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PUT YOUR MONEY WHERE YOUR MOUTH IS: ETHICAL GUIDELINES FOR LAWYERS INVESTING IN CLIENTS

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Whether and how lawyers may invest in their clients is a perennial topic of interest for business lawyers, ebbing and flowing with the economy. In the dot-com boom of the 1990s Silicon Valley firms touted the huge profits they made from taking equity in their clients, riding the IPO wave to (hoped-for) mutual success. Two decades on, lawyers and law firms continue to invest in clients, often through venture funds or other investment vehicles. It is not uncommon for lawyers to invest in their clients, particularly for lawyers or law firms that represent emerging companies. It is also accepted by this point that doing so is not per se unethical, although depending on the facts, there could be ethical risk involved. It is important that lawyers who wish to invest (or take some form of stake) in their clients understand the ethical and other rules that govern their actions, and minimize the risks as much as possible for both them and their clients.

TYPES OF "INVESTMENTS" LAWYERS MAKE IN THEIR CLIENTS

Lawyers invest in their clients in a number of ways. Lawyers who represent emerging company clients sometimes take a stake in the venture in lieu of their fees, since the client may be cash-strapped but in need of legal services.[01] This practice is sometimes referred to as "equity billing." Similarly, lawyers may take a stake in a patent or other intellectual property in lieu of fees. Larger law firms may invest in their clients as part of an early round of financing, on the same terms as certain other classes of investors; this may be done through an investment entity or fund that is separate from the law firm itself (and may include as members all or some of the firm's partners.) Tax consequences of these alternatives differ.

Investing in clients may provide a competitive edge for a law firm. "From the client's perspective, the lawyer's willingness to invest with entrepreneurs in a start-up company frequently is viewed as a vote of confidence in the enterprise's prospects."[02] Further, a law firm's willingness to invest in an enterprise may provide an additional boost of additional capital (if the law firm is investing cash as opposed to providing services in exchange for stock) or as a way to obtain legal services the client could not easily afford otherwise.

As the type of work lawyers perform for clients evolves, and the needs of their clients change, the types of investments lawyers may make (or interests they will accept) may change as well. For example, the classic situation where lawyers invest in their clients is where the cash-strapped founders come to the lawyer seeking assistance in forming a company.[03] The lawyer's role in assisting that type of client may be quite different from the role played by a lawyer or law firm who comes in later, after the founder or group of founders established the company with seed funding and using entity formation assistance available on-line or through inexpensive on-line legal resources.[04] Similarly, many people who have founded start-up companies in recent years are experienced entrepreneurs or industry veterans, who often have significant personal resources or access to funding. These varying contexts provide a complex landscape within which lawyers provide legal services, develop relationships with clients, and take stock or other interests in their clients. The ethical analysis becomes more complex at the same time.

ETHICAL CONCERNS

The most significant ethical concern when a lawyer invests in a client is that of conflict of interest: a lawyer who invests in a client may be at risk of a claim of self-dealing.[05] Related issues include ensuring fairness to the client (in accordance with the business transactions with clients rule), adequate disclosure, and whether a client may give informed consent.

The potential for a conflict of interest is an obvious risk, pitting a lawyer's financial interest against the fiduciary duties owed to the client, and threatening the independence of judgment required for the lawyer to competently represent the client. California Rules of Professional Conduct (CRPC) rule 1.7 provides that a lawyer must obtain a client's informed written consent if "there is a significant risk the lawyer's representation of the client will be materially limited by … the lawyer's own interests."[06] Moreover, informed consent by itself is not enough to resolve a conflict: the lawyer facing such a situation must also reasonably believe that he or she will be able to provide competent and diligent representation.[07]

CRPC rule 1.8.1 applies to lawyers who "enter into a business transaction with a client, or knowingly acquire an ownership, possessory, security, or other pecuniary interest adverse to a client." The rule requires that (A) such transactions be "fair and reasonable to the client," with the terms fully disclosed in writing in a manner which the client reasonably should understand; (B) the client be separately represented in the transaction or advised of the right to seek the advice of independent counsel, and given a reasonable opportunity to do so; and (C) the client thereafter consent in writing to the terms of the transaction, and the lawyer's role in it.[08]

