



THE CALIFORNIA GOLD RUSH AND THE MODEL RULES:
DO THE PROSPECTORS HAVE SUFFICIENT GUIDANCE?

TONY GOODMAN

Abstract

The economic climate that existed in Silicon Valley in the mid to late 1990's made prevalent the practice of receiving equity in a client in lieu of a legal fee, i.e. prospecting. This practice potentially impacts three of the Model Rules of Professional Conduct: 1.8(a), 1.7(b), and 1.5. None of these Rules gives the lawyer clear guidance in this situation. Because this arrangement has become an accepted alternative billing practice, this Comment proposes two amendments to the Model Rules to more clearly address the issues that arise when a lawyer accepts shares of stock in lieu of a legal fee.

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Greed ... is good, greed is right, greed works, greed clarifies, cuts through,
and captures the essence of the evolutionary spirit.¹

INTRODUCTION

Suppose that it's 1998 and Clarence Buckhauser is a partner in Bearden, Handler & Main, a ten-attorney law firm located in Silicon Valley in northern California. Bearden, Handler & Main primarily does corporate work for small companies. Halle Williams, an old friend of Clarence's from college, invited Clarence to lunch to discuss her new company, OldFlames.Com. OldFlames.Com, a company that locates ex-boyfriends and ex-girlfriends for its customers, was seeking legal representation. Halle offered to give Clarence's firm fifty thousand shares of Oldflames.Com if they agreed to represent her. Clarence discussed the idea with the rest of the partners and they agreed to represent OldFlames.Com in exchange for fifty thousand shares of stock. Six months later, the company's stock was trading at \$20 a share, giving Bearden, Handler & Main a value of \$1 million. It was the largest single pay off that the firm had ever received, and the other partners were overjoyed with Clarence's savvy business decision.

Clarence Buckhauser and Bearden, Handler, & Main were taking advantage of the relatively new concept of accepting equity in a client in lieu of legal fees. This phenomenon largely originated in the so-called "dot-com" market that centered around Silicon Valley in the mid to late 1990s. Because lawyers' conduct is governed by the Model Rules of Professional Conduct (Model Rules), a question arises as to whether taking equity in a client in lieu of legal fees implicates the Model Rules.

This Comment will discuss the ethical implications that arise when a lawyer acquires equity in a client as a form of legal fee. Part I.A discusses Rule 1.8 of the Model Rules of Professional Conduct, which governs business transactions between a lawyer and client. Part I.B explores Rule 1.7, which deals with conflicts of interests. Part I.C examines Rules 1.5, which provides guidelines for the reasonableness of the lawyer's fee. Part II.A discusses the entrepreneurial climate that existed in Silicon Valley to illustrate how the issue of equity as a form of legal fee arose. Part II.B considers criticisms of using equity in a client as a form of legal fee. Part II.C applies the Model Rules of Professional Conduct to the entrepreneurial climate. Part III proposes that the Model Rules be amended to address the situation in which a lawyer receives equity instead of a legal fee. Part III.A proposes that a comment be added to

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¹ WALL STREET (Twentieth Century Fox 1987). *Wall Street* is the story of a young and ambitious stockbroker who, while in search of new clients, is acquainted with a financial wizard with a genius for accumulating wealth. *Id.*

Model Rule 1.5 that notes that whether a fee is reasonable where a lawyer receives equity in a client is determined by the total value of that equity at the time of the IPO. Finally, Part III.B proposes that a comment be added to Rule 1.7 to permit the client to obtain an independent legal opinion on any matter that may give rise to a conflict of interest without disqualifying the lawyer.

I. APPLICABILITY OF THE MODEL RULES

Lawyers' conduct is governed by the Model Rules of Professional Responsibility (Model Rules).² The Model Rules do not prohibit lawyers from entering into business transactions with their clients.³ Rather, they merely establish guidelines to ensure that the transaction is fair and reasonable with respect to the lawyer's interest.⁴ Therefore, the Model Rules would not prohibit the hypothetical firm of Bearden, Handler & Main from accepting shares of OldFlames.Com. Rather, the Model Rules would provide a framework for the transaction. Model Rules 1.8(a), 1.7(b), and 1.5 apply when lawyers wish to acquire equity interest in their clients.⁵

A. Model Rule 1.8(a)

Under Model Rule 1.8(a), an attorney should not enter into a business transaction with a client unless:

- (1) the transaction and terms . . . are fair and reasonable to the client and fully disclosed . . . in writing . . . in a manner which can be reasonably understood by the client;
- (2) the client is given a reasonable opportunity to seek the advice of independent counsel . . . ; and
- (3) the client consents [to the transaction] in writing⁶

The focus of Model Rule 1.8 is to prevent a lawyer from overreaching in a situation where he or she would have a superior bargaining position or prevent a

² MODEL RULES OF PROF'L CONDUCT. The Model Rules are promulgated by the American Bar Association. The Model Rules were adopted on August 2, 1983 and were amended in 1987, 1989, 1990, 1991, 1992, 1993, 1994, 1995, 1996, 1997, 1998, and 2000. All attorneys are subject to the Model Rules because of their membership in the ABA, a condition of retaining a license to practice law.

³ See, e.g., MODEL RULES OF PROF'L CONDUCT R. 1.8 (2001) (providing that a lawyer is able to "enter into a business transaction with a client" if three conditions are met).

⁴ Debra Baker, *Who Wants to be a Millionaire?*, A.B.A. J., Feb. 2000, at 36, 36; see also MODEL RULES OF PROF'L CONDUCT R. 1.8 cmt. (2001) ("As a general principle, all transactions between client and lawyer should be fair and reasonable to the client.").

