

Accepting Payment In Securities In Lieu Of Money

BY ROY SIMON

In July, the Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York issued an important opinion about the right of a lawyer to accept stock, stock options, or other securities in lieu of fees. This has become a key ethics question for lawyers who represent Internet start ups that cannot afford hourly rates, but it may also affect other lawyers, including in-house lawyers who receive stock options as part of their compensation package. This article summarizes the City Bar's opinion.

N.Y. City Bar Op. 2000-02: May an attorney agree to accept securities in a corporate client instead of charging money for legal services? **Yes**, subject to various conditions.

First, the resulting fee must not be "excessive." DR 2-106(A) does not prohibit an agreement to accept securities in exchange for legal services, but it does prohibit excessive fees. DR 2-106(B) provides an objective test for determining whether a fee is "excessive" and provides eight factors to assist in making this determination. However, determining what is excessive is "a fact-specific exercise," and the eight factors "are not meant to be all-inclusive." When securities are received for legal services, "there are additional factors which should be considered, especially where the securities to be received are those of a 'start-up' business, or are part of or in connection with a public offering of the securities." Some additional factors to consider in those situations are:

- (1) the likelihood the transaction in question will or will not close and whether there are any contingent plans for payment of legal fees;
- (2) the estimated current and future value of the equity [i.e., securities] interest considering all the normal risks of a start-up business and any specific risks to the business or its assets;
- (3) the liquidity of the interest, including whether it is now or may in the future be publicly traded;
- (4) any restrictions on transfer of the interest, whether by agreement with the client or by law;
- (5) the percentage amount of the interest, and what, if any, degree of control it provides the lawyer over the business; and
- (6) what restrictions, if any, are placed on the money used to pay for the equity interest for example that it must be used to pay future legal bills.

When should the value of the securities be measured? Stock in a corporation that turns out to be successful might seem excessive once the success is achieved. But evaluating the fee at the end point, with the wisdom of hindsight, would ignore the risk that the venture would fail and the securities (the fee) would have little or no value. Accordingly:

[A] determination of whether a fee accepted in the form of securities is excessive requires a determination of value be made **at the time the agreement is reached**. ... [T]his test may allow attorneys to receive fees that turn out to be spectacular windfalls in relation to the compensation

that would normally be received on a cash basis. But as long as the reward stems from the investment risk accepted, not from an excessive fee, the result will equate to a lawyer 's investing cash, not services, in the venture.

Not all stock-for-fees arrangements will pass muster under this test. Where the risks are minimal and the amount of securities is excessive in relation to the services to be rendered, "the fee would not cease to be 'excessive' merely because the venture was not a sure thing." (A lawyer might also face possible civil liability for an excessive fee, or a client might justifiably refuse to pay the fee, and this problem is compounded by the rule that "an attorney, as a fiduciary, bears the burden of proving that the transaction entered into with a client is reasonable and not the fruit of undue influence.") Thus, a lawyer accepting client securities as payment "should seriously consider engaging an investment professional to advise as to the value of the securities so given."

The transaction may also need to comply with DR 2-106(D), which governs contingent fees. Because it is difficult to estimate the value of the securities (*i.e.*, the fee) until the success or failure of the matter or transaction has been established, there are "obvious elements of contingency" in such an arrangement. If a public offering fails, the lawyer probably will not receive any securities (or the securities will be worthless). DR 2-106(D) was apparently drafted with litigated actions in mind, but "there is no exception made in the provision for transactional matters." EC 2-20 states that a lawyer "generally should decline to accept employment on a contingent fee basis by one who is able to pay a reasonable fixed fee." Thus, a stock-for-fees transaction that includes a "contingent" element "is disfavored where the client could pay a reasonable cash fee." However, since many clients seeking to exchange their securities for legal services are "start-up companies that are strapped for cash, we view such arrangements to be consistent with EC 2-20."

EC 2-24 states "even a person of means may be unable to pay a reasonable fee, which is large because of the complexity, novelty, or difficulty of the problem or similar factors." Since most matters in which client's attempt to pay fees with securities are complex transactions, "even well-established commercial clients may not readily be in a position to be 'able to' pay a cash fee for the legal services they require."

Under DR 2-110(A)(3), if the lawyer withdraws or is prematurely discharged he is entitled to receive only the value that the work to the date of discharge or withdrawal justifies. If the work has not been completed, "receipt of the entire fee contemplated to be charged at the outset would be excessive and must be credited or refunded to the client."

That principle applies also to an arrangement under which a client gives a lawyer securities in payment for legal services to be rendered. (The Committee did not cite DR 2-110(A)(3), but did cite *In re Cooperman*, 83 N.Y.2d 465, 611 N.Y.S.2d 465 (1994), which construed that provision.)

The transaction must also comply with DR 5-101(A). The lawyer must initially determine whether this ownership interest in the client "would, or reasonably may, affect the exercise of her independent professional judgment on behalf of the client." If so, the lawyer must determine whether "a 'disinterested lawyer' would believe that the effect on the lawyer 's exercise of professional judgment will be adversely affected because the lawyer stands to be paid in securities of her client." If the effect would be adverse, then "the conflict is non-consentable and the representation on those terms must be declined." On the other hand, if the effect on the representation would not be adverse, then "the arrangement can proceed if

the client consents to the representation after the implications of the lawyer's interest are fully disclosed." The Committee believes that every securities-for-fees arrangement "reasonably may affect the professional judgment of the lawyer on behalf of her client." For example, when a lawyer accepts securities in a client corporation as a fee for negotiating and documenting an equity investment, or for representing it in connection with an initial public offering, "there is a risk that the lawyer's judgment will be skewed in favor of the transaction to such an extent that the lawyer may fail to exercise independent professional judgment." The lawyer's interest in the securities "may create economic pressure to 'get the deal done,' which pressure in turn may impact the lawyer's independent judgment on disclosure issues." In this respect, the risk is not significantly different from the risk presented when the lawyer's cash fee depends (in whole or in part) on whether a business transaction successfully closes. In both cases, the lawyer is "invested" in the transaction.