Each of these provisions is equally important to ensuring that the transaction passes ethical muster as well as to its enforceability. In *Passante v. McWilliam*, 53 Cal. App. 4th 1240 (1997), the court of appeal found that a company's promise to award its corporate attorney three percent of its stock was not enforceable. There, the attorney arranged a loan to the corporation (with the money coming from the attorney's brother-in-law) at a critical point; in exchange, the board offered the attorney the stock, but never transferred ownership to the attorney. The court found that the promise of stock was either an unenforceable promise of a gift, or, if it was truly bargained-for, was unenforceable due to the attorney's failure to make the disclosures required by rule 3-300 (the predecessor to current rule 1.8.1).[09] Similarly, in *Fair v. Bakhtiari*, 195 Cal. App. 4th 1135 (2011), the court affirmed the trial court's decision voiding business agreements between an attorney and his clients based (in part) upon the attorney's failure to comply with rule 3-300.[10]

ABA Formal Ethics Opinion 00-418 considered the ethical considerations of attorneys investing in clients.[11] The opinion focused on the stock-for-fees scenario and set forth certain conditions that must be satisfied to secure compliance with the business transactions rule. The lawyer must: (1) explain the transaction so that the client can understand its terms as well as its potential effect on the lawyer-client relationship; (2) describe the scope of services to be performed in exchange for the stock, and must set forth whether the lawyer may retain the stock if the attorney-client relationship ends before all the agreed-upon services are performed; (3) disclose to the client that conflicts could arise that could affect the lawyer's exercise of independent professional judgment, including where the lawyer's desire to protect the value of the stock may conflict with the client's goals; and (4) advise the client to consult an independent lawyer concerning whether to enter into the transaction, and that should conflicts arise after the stock is issued, the disclosing lawyer may need to withdraw.

The question of the fairness of the transaction is one that requires attention and possible documentation at the outset. Certain difficulties exist: in some cases, it may be hard to value the stock (or other interest) at the time it was exchanged; if the value significantly increases by the time the reasonableness of the transaction is being assessed, the lawyer may have difficulty enforcing the arrangement. The ABA opinion recommends that the lawyer:

establish a reasonable fee for her services based on the factors enumerated under [Model Rule] 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.[12]

If that is not possible, "the 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."[13] To assist in documenting the lawyer's participation, an ethics opinion issued by the New Hampshire Bar Association suggests that the lawyer accepting stock for fees keep track of time spent performing legal services for the client, just as though the client were being billed on an hourly basis.[14]

The required level of disclosure may differ, depending upon the experience and knowledge of the client. A case from Massachusetts suggests that in weighing whether a lawyer made an appropriate disclosure in connection with a stock-for-fees transaction, courts may take into account "the knowledge and sophistication of the [company founders] concerning shareholder rights and obligation in assessing the adequacy of [the lawyer's] disclosure."[15] The lawyer will always bear the burden of proving that disclosure was adequate.[16]

The ethics opinions and most of the few cases that exist usually focus on the stock-for-fees scenario. The ethical concerns that arise under other investment situations will vary. For example, when the situation involves a lawyer or law firm investing in their clients on the same terms as other investors, certain of the ethical risks are considerably lessened. First, fairness of the terms of the transaction is easier to establish: if the law firm invests on the same terms as are offered to other investors, the fairness of the transaction may be presumed, at least in terms of the price paid by the law firm for its shares. Equally, since the firm is not exchanging services for shares, there is no need to value those services (something that may be difficult to do). Second, depending on the type of investment vehicle (a venture fund owned by partners of a firm but separate from the firm itself, for example), the potential conflicts of interest may be lessened, particularly if the lawyer investment in the client company represents only a small percentage of the total equity of the client company, or on the other side of the equation only a small percentage of the lawyer's or law firm's holdings. The desire to minimize conflicts has resulted in many law firms adopting guidelines that, for example, limit investment in any one client to a nonmaterial sum, and the share of equity to an insubstantial percentage of the client's total equity shares.[17]

MALPRACTICE INSURANCE CONSIDERATIONS

Many professional liability policies that insure lawyers and law firms contain provisions that exclude claims that arise out of a lawyer's activities as an "officer, partner, trustee or employee" of a business organization. Another common provision excludes coverage where a claim is made by an entity in which a lawyer (and, sometimes, members of his or her immediate family) has an ownership interest that exceeds a certain specified minimum (usually between ten and twenty-five percent). Courts have upheld these limitations as valid.[18]

Lawyers and law firms that hold equity or other interests in their clients should review their policies to make sure that they understand any exclusions and obtain additional coverage where necessary.