⁵ Edward H. Cohen, *Lawyers Investing in Their Clients: The Rules of Professional Responsibility*, in DEVELOPMENTS IN LAWYER ETHICS: MEGATRENDS OR JUST SOUND AND FURY 27, 32 (ABA Section of Business Law ed., 2001).

⁶ MODEL RULES OF PROF'L CONDUCT R. 1.8(a) (2001).

situation where he or she could “exert undue influence to secure favorable terms in a transaction.”⁷ Typically, courts place the burden upon the lawyer to prove that he or she did not take advantage of a fiduciary relationship with their client.⁸ Also, courts apply a strict scrutiny⁹ standard when a client challenges his or her attorney in court over the fairness of such a transaction.¹⁰ The applicability of Rule 1.8 does not depend on the facts of the case but “applies even when an unsophisticated attorney is dealing with a sophisticated client.”¹¹

The comments following Rule 1.8(a) state that the requirements do not apply to standard commercial transactions for products or services which the client generally markets to others.¹² The comments note that in such instances the lawyer has no advantage over the client.¹³ There are critics who claim that investing in a client is not an ordinary business transaction, and that attorneys who are involved in such transactions with newly formed companies are put in a superior bargaining position because they can discern from the very beginning whether a particular client has the ability to become profitable.¹⁴

Under Rule 1.8, business transactions with clients must be fair, with all terms and implications fully disclosed in a manner that the client would be able to understand.¹⁵ This is important because it helps the client to understand the lawyer’s role.¹⁶ For example, a lawyer could vote at a shareholder meeting, and that such a vote could be the deciding vote.¹⁷ Thus, it is possible that the lawyer could gain a controlling interest of the company.¹⁸ An equally important consideration is the existence of conflicts that may be created for the lawyers. Those conflicts are potentially compounded as an investment and becomes a larger percentage of the lawyer’s portfolio.¹⁹

Also, it is important that the information that the client receives is conveyed in a way that the client can understand, “without resorting to legalese.”²⁰ Finally, it is

⁷ See Cohen, *supra* note 5, at 30.

⁸ See Sarah Helene Sharp, *On Being a Blab or a Babler: The Ethics and Propriety of Divulging Client Confidences*, 11 GEO. J. LEGAL ETHICS 79, 80 (1997) (“The obligation to maintain client confidences arises from the attorney’s role as fiduciary.”).

⁹ See Cohen, *supra* note 5, at 30 (noting that this standard becomes even “stricter” when the lawyer is dealing with a client who is less educated or sophisticated or who has financial difficulties).

¹⁰ CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 8.11.3 (1986).

¹¹ See Cohen, *supra* note 5, at 30.

¹² See MODEL RULES OF PROF’L CONDUCT R. 1.8 cmt. 1 (2001) (listing some of the standard commercial transactions as “banking or brokerage services, medical services, products manufactured or distributed by the client, or utilities’ services”).

¹³ *Id.*

¹⁴ See WOLFRAM, *supra* note 10, at § 7.2.2.

¹⁵ See *id.* at § 8.11.4 (providing that full disclosure involves informing the client fully of things such as the nature and each of the terms of the transaction, the nature and extent of the lawyer’s interest, the ways in which a lawyer’s participation in the transaction might affect the lawyer’s exercise of professional judgment).

¹⁶ See Cohen, *supra* note 5, at 32.

¹⁷ *Id.* at 32.

¹⁸ *Id.*

¹⁹ Cohen, *supra* note 5, at 36.

²⁰ See *id.* (noting that legalese would be equivalent to “skating over issues before it is clear the client really does fully comprehend”).

also essential that these types of disclosures be made in writing.²¹ This is important because “it creates a document admissible in court, it allows the client to review the information at its leisure, and it gives the client something to take to a disinterested third party to examine.”²² Rule 1.8 also requires that clients be given a reasonable opportunity to seek the advice of independent counsel regarding the proposed transaction.²³

B. Model Rule 1.7(b)

Under Model Rule 1.7(b), “[a] lawyer shall not represent a client if the representation may be materially limited by the lawyer’s own interests.”²⁴ However, such representation is permitted when: “(1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation.”²⁵

If a lawyer has a reasonable belief that the representation would be limited by his or her own interests, the lawyer should conclude that the client should not agree to the representation under the circumstances.²⁶ Therefore, the lawyer would refuse the representation irrespective of whether the client consents.²⁷

According to clause (2), there must be a “communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question.”²⁸ The primary focus of Rule 1.7(b) is the attorney’s duty of loyalty to his or her client.²⁹ Many commentators agree that this will always be the case where a lawyer owns shares in a client.³⁰ Where a lawyer has an equity interest in a client, and particularly where the lawyer is rendering an opinion on an issue that may affect the market for the client’s stock, “theoretically, he or she would have an incentive to not be completely truthful or thorough when submitting disclosure

²¹ See WOLFRAM, *supra* note 11, at § 8.11.4. Wolfram provides that a full disclosure involves ensuring that the client fully understands:

(1) the nature of the transaction and its terms; (2) the nature and extent of the lawyer’s interest; (3) the ways the lawyer’s professional judgment might be affected; (4) the desirability of the client’s seeking independent legal advice; and (5) the nature of the respective risks and advantages to each party.

Id.

²² *Id.*

²³ See *id.* (noting that there is authority for the proposition that the counsel need not necessarily be legal counsel).

²⁴ MODEL RULES OF PROF’L CONDUCT R. 1.7(b) (2001).

²⁵ *Id.*; see also Cohen, *supra* note 5, at 34 (providing that whether the lawyer has a reasonable belief that the representation will be affected is determined by an objective “disinterested lawyer” standard).