Contingent fees are ethical if reasonable and if the client has been informed about alternative billing arrangements. "We see no ethical distinction between the transactional contingent fee and agreeing to take client securities instead of cash fees." Such an arrangement can pass muster under DR 5-101(A)'s "disinterested lawyer" test even if it may affect the lawyer's independent professional judgment, but DR 5-101(A) "would preclude any arrangement if there exists a reasonable probability (viewed objectively) that the lawyer's interests will affect adversely the advice to be given or the specific services to be rendered to the client."

Standing alone, a lawyer's acceptance of a "stake in the action" does not always warrant the conclusion that his exercise of professional judgment will be adversely affected. Whether a reasonable probability of such an adverse effect exists "is factually driven and demands an analysis of the nature and relationship of the particular interest and the specific legal services to be rendered." Some "salient factors" may be "the size of the investment in proportion to the holdings of other investors, the potential value of the investment in relation to the law firm's earnings or assets, the possible impact on the lawyer of levels of risk involved, and whether the investment is active or passive."

In some situations, there will be "a likelihood, when viewed objectively, that the lawyer's interest in 'getting the deal done' will adversely affect the lawyer's independent professional judgment." The risk of such an adverse effect would be especially high, for example, in the case of "a potentially very large fee paid in client securities which represents both a significant portion of the law firm's revenues and a substantial stake in the client's business." In these circumstances, the lawyer's desire to obtain such a fee "might diminish the willingness of the attorney, albeit unconsciously, to advise the client company to disclose negative information or increase the lawyer's willingness to issue a questionable legal opinion required to close the deal." In such situations, "the conflict would be non-consentable and the fee arrangement ethically prohibited."

If the lawyer's representation of the client will not be adversely affected by an agreement to accept client securities as payment for future legal services, DR 5-101(A) allows the representation if "full disclosure is made to the client and the client's consent is obtained" — and "the Committee recommends that the disclosure and consent be in writing" even though DR 5-101(A) does not require written consent.

Disclosure should include: (1) the risks inherent in representation by a lawyer with a financial, business, property, or personal interest in the company, including the effects upon the lawyer's recommendations to the client; (2) the conflicts that might arise between lawyer/shareholder and client or its management

and the range of possible consequences stemming from them; and (3) any potential impact on the attorney/client privilege and confidentiality rules, particularly in communications between the client and the attorney in his role as investor rather than as counsel.

The transaction may also need to comply with DR 5-104(A), which requires a “two-part inquiry”: First, the attorney must determine if the attorney and her client have differing interests and if the client expects the lawyer to exercise professional judgment on the client’s behalf.

If the answer is “yes”, the attorney must show that the terms are fair and reasonable and have been given to the client in clear written form, that the attorney has advised the client that he may consult independent counsel and that the client has consented in writing after full disclosure.

DR 5-104(A) does not “automatically impose any consent or disclosure requirements on all transactions in which an attorney accepts securities in a client company for legal services to be rendered, at least where such an agreement is reached at the outset of the representation.” The rule applies if the lawyer will provide independent advice in the transaction by which the securities for services exchange is made. “If the lawyer is expected to play any role in advising the client, especially if a client lacks sophistication, the mandates of DR 5-104(A) must be followed.”

However, there is “a crucial difference between bargaining with the client, a function that puts the lawyer squarely on the other side of the table, and providing advice to the client relating to a transaction, including a transaction involving fees, where the client expects to rely on the attorney’s judgment.”

Quoting Simon’s New York Code Of Professional Responsibility Annotated, the Committee agreed that “garden variety fee arrangements generally can be expected to fall outside the scope of DR 5-104(A) because the client will rarely be relying on the lawyer to provide ‘independent advice’ in connection with such an arrangement.” But even when DR 5-104(A) does not apply, the New York Court of Appeals has cautioned that transactions between attorneys and their clients are “not advisable.” As Professors Hazard and Hodes say in their treatise, “there are no transactions that courts will scrutinize with more jealousy than dealings between an attorney and his clients.” In litigation over a stock-for-fees arrangement, therefore, the terms of the agreement would be construed most favorably to the client. If the attorney cannot demonstrate that the client was “fully aware of the consequences” and that there was “no exploitation of the client’s confidence in the attorney,” the client may be able to rescind the agreement. “If the attorney makes complete disclosure, obtains client consent and informs the client that the client should seek independent advice with respect to the fee arrangement, even where such measures are not required by DR 5-104, the lawyer may reduce the likelihood of such an adverse result.” Thus, even where DR 5-104(A) is not mandated,” the more prudent course for an attorney exchanging legal services for securities in the client company would be to follow the disclosure and written consent requirements of the rule.”

Roy Simon, Professor of Law at Hofstra’s School of Law, writes Simon’s New York Code of Professional Responsibility Annotated, published by West. The book is revised annually.