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BLUEPRINT FOR ACQUIRING STOCK IN A CORPORATE CLIENT

By Pamela Phillips and Phyllis A. Jaudes

American lawyers have long had a tradition of investing in their clients' businesses. Recently, the practice has received considerable attention as high-tech and Internet stocks raced toward the moon. Attorneys wishing to invest in their clients must maneuver around a number of potential ethical problems, but fortunately for California attorneys, the California Rules of Professional Conduct (the "Rules") provide a good road map for doing so. Civil case law also addresses the requirements for transactions with clients.

As a preliminary matter, these rules should *not* apply to an "open-market" transaction, for example, if the attorney simply buys shares in a publicly-traded client company on the same terms available to the general public. *See* ABA Formal Opinion 00-418 at 3, n.7. California has a similar rule.[1/] For any other type of investment in a client company, however, the attorney needs to be aware of the ethical rules that might apply. In this article, we synthesize the standards found in civil law and in various disciplinary rules to set out a practical blueprint for attorneys acquiring equity in corporate clients.[2/]

Doing Business With a Client

Attorneys are allowed to negotiate at arm's length with their clients in setting up the initial fee agreement, subject to the ethical rules that fees charged cannot be "unconscionable." Rule 4-200. We deal with stock-for-fees later in this article. But all other business dealings between lawyers and their clients are "scrutinized by courts with jealous care." *Felton v. Le Breton*, 92 Cal. 457, 469 (1891). As a result, these other transactions are subject to a rebuttable presumption that they were entered into under undue influence and without sufficient consideration. *Bradner v. Vasquez*, 43 Cal. 2d 147, 151 (1954). Since the lawyer holds a position of trust vis-à-vis the client, both case law and ethical rules seek to prevent the attorney from taking advantage of that trust, even inadvertently.

To be conservative, lawyers should assume that acquiring stock in a client constitutes "doing business with a client" — perhaps even if the stock is gratuitously received. *Passante v. McWilliam*, 53 Cal. App. 4th 1240 (1997) (rules governing an attorney's business transaction with client applied even where corporate client's Board of Directors voluntarily bestowed stock on attorney in gratitude for his excellent service). A recent ABA opinion concludes that purchasing stock through an investment partnership controlled by attorneys is also subject to the requirements for attorney-client business transactions. ABA Formal Op. 00-418 at n.6 (July 7, 2000).[3/]

Rule 3-300

California lawyers may invest in their clients if the lawyers comply with Rule 3-300. Under Rule 3-300, attorney investments in clients must comply with the following requirements:

- The terms must be *fair and reasonable* to the client;
- The lawyer must *explain* the terms in writing in a way that the client *should reasonably understand*;
- The lawyer must tell the client in writing that the client may seek the advice of an *independent lawyer* of the client's choice;
- The client must have a reasonable *opportunity* to consult with independent counsel; and
- The client must *consent* to the transaction in writing.

Rule 3-300(A), (B), (C). The official comment to the rule states that the rule does not apply to the initial retainer

agreement with one exception discussed below.

"Fair and reasonable"

Even if the client consents to the transaction, a court will not enforce the transaction unless the attorney demonstrates that the investment was fair and reasonable to the client. *Hunniecutt v. State Bar*, 44 Cal. 3d 362, 372-373 (1988). Sensibly, the ABA says that fairness should be judged at the time of the transaction. ABA Formal Op. 00-418 at 4.

If the stock increases significantly in value, a client could later argue that the transaction was not fair and reasonable. Therefore, an attorney might wish to do three things in the written conflicts waiver letter or similar document: (a) include a specific discussion of the fairness of the transaction; (b) for pre-IPO stock, note that the value of the stock is uncertain; and (c) state that both attorney and client agree that the fairness of the transaction should be judged as of the time of the transaction, not with hindsight.

Explain terms in writing

The attorney must explain the terms of the transaction in writing to the client, in a manner that the client reasonably should understand. Courts want the client to "know what it is getting into" in the transaction. If the client later challenges the transaction, the attorney must be able to show that the "client acted with full knowledge of all the facts connected with such transaction, and fully understood their effect." *Beery v. State Bar*, 43 Cal. 3d 802, 812 (1987).

One way to meet this requirement is to explain the significant facts, and their possible negative consequences, if any, in the conflicts waiver letter to the client. The ABA opinion injects some common sense here — you need not drown the client in details; focus on the important points. ABA Formal Op. 00-418 at 7.

Independent counsel

In the same letter or another document, the lawyer should advise the client that it is free to seek independent counsel to advise it about whether to enter into the transaction. The lawyer might even say that he or she will not advise the client about the transaction.