²⁶ MODEL RULES OF PROF’L CONDUCT R. 1.7(b) cmt. 5 (2001). Comment 5 to Model Rule 1.7 notes that a client may consent to the representation even where there is a conflict under Model Rule 1.7(a)(1). *Id.* The Comment then directs the lawyer to Model Rule 1.7(b)(1) which precludes the representation under those circumstances even if the client consents. *Id.*

²⁷ *Id.*

²⁸ MODEL RULES OF PROF’L CONDUCT R. 1.7(b)(2) (2001).

²⁹ See *id.* at 1.7 cmt. 1 (“Loyalty is an essential element in the lawyer’s relationship to a client.”).

³⁰ Cohen, *supra* note 5, at 35.

documents or rendering third party opinions in situations where honesty or accuracy might result in a decline in the market value of the lawyer's shares."³¹

In fact, Rule 1.7 (b) is applicable throughout the representation of a client, and not just at the commencement of the relationship.³² Therefore, where the lawyer has an equity interest in the client, the change in the value of the shares during the duration of the representation must be considered.³³ In addition, changes to the lawyer's portfolio of assets is also a factor that must be considered at all times during the representation.³⁴

C. Model Rule 1.5

Under Model Rule 1.5, a lawyer's fee must be reasonable.³⁵ Rule 1.5 lists eight criteria to assist in the determination of reasonableness:

- (1) the time and labor required, the . . . difficulty of the questions involved, and the skill [necessary];
- (2) the likelihood . . . that the acceptance of . . . employment will preclude other employment . . . ;
- (3) the [customary] fee . . . in the locality for similar legal services;
- (4) the amount involved and the results obtained;
- (5) . . . time limitations . . . ;
- (6) the nature and length of the professional relationship . . . ;
- (7) the experience, reputation, and ability of [the attorney]; and
- (8) whether the fee is fixed or contingent.³⁶

Rule 1.5 requires that the value of the equity in a client that a lawyer receives in lieu of legal fees must be reasonable.³⁷ However, valuation³⁸ issues arise in the case

³¹ See *id.* (noting that this analysis "seems unreasonable in most circumstances").

³² MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 2 (2001) (providing that the lawyer should withdraw from the representation if facts that implicate the rule arise at any time during the representation).

³³ Cohen, *supra* note 5, at 36.

³⁴ *Id.*

³⁵ MODEL RULES OF PROF'L CONDUCT R. 1.5 (2001).

³⁶ *Id.*

³⁷ *Id.*; see also Cohen, *supra* note 5, at 38.

³⁸ See A.A. GROPELLI & EHSAN NIKBAKHT, FINANCE: INTRODUCTION TO FINANCIAL ANALYSIS AND MUCH MORE 51 (4th ed. 2000) (defining "valuation" as the measure of the value of money as it changes over time).

of securities, especially when stock in a privately held company is involved.³⁹ When considering the reasonableness of the lawyer's fee, any increase in the value of the shares should not be considered.⁴⁰ Some commentators assert that Rule 1.5 is not violated even if the client's shares increase "astronomically."⁴¹ Therefore, if a client's securities should appreciate after the lawyer has accepted those securities in consideration of performing legal services, the ethical rules still would not be violated.

Comment 2 to Rule 1.5 states, "a lawyer may accept property in payment for services, such as the ownership in an enterprise, providing this does not involve acquisition of a proprietary interest in the cause of action or subject matter of the litigation contrary to Rule 1.8 (j)."⁴² However, critics could argue that taking stock in lieu of fees, at least as payment for representing a client, might constitute such a potential proprietary interest.⁴³ This type of criticism resonated in economic climate of the 1990's.

II. STARTUPS, LEGAL FEES, AND THE MODEL RULES

A. *Startups and Legal Fees*

In the late 1990's the country experienced a prolific economic boom. This boom was due in part to the evolution and expansion of the Internet.⁴⁴ In general, the Internet created a new market for three types of businesses. First, it created a market for companies who had previously only sold their products or services in brick and mortar stores.⁴⁵ Second, it created a wave of new companies that were started

³⁹ See WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS 601 (4th ed. 2000) (providing that a privately held company is also known as a closely held corporation, and is one in which there are relatively few stockholders and no public market for the stock).

⁴⁰ See Cohen, *supra* note 5, at 38.

⁴¹ See *id.* (surmising that the value of the securities received are sometimes confused with the value of the lawyer's services and concluding that this is improper hindsight).

⁴² MODEL RULES OF PROF'L CONDUCT R. 1.5 cmt. 2 (2001).

⁴³ See Cohen, *supra* note 5, at 39.

⁴⁴ See generally *Internet Boosting the U.S. Economy, Study Finds*, at <http://www.cnn.com/2000/US/06/06/internet.economy> (Jun. 6, 2000). The Internet, as it is known today, has its beginnings in a 1969 U.S. Department of Defense Advanced Research Project Agency (DARPA) experimental project to develop a super-network. *ACLU v. Reno*, 929 F. Supp. 824, 830-31 (E.D. Pa. 1996). The network, known as the ARPANET, linked military, defense contractor, and university laboratory computers that were conducting defense-related research. *Id.* One of the goals of the network project was to enable vital communications to continue even if portions of the network were damaged or inoperable. *Id.* To meet this goal, multiple links to and from each computer on the network were created to allow several paths by which a communication could be transmitted. *Id.* As the ARPANET developed, similar networks were created to link businesses, universities, and other entities throughout the world. *Id.* at 832. Eventually, these various networks were connected, creating the series of linked networks that we know as the Internet. *Id.* The ARPANET evolved to being referred to as the "DARPA Internet" and finally just the "Internet." *Id.*

⁴⁵ See generally Mike Koller, *Brick-and-Mortar Presence Translates to Online Sales*, at <http://www.internetweek.com/story/INW20010802S0005> (Aug. 2, 2001); Margaret L. Young & Jennifer Read, *Dot-Com, Brick-and-Mortar Firm Managers Discuss Internet in Supply Chains*, at <http://www.stanford.edu/dept/news/report/news/june28/supplychain-628.html> (Jun. 28, 2000).