LAW FIRM RISK MANAGEMENT POLICY ISSUES

Law firms that wish to consider investing in clients should undertake a careful analysis. The threshold issue is: Should the firm allow investments in clients? It can be lucrative and can cement client relationships, but it can also be risky.

If the law firm decides to proceed, it needs to establish policies. These policies must set forth ground rules; who can invest, when, how much, and how. The firm should decide whether it will invest in all emerging company clients, no clients, or only some. The firm should determine whether to allow individual lawyers to invest or whether to limit investments to the firm as a whole. Some firms require that the attorneys must first offer an investment opportunity to the firm. If the firm decides to adopt that requirement, it must decide what rules should govern that process. The firm should decide whether the firm should make any investments directly or whether the firm should set up a separate entity to make the investments; whether to establish an investment committee to make investment decisions (rather than individual attorneys) and what criteria the committee should follow; and whether to have any "disqualification" or "recusal" rules, which would take investment decisions out of the hands of the lawyers doing the work for the client. Lastly, the firm should decide whether to put any limits on the amount of the investments and ensure that a sound process is in place to obtain informed written consent from clients, as applicable.

CONCLUSION

Law firms and individual lawyers invest in clients for many reasons. The principal ethical concerns are that the transaction be fair and that conflicts be disclosed and appropriately resolved through a client's informed written consent. Lawyers who invest in clients should make careful decisions about the form and timing of such investments, ensure that the transactions are objectively fair and reasonable, and document the details. Lawyers should also give careful thought to potential conflicts, disclose all such conflicts as applicable, and under most scenarios, advise the client to seek the advice of independent counsel before entering into a transaction with the lawyer.

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01 Many emerging company lawyers will represent their clients on a deferred-fee basis. That is, the law firm agrees that its fees will not be due and payable until some later date or defined event. Such deferred fees are sometimes characterized as "investments" in clients, but are not, strictly speaking, the kind of arrangements that are the focus of this article unless the company provides some type of equity to the law firm in exchange for the agreement to defer payment of fees. The ethical rules that apply to the deferred fee/no stock arrangement are the same general rules that apply to most other fee arrangements. See Cal. Rules of Prof'l Conduct r. 4-200 (Fees for Legal Services); Cal. Bus. & Prof. Code §§ 6147, 6148.

02 ABA Comm. on Ethics and Pro., Formal Op. 00-418 (2000) (Acquiring Ownership in a Client in Connection with Performing Legal Services) (hereinafter "ABA Formal Opin. 00-418").

03 *Maynard*, *supra* note 1, at 404-05.

04 See, *e.g.*, Forms, Orrick Tech Studio, https://www.orrick.com/en/Total-Access/Tool-Kit/Start-Up-Forms (last visited June 25, 2024); *How to Form a Corporation in 11 steps*, Legalzoom, https://www.legalzoom.com/articles/how-to-form-a-corporation (last visited June 25, 2023).

05 See, *e.g.*, BGJ Associates, LLC v. Wilson, 113 Cal. App. 4th, 1217 (2003); Rhodes v. Buechel, 685 N.Y.S.2d 65 (1999).

06 Cal. Rules of Prof'l Conduct r. 1.7(b).

07 *Id.* at r. 1.7(d)(a).

08 Model Rules of Prof'l Conduct r. 1.8 (Am. Bar Ass'n) contains similar provisions.

09 Passante v. McWilliam, 53 Cal. App. 4th 1240, 1247-48.

10 See *also BGJ Associates, LLC v. Wilson*, *supra*, 113 Cal. App. 4th at 1229.

11 ABA Formal Opin. 00-418.

12 *Id.* at 4.

13 *Id.* at 5.

14 N.H. Bar Ass'n Ethics Comm., Op. 2 (2000) (Taking Stock in Your Client As Legal Fees or As an Investment).

15 Rubin v. Murray, 943 N.E.2d 949, 956 (Mass. App. Ct. 2011) .

16 See Rhodes v. Buechel, 258 A.D.2d 274, 685 (N.Y.S.2d 1999).

17 See ABA Formal Opin. 00-418 at 10-11.

18 See Blumberg v. Guarantee Ins. Co., 192 Cal. App. 3d 1286, 1296 (1987).