The client must also have a reasonable opportunity to seek independent advice, preferably before the final documentation for the transaction is signed. The client is not required to obtain independent advice; it must simply have a reasonable opportunity to do so. While the ABA opinion says the attorney should *recommend* that the client obtain independent advice about the investment, the California rule does not require this.[4/]

Written consent

Finally, the client must consent to the investment transaction in writing. The client's signature on the stock purchase agreement could suffice *if* the lawyer has complied with the other disclosure requirements set forth above.

Timing

Ideally, the attorney should fulfill all of these requirements *before* the transaction is completed (or at least before the final transaction documentation is signed). However, even if you have failed to do so before completing the transaction, you can still seek to comply with Rule 3-300 after the fact. A court is likely to give weight to written consent from the client, even if you obtained it late, as long as the consent is truly informed and the client understands it has the option to decline the consent.

Consequences of Violating Rule 3-300

Failure to comply with Rule 3-300 can result in disciplinary action. It can also have a significant financial downside for the attorney: the client may be able to *void* the transaction, even if the client has received the benefit of the transaction. *Passante v. McWilliam*, 53 Cal. App. 4th 1240, 1248 (1997) (corporate client was entitled to renege on its promise to give attorney 3% of the company's stock, ultimately worth $33 million, on either of two grounds: that the promise to grant stock to its lawyer was a business transaction that was unenforceable because lawyer failed to comply with Rule 3-300, or the client's promise of stock was gratuitous and thus unenforceable). Of course, a client is most likely to seek rescission in cases where the stock has increased significantly in value — precisely the situation in which the attorney would most like to hold onto it! Thus, failure to comply with the strict requirements of Rule 3-300 can carry a high price tag.

What to Say About Potential Conflicts of Interest

In the ABA's view, owning stock in a client does not itself create an inherent conflict of interest. ABA Formal Op. 00-418 at 9. But the ABA opines that under some circumstances, a lawyer should also advise the client of the transaction's "potential effects on the client-lawyer relationship." *Id.* at 6. The opinion offers only one

example: the lawyer should alert the client if the lawyer's acquisition of stock may limit the client's control of the corporation. *Id.* Another example might be if the stock were financially significant to the attorney's overall worth, such that a precipitous decline in its value could create tension between the attorney's own interests and the client's.

In the typical Silicon Valley model of investing, this would usually not be the case. In Silicon Valley, investments in any one client are generally relatively modest; likewise, the interest of any individual attorney is usually diluted by that attorney's participation with his or her colleagues in an investment pool. Thus, the holdings of any particular attorney working on the client's matters are not usually financially significant. Further, the attorneys involved in these investments recognize that a stock's loss in value, while not desirable, is a common occurrence, especially in the volatile technology sector, and they accept that basic risk of investing. Nonetheless, if you can foresee potential conflicts, discuss them in your waiver letter.

Owning stock in a client might also require compliance with two other California conflicts rules. For instance, if an attorney owns stock in a client and that client turns up as a party in a matter in which the attorney is representing another client, then the attorney's investment could trigger the disclosure requirements of Rule 3-310(B)(1) or (2) (attorney must disclose in writing certain financial relationships with other parties or witnesses to a matter).

As another example, Rule 3-310(B)(4) requires disclosure when the attorney has an "interest in the subject matter of the representation." The mere ownership of stock in a client company most often will not constitute such an interest, particularly in the typical Silicon Valley investment where the size of the investment, and its significance to the lawyer's personal assets, are both modest, and the lawyer's work often has no direct relationship to the value of the stock.

However, common sense and the ABA ethics opinion both suggest that where the outcome of the representation is likely to have a significant effect on the overall value of the attorney's stock — as it could in some mergers or buy-outs, for example — then the attorney who owns stock in the client (or in another party to a transaction) might be considered to have an "interest in the subject matter of the representation."

As the ABA points out, limiting the percentage of stock a lawyer holds in a corporate client will help to limit the possibility that the lawyer's own holdings could compromise his or her objectivity. ABA Formal Op. 00-418 at 11. In the ABA's view, when a conflict arises, transferring the work to another attorney in the firm could cure any conflict, at least with client consent. *Id.* at 10 n.31.

Stock for Fees

Rule 3-300 does not appear to apply to a stock-for-fees arrangement that is negotiated as part of the initial retainer agreement. *See* Official Comment to Rule 3-300. Although an exception applies if the initial fee agreement gives the attorney a financial or pecuniary interest "adverse to" a client, this "adverse to" exception is narrowly construed and should not include the mere purchase of stock. Buying a controlling interest could trigger the exception, however. And negotiating for stock *after* the attorney-client relationship is formed would trigger Rule 3-300's requirements.