for the specific purpose of selling goods and services on the Internet.⁴⁶ Third, it generated a large need for companies to provide technical support and expertise with respect to the Internet.⁴⁷ Many of these “start-up”⁴⁸ companies in the computer services and products industry centered around Silicon Valley.⁴⁹

The public vigorously responded to the Internet market and, consequentially, start-up companies that were centered around the Internet popped up overnight. Because of the public response to the Internet, when the company would hold an initial public offering (IPO), investor response would often send the value of the stock skyrocketing.⁵⁰ Start-up companies were often created by engineers and scientists who typically knew little about business practices.⁵¹ In addition, these companies initially had little capital with which to pay legal fees.⁵² Thus, the situation developed where a start-up would offer shares of stock in exchange for legal fees.⁵³ In fact, it has been characterized as “practically standard operating procedure” for firms to take equity in their clients in Silicon Valley.⁵⁴

For example, the law firm of Wilson Sonsini Goodrich & Rosati (Wilson Sonsini) represented a small California based computer company that was going public in

⁴⁶ See generally Rich Kellett, *Online Selling Can Get Complicated*, at http://www.fcw.com/fcw/articles/2000/0619/web_dotgov-06-22-00.asp (Jun. 22, 2000).

⁴⁷ See generally Brendan B. Read, *Tech Support Beyond Y2K*, at <http://www.callcentermagazine.com/article/CCM20000524S0014> (Feb. 1, 2000).

⁴⁸ A start-up is a new business venture. *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 432 (3rd ed. 1991). Start-up is the earliest stage at which a venture capital investor or investment pool will provide funds to an enterprise. *Id.* These funds, also called seed money, are usually invested on the basis of a business plan detailing the background of the management group along with market and financial projections. *Id.*

⁴⁹ Before the economic boom, Silicon Valley was a largely agricultural place, “more famous for prunes than for computers” and Palo Alto, a small city outside of San Francisco, was home to a fair number of lawyers. Lawrence M. Friedman, et al., *The Growth of Large Law Firms and its Effect on the Legal Profession and the Legal Education: Law, Lawyers, and Legal Practice in Silicon Valley: A Preliminary Report*, 64 *IND. L.J.* 555, 556 (1989). Although it wasn’t as well known as San Francisco, Palo Alto quickly became a thriving legal center. *Id.* In the 1920’s, Sunnyvale, Menlo Park, and Mountain View each had one or two lawyers, San Jose and Redwood City had about twenty lawyers each, while the much smaller city of Palo Alto had fourteen. *Id.* In the 1950’s the number of lawyers grew to 50, then to 250 in the 1960’s. *Id.* Today Palo Alto has over 1,000 lawyers practicing within the city limits. *Id.* With a population under 60,000, Palo Alto has “perhaps the highest ratio of lawyers to population anywhere in the United States outside Manhattan and perhaps Washington, D.C.” *Id.*

⁵⁰ An initial public offering occurs when a company offers shares of its stock to the public for the first time. *JAMES D. COX ET AL., SECURITIES REGULATION CASES AND MATERIALS* 211 (2d ed. 1997).

⁵¹ Friedman, *supra* note 49, at 557 (noting that these owners required “access to elementary advice about such matters as record-keeping for tax and accounting purposes, and such basic legal services as the drafting of partnership agreements and secured financing documents”).

⁵² *Id.* at 559.

⁵³ Baker, *supra* note 4, at 36. Because of the economic boom, Silicon Valley lawyers were required to expand their legal services to meet the needs of their high-tech clients. See Friedman, *supra* note 49, at 556. Due to the type of clients they serve, these lawyers are considered to be highly specialized. *Id.* “They can give ‘full-service’ advice because they know the industry and don’t have to be educated constantly in every new client’s problems at the client’s expense.” *Id.*

⁵⁴ *Id.* at 39.

1999.⁵⁵ Wilson Sonsini held over 102,000 shares of its client's stock.⁵⁶ At the end of trading on the day of the IPO, shares with an issue price of \$30 closed at \$239.25 per share, netting the firm a value of \$24.5 million.⁵⁷

Wilson Sonsini also held over 2 million shares of another client, an online grocer, when it went public.⁵⁸ The firm's portfolio increased over \$51 million as a result of the client's IPO.⁵⁹ The firm also received equity in one of its clients, an Internet search engine.⁶⁰ When this company went public, the value of the firm's holdings increased by over \$17 million.⁶¹

The law firm of Cooley Godward had an equity interest in 20 of its 23 clients which had IPOs in 1999.⁶² After the bell sounded ending the day of trading in each of the 20 occurrences, the value of the Cooley Godward holdings exceeded \$1 million.⁶³

One Silicon Valley law firm, the Venture Law Group, actively seeks out investment opportunities in its clients.⁶⁴ The firm actually encourages its partners to take an equity interest in their clients.⁶⁵ The firm handled IPOs for 17 clients in 1999, two of which increased the value of the firm's holdings by more than \$1 million after trading ended on the day of the IPO.⁶⁶

It was these types of profits that were available in the IPO market that drove an increasing number of law firms to take equity in lieu of legal fees in their soon-to-be-public clients.⁶⁷

⁵⁵ See *id.* at 36 (providing that the company was VA Linux, a company that produces computer operating systems). The phrase "going public" refers to the IPO situation, where a company that is starting out or has been closely held, offers its shares for public sale.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ See *id.* (providing that the firm owned stock in Webvan, a company that delivers groceries directly to customers' homes).

⁵⁹ *Id.*

⁶⁰ See *id.* (reporting that the firm held 273,773 shares of Ask Jeeves, an internet search engine).

