it is necessary to disclose methods of manufacture, for business or regulatory reasons, it may be beneficial to hold manufacturing methods as trade secrets. However, if the manufacturing process can be deduced by analyzing the product (“reverse engineering”) it may be preferable to file claims on the manufacturing methods as well.

Obtaining broad composition of matter claims on the individual novel components (cells, device) provides support for platform strategies, where the components are likely to serve multiple indications; this strategy also prevents competitors from making small changes to the final composite product and bringing forward a ‘new’ composition. Robust (but narrow) patent protection of the final composite product

58 For a comparison of patents to trade secrets, see 2 LOUIS ALTMAN & MALLA POLLACK, CALLMANN ON UNFAIR COMPETITION, TRADEMARKS & MONOPOLIES § 14:15 (4th ed. 2011).
59 See Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 476 (1974) (defining “reverse engineering” as “starting with the known product and working backward to divine the process which aided in its development or manufacture.”).
can provide additional insurance that the specific product is protected, along with the revenue that it may generate.

Establishing effective strategies to control the timing of patent filings can be challenging, especially in environments where public disclosure of intellectual property must occur for business or technical reasons. The competitive landscape matrix can provide some guidance. In Example 2, the landscape (including issued patents and patent applications) is extensive; applications involving cells are numerous. Thus, seeking coverage for the blood-derived cells and the delivery device as stand-alone compositions of matter is advisable. However, the methods used to make the cells and the device may be best kept trade secret, providing the methods will not appear in the public domain. While methods can be easy to work around, the methods used to deliver the cells + hydrogel and repair the heart will be exposed to the end-users, and therefore it may be advisable to seek coverage. In a crowded field such as the one in this example, the timing of filing patent applications must be weighed carefully. Filing as late in the development process as possible may provide the benefit of a long post-commercial patent life, but will carry the risk that a competitor files a blocking patent with an earlier priority date.\(^{61}\) Likewise, filing early reduces competitive risks, but could shorten the post-commercial patent life and, if filed too early (before methods and designs are solidified), could actually compromise the ability to protect the actual product.\(^{62}\) Patent prosecution can be time-consuming; among the examples provided in Table 1, the average time from priority date to issuance of claims in the patent was 5.3 years.\(^{63}\) The gap of time between filing a patent and obtaining issued claims may be a factor in determining when to file, so that claims are issued or in later-stage prosecution when the product is released onto the market.

IV. SUMMARY

In summary, the role of a technology manager extends well beyond managing technical strategy and operations. Intellectual property, whether protected in the form of a patent or as trade secret, is the foundation for revenue streams captured by market position, licensing fees, and royalties. Strategic research and development is most effective when conducted with full knowledge and consideration

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\(^{63}\) See Table 1.
of the competitive landscape. Comparative analysis practices and tools are invaluable in the stewardship of technology from concept through commercialization. Finally, a close partnership between technical, legal, and business functions is critical in the execution of a sound intellectual property strategy.
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ETHICS FOR BUSINESS LAWYERS REPRESENTING START-UP COMPANIES

Therese Maynard†

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

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\(^1\) 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. INT’L 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. 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.]

While there are many ways in which a lawyer may end up owning stock in a corporate client,\(^4\) 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?


\(^5\) 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. 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, 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 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.


8 Id.
not tainted by concerns regarding the lawyer’s personal financial well-being. As a result, the long-standing practice of lawyers has been to avoid taking stock in their corporate clients in lieu of fees. 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- 

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.”

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.


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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\(^{12}\) 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:

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 . . . .

. . .

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

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.

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.

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.\(^\text{18}\)

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\text{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.}\(^\text{19}\)


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

\(^{21}\) 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.*
even though the personal injury lawyer may collect a fee that, with the benefit of hindsight, seems unreasonable.\textsuperscript{25}

The ABA’s 2000 Ethics Opinion also emphasized that Rule 1.8(a) requires that the transaction and its terms must be \textit{fully disclosed in writing} to the client.\textsuperscript{26} According to the ABA, this requires the lawyer to do the following:

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

2. to \textit{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 \textit{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 \textit{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.\textsuperscript{27}

\textsuperscript{25} Id. at 943.
\textsuperscript{26} 2000 Ethics Opinion, \textit{supra} note 14, at 5-6.
\textsuperscript{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

(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.


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. 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.” 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.

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. 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?\(^3\)

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.\(^4\) Moreover, some lawyers claim that this billing practice:

\[
\text{[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.} \(^5\)
\]

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

\(^3\)Id.
\(^4\)See generally Puri, supra note 15.
\(^5\)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

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

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.
41 Id. at 553.
44 See Hurt, supra note 9, at 912-13.
45 Id.
arrangements.\textsuperscript{46} Another way in which lawyers argue that equity billing arrangements \textit{align} the interests of the lawyer and the client is with respect to the lawyer’s billing practices.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.”\textsuperscript{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).\textsuperscript{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.\textsuperscript{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

\textsuperscript{46} Id. at 930-31.
\textsuperscript{47} Id. at 931.
\textsuperscript{48} Id.
\textsuperscript{49} Id.
\textsuperscript{50} Id.
\textsuperscript{51} Id.
\textsuperscript{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,

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

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

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 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.”

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

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....

* * * * *

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.

* * * * *

[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.

* * * * *

**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 be 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.

[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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