

The Lawyers' Dilemma: Taking Stock As Compensation For Legal Services

Historically it has been unusual for law firms to own stock in their clients. Generally, the legal profession had a dim view of this practice fearing conflicts between a lawyer's own interests and those of the client.

Recent publications have reported, however, that it is now accepted practice for law firms to take equity positions in their clients. Indeed, it is now common for both clients and law firms to insist on an equity position as a condition of the legal engagement.

Why this change?

From the law firm's perspective, the ability to own equity provides an opportunity to be able to cash in on the potential of technology stocks and the stock market. For example, one Palo Alto law firm was reported to have had earlier this year an estimated stock portfolio in its clients of more than Two Hundred Million Dollars (\$200,000,000).

From the client's perspective, this arrangement may also be advantageous. Many of these clients are cash poor and are expending their cash resources at very high rates. Their lawyers owning stock is a reflection of their confidence and commitment to the client. If the law firm has a significant equity interest, the client may feel that the firm will be more responsive to its needs.

Despite these economic incentives, there are serious potential adverse consequences of owning equity. Most obviously there is the risk that the professional judgment of law firms owning equity will be impaired placing them at risk of increased liability claims.

The economics of investing in clients also are not entirely positive. Even assuming the ultimate value of stock ownership, the stock will be "restricted" and, accordingly, will have to be held on a long-term basis before liquidation. In addition, not all technology companies are successful. Knowledgeable observers estimate that losers outnumber winners by as much as 20 to 1. This economic risk is greater for lawyers in small firms or with less experience who may be taking greater risks in the hope of "cashing in" on the stock market.

Certain Fundamental Legal Fiduciary Concepts

There is nothing specifically improper under the California Rules of Professional Conduct with a lawyer accepting stock in his client. The lawyer is a fiduciary of the very highest order imposing on him a duty to communicate all information relevant to the transaction.

Of specific relevance is California Code of Professional Responsibility Rule 4-200(A) which states:

"A member shall not enter into an agreement for charge, or collect an illegal or unconscionable fee."

In light of these considerations as well as California Code of Professional Responsibility Rule 3-300, the lawyer should secure the written agreement of the client to the terms and conditions of the stock acquisition. The agreement needs to be clear, concise and reflect an understandable statement of the terms and conditions of the stock acquisition. It should include the following matters at a minimum:

1. Approval of the agreement by the Company's Board of Directors;
2. Acknowledgment that the client has sought or used independent counsel to advise it or [more likely] that the law firm has recommended that such independent advice and review be obtained. The agreement also should prominently display the law firm's recommendation that independent legal advice be obtained;
3. A clear and thorough explanation of the comparative value of the legal services and the value of the stock with a statement as to the basis for this determination; and
4. Disclosure of the actual or potential conflicts of interest that may result.

PRACTICAL ISSUES AND CONCERNS

Conflicts of Interest

At the most fundamental level, the lawyer must be comfortable that stock ownership will not adversely affect his independence and judgment or ability to represent his client in a professional manner. The lawyer should consider, for example, the following potential conflicts:

1. Voting in or taking sides in issues relating to the management and operation of the Company;
2. Negotiating or advising on shareholder agreements;
3. Negotiating or advising on registration rights for the lawyer's stock;
4. Providing of legal opinions in business transactions;
5. Disqualification of the lawyer in litigation;
6. Representing the client in stock offerings; and
7. Representing competitors of the client.

SECURITIES LAW ISSUES

Section 12 of Securities Act of 1933

Normally liability under Section 12, which permits private rights of actions for rescission, or in certain specific situations for damages, for violation of the registration requirements of the Securities Act of 1933 ("1933 Act") and for violation of the anti-fraud disclosure standards of federal securities laws in purported 1933 Act exempt securities offerings, cannot be attributed to attorneys who have merely prepared the securities offering. However, under the case of *Pinter v. Dahl*, 108 S. Ct 2063 (1988) liability may attach to persons who do not pass title to the securities being sold if they realize a personal benefit from the sale. Under this standard, lawyers who own stock could be exposed to a greater risk of potential liability.

Exempt Offerings--Restricted Securities

The securities that are issued to the lawyer will be "restricted" and may not be sold, except pursuant to a registration statement or a claimed exemption from registration (e.g. Rule 144). Accordingly, the securities will be "illiquid" and may have to be held for years before they may be sold in the public securities markets (assuming the client ultimately has a public offering of its securities).

If the client subsequently has an initial public offering, the lawyer's stock will usually be subject to the underwriter's "lock-up" restrictions. Normally these restrictions prevent the stockholder from selling his securities for a minimum period of 180 days following the effective date of the initial public offering.

10b-5 Anti-Fraud Issues

Whenever the lawyer decides to sell any of his stock, he needs to be very sensitive to whether he has material non-public information concerning his client. If the answer is arguably in the affirmative, the lawyer may be subject to a claim for violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder if he sells any portion of his equity interest. These considerations may severely limit the times when the stock may be sold.

If the client should be sued for violation of Rule 10b-5 (e.g. involving a material misstatement of fact or a material omission) the lawyer may be subject to a greater likelihood of being named in the lawsuit.

TAX ISSUES

Stock Purchase for Cash

If the client's stock is purchased for cash, normally the cash purchase price per share will be the lawyer's tax basis in the stock assuming the stock is purchased at its fair market value. No tax liability will be incurred on the acquisition, and upon the sale of the stock, the lawyer will realize a short or long term capital gain or loss depending on the holding period for the stock.

Stock Issued for Professional Services

If the stock is issued for services rendered, the fair market value of the stock will be taxable to the lawyer as ordinary income at the time the lawyer is issued the shares. If the stock is to be issued according to a vesting schedule as services are rendered (note under most state corporate laws stock may not be issued for future services) the stock may have a higher fair market value (i.e., a greater tax liability) as the stock is earned by the lawyer.

Stock Options

In situations where the client is a start-up or privately owned corporation, there will normally not be a "readily ascertainable market value" for the options. Accordingly, a Section 83(b) election will not usually be available and the lawyer will not be able to base his initial tax liability on a lower valuation for the stock at the time the options are granted. The stock options will be treated as non-qualified stock options and the lawyer will recognize ordinary income upon exercise equal to the difference between the exercise price and the then fair market value of the stock. This spread will constitute the tax basis for the stock. Upon sale of the stock, a short or long term capital gain or loss will be recognized.

Lawyers should also be aware, that unless registration rights have been granted in connection with the acquisition of the shares, the stockholder will have to hold the stock for a minimum period of one year before the shares may be eligible to be resold in the public securities markets pursuant to SEC Rule 144. These SEC stock restrictions, however, are not considered by the IRS in determining the fair market value of the securities for tax purposes.

Malpractice Insurance

The lawyer's malpractice application and policy should be reviewed. Typically there may be a question in the policy application as to the lawyer's practice of acquiring the securities of law firm clients. In addition, the normal lawyer's E & O policy may exclude coverage under certain circumstances for claims against the insured relating to a client whose securities are owned by the insured. These exclusions may be based on the firm's equity ownership exceeding certain percentage limits which usually are set forth in the policy. Other policies may have a blanket exclusion where a client's securities are owned by the law firm.