⁶¹ *Id.*

⁶² See *id.* at 37 (noting that some of the companies were Alteon WebSystems, MP3.com, and Nvidia).

⁶³ *Id.* A bell signals the beginning and ending of trading each day on the New York Stock Exchange (NYSE). *NYSE*, at <http://www.nyse.com> (last visited Oct. 25, 2001). Use of the bell was introduced when continuous trading was instituted in the 1870s. *Id.* The NYSE originally used a Chinese Gong, but a brass bell has been used since the NYSE moved to its current location in 1903. *Id.*

⁶⁴ See *id.* at 41 (quoting one of the firm's founding partners, who provided: "[t]hink of [Venture Law Group] as a combination of a very good corporate/securities law firm, a consulting firm, a venture capital fund and an investment bank").

⁶⁵ *Id.*

⁶⁶ See *id.* (noting that the two clients of the firm that netted more than a \$1 million increase in value were Foundry Networks and Etoys.com).

⁶⁷ See Baker, *supra* note 4, at 36. Coincidentally, law firms took advantage of the opportunity to invest in their clients as a way to control attrition as many of those same clients often tempted the firms' top legal talent to go to work for the client. *Id.* at 37.

B. Criticisms of Equity in a Client as a Form of Legal Fee

Firms that entered into these types of transactions asserted that they were merely capitalizing on a “technology revolution that had created a culture in which stock was considered an acceptable alternative to cash.”⁶⁸ The practice of taking equity in clients is becoming more widespread. For example, in 1999, according to Securities and Exchange Commission records, one out of every three lawyers that represented the more than 500 companies that went public that year held stock in their clients at the time of the initial public offering.⁶⁹ Critics feared that this IPO frenzy would eventually have the practice of law dictated by investment strategies.⁷⁰ Their concern was that lawyers’ professional judgment would be impaired by the “lure of becoming a ‘.com’ millionaire.”⁷¹

Historically, the legal profession has not been a proponent of lawyers holding equity interest in clients.⁷² The concern has been with conflicts between a lawyer’s own interests and the client’s interest.⁷³ The ABA Business Law Section’s Committee on Lawyer Business Ethics prepared a report that examined the issues of professional liability and ethical implications that arise from this type of alternative billing arrangement.⁷⁴ One of the findings of the report was that even when

⁶⁸ *Id.* at 37. The author agrees that taking equity in a client does not violate the Model Rules. Rather, the author is more inclined to see the capitalist nature of the transaction.

The Model Rules clearly find it suspicious when lawyers enter into business transactions with their clients. See WOLFRAM, *supra* note 10, at § 8.11.3. However, the truth is that such transactions benefit both the lawyers and their clients. Gwyneth E. McAlpine, *Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients’ Stock?* 47 UCLA L. REV. 549, 569 (1999). Essentially, the client will gain both the desired capital and also a strategic business partner. *Id.* In addition, the company will gain a business partner with apparent confidence in the venture because, like the client, the lawyer is also taking a risk. *Id.* The structure of the lawyer-client business transaction does in fact protect the client’s interests in such a way that the lawyer is not able to take advantage of the client. *Id.*

In return, the lawyer may receive a significant profit from the investment, which is particularly helpful in mitigating the risk that comes with representing start-up companies. *Id.* In a broader perspective, the success of this type of transaction would allow to accept a wider range of clients in the future, thereby, supporting the entrepreneurial spirit that has inspired the capitalists of America for centuries.

⁶⁹ See *id.* (reporting on an ABA Journal analysis of Securities and Exchange Commission records). The article also reported that the SEC report showed that lawyers’ holdings in over 40 percent of the companies that were involved in IPOs during the study year were worth more than \$1 million. *Id.*

⁷⁰ See *id.* at 38 (noting that the majority of the firms that received stock in clients received the stock for free or, at worst, substantially below its value, thus few of these firms lost money on the transaction).

⁷¹ *Id.* The critics’ contention was that this impairment of judgment would place lawyers at a higher risk of liability claims. *Id.*

⁷² *Id.*

⁷³ MODEL RULES OF PROF’L CONDUCT R. 1.7 (2001). Model Rule 1.7, discussed in Part I.B *supra* provides that “[a] lawyer shall not represent a client if the representation may be materially limited by the lawyer’s own interests.” *Id.*

⁷⁴ Committee on Lawyer Business Ethics, *Business and Ethics Implications of Alternative Billing Practices: Report on Alternative Billing Arrangements*, 54 BUS. LAW. 175 (1998) [hereinafter *ABA Report*]. The ABA report also notes that, to the extent contingent fee arrangements are dependent on the success of the client, particularly where the lawyer explicitly agrees that he or she will not be paid, or will be paid much less, if the client’s venture does not succeed, they may be

precautions are taken, lawyers may still be at risk for being accused of self-dealing.⁷⁵ When a lawyer goes into business with a client, he or she has a burden to establish both informed consent and transactional fairness.⁷⁶ The report notes that transactions where lawyer-client investment is involved typically carry a presumption that they are improper.⁷⁷

When law firms engage in these business transactions with their clients they face a potential “double whammy” if a client’s business is not successful.⁷⁸ Not only can these types of transactions expose the lawyers to adverse financial affects, they can also increase their risk of exposure to liability.⁷⁹ Most importantly, the lawyers who take stock in lieu of their fees may create situations that can become even more problematic because then they are more dependent on the success of the venture.

The critics have even expressed the concern that if the acquiring of equity interest in the client turns out to be less than profitable, then the lawyer has undertaken additional risk without reward.⁸⁰ If the investment turns out to be profitable, the client may believe that the lawyer has taken advantage of the client by receiving compensation that is “unreasonably high for the services rendered.”⁸¹ The critics even assume that a lawyer’s advice to his client with respect to the investment “is always suspect because the client does not know whose interest the lawyer serves.”⁸²

C. Applying the Model Rules

The actual guidelines for lawyers who invest in their clients are Rules 1.7(b) and 1.8(a) discussed above. Rules 1.7(b) and 1.8(a) warn against taking interest that may be adverse to a client, but they do not prohibit a lawyer from engaging in a business transaction with a client.⁸³ These rules simply establish a guideline to ensure that the interest is both fair and reasonable and done with a client’s full knowledge.⁸⁴

The operation of Rule 1.7(b) is illustrated in the case *In re Twohey*, which involved an attorney who was charged with violation of the rule by the Attorney

viewed as investing in that client. *Id.* If this is an accurate comparison, critics believe that it is important to note that acquiring a stock or other investment interests in a client in lieu of payment “raises very specific ethical concerns.” *Id.*

⁷⁵ See *id.* (concluding that the increased use of alternative billing arrangements in place of the traditional hourly billing “adds new dimensions to the attorney-client relationship”).

⁷⁶ MODEL RULES OF PROF’L CONDUCT R. 1.8 (2001). Model Rule 1.8 is discussed in Part I.A. *supra*.

⁷⁷ See *id.* (noting that this area of the law is very much in flux).

⁷⁸ Baker, *supra* note 4, at 39.

⁷⁹ See *id.* (reporting that, according to SEC records, the five law firms with the most 1999 client initial public offerings were all based in the Silicon Valley region).

⁸⁰ See *ABA Report, supra* note 74. The problems of the venture failing are multiplied for small law firms. Baker, *supra* note 4, at 39. While a large law firm may be better able to absorb the lost billings that result from such a representation, the effects could be devastating for a small firm. *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ MODEL RULES OF PROF’L CONDUCT R. 1.7(b) (2001); MODEL RULES OF PROF’L CONDUCT R. 1.8(a) (2001).

⁸⁴ *Id.*

Registration and Disciplinary Commission.⁸⁵ The attorney advised one client to purchase stock in another client, a company that was in the sand processing business.⁸⁶ The sand processing company eventually went bankrupt and the client lost her entire investment.⁸⁷ The court found that the attorney failed to disclose to the client that the company was heavily indebted.⁸⁸ Thus, the court held that the attorney had violated Rule 1.7(b) by not fully disclosing the fact that the attorney's responsibilities were limited by his own interest.⁸⁹ In addition, the attorney did not meet the Rule's requirement that the client consent in writing to the representation.⁹⁰

When the hypothetical firm of Bearden, Handler & Main decided to accept equity in OldFlames.Com, their conduct will be measured against Rule 1.7(b).⁹¹ In this transaction, Clarence and his partners will be in compliance with the Model Rules if their representation was not materially limited by their own interest.⁹² Under Rule 1.7(b), if Clarence's representation would be limited by his own interests, Clarence must then decline representation or else meet two additional requirements: he must reasonably believe that such representation will not be adversely affected and Halle and OldFlames.Com must consent to the representation after consultation.⁹³

When a lawyer acquires equity in a client in lieu of or in addition to fees, that lawyer has entered into a business transaction with that client and, therefore, is subject to the requirements of Model Rule 1.8(a).⁹⁴ Rule 1.8(a) also does not prohibit an attorney from taking an equity interest in a client but merely provides a framework to assure that the transaction is fair and reasonable.⁹⁵ The operation of Rule 1.8(a) is illustrated in *Passante v. McWilliams*, which involved the California equivalent of that Rule.⁹⁶ In *Passante*, a lawyer acquired a 3% interest in a company that produced baseball cards with holograms which precluded the cards from being

⁸⁵ *In re* William Nelson Twohey, 727 N.E.2d 1028 (Ill. 2000).

⁸⁶ *Id.* at 1030.

⁸⁷ *See id.* at 1033 (noting that the client that had invested in the sand company received 5% of the stock in return).

⁸⁸ *Id.* at 1030.

⁸⁹ *Id.*

⁹⁰ *Id.* at 1033. The ARDC recommended that the attorney be suspended from the practice of law for one year but did not require the attorney to pay restitution to the client. *Id.* The Illinois Supreme Court affirmed on the restitution issue but held that the attorney should only be suspended from the practice of law for six months. *Id.*

⁹¹ MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (2001); *see also* Robert C. Kahrl & Anthony T. Jacono, *Rush to Riches: The Rules of Ethics and Greed Control in the Dot.Com World*, MINN. INTELL. PROP. REV. (2001), at http://www.law.umn.edu/mipr/archive/frames/Jacono2001_02_01.htm.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*; *see also* Kahrl & Jacono, *supra* note 91.

⁹⁵ MODEL RULES OF PROFESSIONAL CONDUCT RULE 1.8 (2000). Comment 1 to Model Rule 1.8 provides that "as a general principle, all transactions between client and lawyer should be fair and reasonable to the client." *Id.* at cmt. 1.

⁹⁶ 62 Cal. Rptr. 2d 298 (Cal. Ct. App. 1997). The case involved Rule 3-300 of the California Rules of Professional Conduct. *Id.* at 302. Rule 3-300 prohibits "members from entering 'a business transaction with a client' without first advising the client 'in writing that the client may seek the advice of an independent lawyer of the client's choice.'" *Id.*

counterfeited.⁹⁷ The company, which had lacked the financial means to start producing the cards prior to the lawyer's investment, eventually found success with the new cards. The company reneged on its offer of stock and the lawyer sued to collect. The court held that it was improper for the company to have reneged on the stock offer. However, the court found that the lawyer had failed to advise the company "of the need for independent counsel in connection with its promise."⁹⁸ Thus the jury verdict of \$33 million was disallowed by the trial court and the lawyer was not able to recover due to his ethics violation.⁹⁹

With respect to the hypothetical firm and the transaction between Clarence and Halle, when Bearden, Handler & Main agreed to accept equity in OldFlames.Com in lieu of legal fees, their conduct will be subject to the requirements of Model Rule 1.8(a).¹⁰⁰ As long as Clarence engaged Halle in a transaction that was fair and reasonable, that he fully disclosed and explained all of the terms to Halle, that the transaction was specified in writing, and that Clarence allowed Halle to seek other counsel, Clarence would be in compliance the Rule 1.8(a).¹⁰¹

While construing whether Rule 1.8(a)'s first requirement of fairness and reasonableness to the client has been satisfied, Clarence must also consider the provisions of Rule 1.5.¹⁰² Rule 1.5, described above, required generally that a lawyer's fee be reasonable.¹⁰³ ABA Opinion 418 provides that Rule 1.5 must also be evaluated in discerning whether the equity transaction between Clarence and Halle is fair and reasonable.¹⁰⁴ Clarence must properly weigh these provisions in bartering his legal services for Halle's shares because if there were a disciplinary hearing Clarence would bear the burden of persuasion in demonstrating that the transaction was indeed fair and reasonable.¹⁰⁵ If Clarence failed to comply with the fair and reasonable standard, the equity transfer may be invalidated as it was in *Passante*.¹⁰⁶

⁹⁷ See *id.* at 299 ("As someone once said, if you build it they will come. And by the same token, if you make a baseball card that can't be counterfeited, they will buy it. Which brings us to the case at hand.").

⁹⁸ *Id.* at 302.

⁹⁹ *Id.* at 301.

¹⁰⁰ *Id.*; see also Kahrl & Jacono, *supra* note 91.

¹⁰¹ MODEL RULES OF PROFESSIONAL CONDUCT RULE 1.8 (2000).

¹⁰² See ABA Comm. On Ethics and Prof'l Responsibility, Formal Op. 418 (2000) [hereinafter ABA Opinion 418] (providing that Model Rule 1.5 is relevant to determining whether the Model Rule 1.8 requirement that the terms of the transaction be fair and reasonable to the client).

¹⁰³ MODEL RULES OF PROFESSIONAL CONDUCT RULE 1.8(a) (2000). The three basic requirements of Model Rule 1.8 are that the terms of the transaction are presented in such a fashion that the client can reasonably understand them, that the client have the opportunity to seek advice of other legal counsel, and that the client consent in writing. *Id.*

¹⁰⁴ ABA Opinion 418, *supra* note 102.

¹⁰⁵ See *id.* (noting that this burden is on the lawyer "once proof has been introduced that the lawyer entered into a business transaction with a client").

¹⁰⁶ See *Passante*, 62 Cal. Rptr. 2d at 303 (holding that the promise of stock in return for arranging the funding for the venture was "to use a phrase usually associated with life insurance contracts, an inchoate gift" that was legally unenforceable).

III. A PROPOSED AMENDMENT TO THE MODEL RULES

There is an inherent tension in the idea of a lawyer accepting an ownership interest in a client as a form of legal fee. On the one hand, if the acquiring of an equity interest in the client turns out to be less than profitable, then the lawyer has undertaken additional risk without reward.¹⁰⁷ On the other hand, if the investment turns out to be profitable, the client may believe that the lawyer has taken advantage of the client by receiving compensation that is “unreasonably high for the services rendered.”¹⁰⁸ This latter condition has been criticized because the lawyer's advice to his client with respect to the investment is seen as “suspect because the client does not know whose interest the lawyer serves.”¹⁰⁹

When taking an ownership interest in a client, particularly in the environment described above that existed in Silicon Valley in the last decade, one of the biggest challenges for lawyers lies in providing independent, unbiased advice and to avoid the temptation to “simply rush ahead toward the riches that will certainly follow the IPO.”¹¹⁰ Because of the legal and economic climate of the late 1990's, where new start-up companies needed legal advice but lacked sufficient funding to pay for legal fees, the scenario where a lawyer's fee includes equity in the client has become an accepted alternative billing practice.¹¹¹

When the hypothetical law firm of Bearden, Handler & Main decides to accept shares of OldFlames.Com in return for legal services, its conduct potentially implicates three of the Model Rules. As discussed above, these Rules are 1.8(a), 1.7(b) and 1.5.¹¹² Because this practice is a relatively new phenomenon that was not necessarily widespread in the past, coupled with the fact that the attorney faced with the situation must comply with three rules, this Comment submits that the current Model Rules do not adequately address this situation. Because a lawyer receiving equity in lieu of a legal fee has become an accepted alternative billing practice that surely will continue to be prevalent, this Comment proposes an amendment to the Model Rules that specifically addresses the situation.

A. Using the IPO Price

Any amendment to the Model Rules should address Model Rule 1.8's requirement that the transaction be fair and reasonable to the client.¹¹³ The Rule 1.5

¹⁰⁷ *ABA Report*, *supra* note 74.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* See also *Weiss v. Statewide Grievance Comm.*, 633 A.2d 282, 288 (Conn. 1993) (quoting the client in an action against his attorney as testifying “that he was not sure in what capacity the [attorney] was acting when he offered this advice—as an attorney, a land broker, a money broker or someone ‘looking out for his own interests’”).

¹¹⁰ Kahrl & Jacono, *supra* note 91.

¹¹¹ See Baker *supra* note 4 (reporting that it is “practically standard operating procedure” for firms to take equity in their clients in Silicon Valley).

¹¹² Model Rule 1.8(a) is discussed in Part I.A. Model Rule 1.7(b) is discussed in Part I.B. Model Rule 1.5 is discussed in Part I.C.

¹¹³ See MODEL RULES OF PROFESSIONAL CONDUCT RULE 1.8(a) (2000) (requiring the terms of the business transaction to be “fair and reasonable to the client”).

requirement that a lawyer's fee shall be reasonable in light of all the circumstances, must also be addressed by any amendment.¹¹⁴

Where the lawyer accepts equity in a client in lieu of a legal fee, whether the transaction is fair and reasonable to the client according to Rule 1.8 is ultimately based on the value of the shares. This is due to the fact that the value of the shares is, in actuality, the legal fee, the reasonableness of which is governed by Rule 1.5. In the IPO setting, if the public response to the offering turns out to not be profitable, then the lawyer's fee is unreasonably low.¹¹⁵ In contrast, if the response to the IPO is favorable and the investment turns out to be profitable, the lawyer's fee is unreasonably high and may violate Rule 1.5.¹¹⁶ Thus, the intersection of Rules 1.8(a) and 1.5 may pose a problem for the lawyer handling the IPO.

Under Rule 1.8, the client is afforded the opportunity to seek the advice of independent counsel to determine if the transaction is fair and reasonable.¹¹⁷ At the time when the client would seek this advice, the amount of the legal fee has not yet been determined. This is due to the fact that the shares of stock offered in lieu of a legal fee have not been valued. Thus, there is no basis on which to determine if the legal fee is reasonable under Rule 1.5 and therefore fair and reasonable to the client under Rule 1.8.¹¹⁸

This Comment proposes that the reasonableness of the legal fee be determined by the price per share set for the IPO. The price per share determination is typically made by an investment banker.¹¹⁹ The expertise of an investment banker is far superior to that of an independent counsel looking at the transaction prior to the IPO or that of a disciplinary board determining if the legal fee was reasonable after the fact.

Had OldFlames.Com sought an independent legal opinion prior to offering equity to Clarence and his firm under Rule 1.8, the IPO price would provide a definitive answer. For example, if the IPO price were set by the investment banker at \$7 per share and the 50,000 shares would translate into a \$350,000 legal fee. The independent counsel would then offer an opinion as to whether this fee was reasonable under Rule 1.5 and thus fair and reasonable under Rule 1.8. The fact that the hypothetical firm ended up with a \$1 million legal fee would be of no consequence under the proposed amendment made by this Comment. This Comment proposes that a comment be added to Model Rule 1.5 that notes that whether a fee is reasonable where a lawyer receives equity in a client is determined by the total value of that equity at the time of the IPO.

¹¹⁴ See MODEL RULES OF PROFESSIONAL CONDUCT RULE 1.5 (2000) ("A lawyer's fee shall be reasonable.").

¹¹⁵ See *ABA Report*, *supra* note 74.

¹¹⁶ See *id.*

¹¹⁷ See MODEL RULES OF PROFESSIONAL CONDUCT RULE 1.8(a) (2000).

¹¹⁸ See COX ET AL., *supra* note 50, at X (providing that an investment banker is called in to value the shares of a company before the IPO).

¹¹⁹ See *id.*

B. Seeking An Independent Legal Opinion

The amendment should also provide guidelines for a lawyer who, because of his interest in the company, may at times see a conflict between his interest and that of the client in violation of Rule 1.7. Rule 1.7(b) concerns the potential conflict between the lawyer's and client's respective interests in the transaction and is applicable throughout the duration of the transaction.¹²⁰ Thus, if a conflict arises after the representation has been undertaken, the lawyer must withdraw according to Rule 1.7.¹²¹

This presents an issue where the lawyer has an equity interest in the client and is rendering a legal opinion that could affect the price per share of the client's stock. In that instance, the lawyer's interest may be adverse to the client's interest. If the lawyer's investment in the client becomes significantly more valuable the conflict is accentuated. In addition, if the equity in the client is a significant proportion of the lawyer's investment portfolio, there is potential conflict.¹²²

Because Rule 1.7 is applicable throughout the representation, the lawyer may be forced to withdraw. This presents a problem as a practical matter, particularly if the lawyer and client have a long-term lawyer-client relationship. This Comment proposes that a comment be added to Rule 1.7 to permit the client to obtain an independent legal opinion on any matter that may give rise to a conflict of interest without disqualifying the lawyer.

IV. CONCLUSION

The economic climate has changed from gold rush that existed in Silicon Valley in the mid to late 1990's. However, the gold rush gave rise to the practice of prospecting, that is, receiving equity in lieu of a legal fee has become an accepted alternative billing practice. As we live in a capitalist society, new companies that often lack the funds to pay legal fees open their doors every day. Thus, the hypothetical scenario involving Bearden, Handler & Main and OldFlames.Com will surely be repeated. Because this practice is a relatively new phenomenon, the Model Rules of Professional Conduct do not adequately address it.

Accordingly, a comment should be added to Model Rule 1.5 that provides that the reasonableness of the lawyer's fee in a case where the lawyer received equity is determined by the offer price of the stock in the IPO. In addition, a comment should be added to Model Rule 1.7 that allows a lawyer to seek an independent legal opinion in a case where the lawyer would have been conflicted out of the representation. Given what has been termed a "nebulous nature of the standards of prudence in this area of law,"¹²³ both of these proposed comments will provide the prospectors the guidance they require.

¹²⁰ See MODEL RULES OF PROFESSIONAL CONDUCT RULE 1.7(b) (2000).

¹²¹ *Id.*

¹²² See Cohen, *supra* note 5, at 36.

¹²³ Kahrl & Jacono, *supra* note 91. Kahrl & Jacono focus on the narrow situation where an attorney is required to make certain disclosures with respect to intellectual property rights on the draft offering statement on his desk that accompanies setting up the initial public offering. *Id.*