If the attorney obtains the stock as part or all of the attorney's fee, then the attorney should comply with the provisions of Rule 4-200. Under Rule 4-200, fees for legal services may not be illegal or unconscionable. Rule 4-200(A). An unconscionable fee is one that is "so exorbitant and wholly disproportionate to the services performed as to shock the conscience." *Bushman v. State Bar*, 11 Cal. 3d. 558, 563 (1974). Unconscionability is determined based on "all the facts and circumstances existing *at the time the agreement is entered into* except where the parties contemplate that the fee will be affected by later events." Rule 4-200(B) (emphasis added).

In light of the phenomenal heights to which some high-tech and Internet stocks have risen in the past few years, a client trying to avoid an obligation might argue that the "later events" caveat applies and that the fee is unconscionable because of the huge increase in the stock's value.

Thus, if a lawyer is taking stock for fees, the attorney may want to document in the disclosure letter that the client and attorney agree the stock taken is not an unconscionable fee, citing the circumstances that buttress that conclusion. For example, such a letter might refer to the following facts: the stock currently is not publicly traded and its market value is unknown; the value could vary because of uncertainties in the market; and the value of the stock was set by outside investors (e.g., venture capital firms) and not the attorneys. It might also be helpful to recite that the parties agree that it is fair to judge the propriety of the fee at the time of investment, not with hindsight.

The ABA's rule on fees is different from California's rule. The ABA requires a lawyer's fee to be "reasonable." Model Rule 1.5. Surprisingly, the ABA ethics opinion concludes that the "reasonable fee" rule will apply even if an attorney purchases stock rather than accepting it in lieu of cash for the lawyer's fee. ABA Formal Op. 00-418 at 3 n.6. The ABA opines that its "reasonable fee" rule applies whenever an attorney's opportunity to invest arises *in connection with* the attorney's undertaking of legal services, even if the stock is not part of the fee arrangement. Thus, according to the ABA, an attorney needs to comply with the "reasonable fee" rule unless, for instance, the attorney purchases the stock on the open market on terms equally available to the general public. *Id.* at 3 n.6 and n.7.

The ABA's conclusion on this point makes no sense and should not be adopted by California courts. Nothing in California law suggests that its standards for legal fees (Rule 4-200) apply to every business transaction with a client. Based on the construction and content of California's rules, the opposite is intended: Rules 3-300 and 4-200 are different rules for different situations; besides, Rule 3-300 already has a "fairness" factor built into it. In addition, California courts could not impose a "reasonable" fee standard because California's standard is "unconscionability." Thus, if a California attorney is purchasing stock as an investment, rather than taking it in lieu of cash for fees, the attorney should not need to consider Rule 4-200. But the attorney should comply with California Rule 3-300.

Keep Monitoring for Conflicts

Of course, an attorney's duties go beyond those laid out in the disciplinary rules. Attorneys must always be mindful of their fiduciary duties of loyalty, independence and objectivity. Once an attorney owns stock in a client, the attorney should monitor his or her performance to make sure that the investment is not interfering with any of those fiduciary duties. *Compare* ABA Model Rule 1.7(a) (attorney should not represent client unless attorney believes the representation will not be adversely affected by attorney's own interests).

FOOTNOTES

1. Rule 3-300 of the California Rules of Professional Conduct. The official comment states: "Rule 3-300 is not intended to apply where the member and client each make an investment on terms offered to the general public or a significant portion thereof."

2. We assume the equity being acquired is stock in a corporate client. However, the same analysis would apply to other interests which a lawyer might acquire in a client.

3. The ABA opinion is not binding on California's State Bar or courts. California Rule 1-100(A). However, ABA Model Rule 1.8, the rule governing business transactions with clients, sets out requirements similar to those in the corresponding California rule, Rule 3-300. For this reason, courts in California may consult the ABA opinion for guidance to the extent that it is not inconsistent with California law.

4. California courts have chastised lawyers for not *recommending* independent counsel where the transaction is unique and the attorney participated in negotiating the terms, but those transactions are a far cry from the typical Silicon Valley stock purchase, where the attorney simply accepts a price negotiated by others.

ATTORNEY HANDBOOK FOR INVESTING IN CLIENTS

Rogers Joseph O'Donnell & Phillips' "Attorney Handbook for Investing in Clients" is available for $225. The Handbook includes:

- recommended law firm risk management policies
- a checklist for investing in clients
- specific points to cover in a conflicts letter to the client and
- other useful information.

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ROGERS JOSEPH O'DONNELL & PHILLIPS

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J. Michael Matthews
Suzanne M. Mellard
Merri A. Baldwin
Sean M. SeLegue
Phyllis A. Jaudes
Richard A. Jackson
John S. Throckmorton
Amber Lee

311 California Street, 10th Floor
San Francisco, CA 94104
Telephone: 415.956.2828
Facsimile: 415.956.6457
E-mail: rjop@rjop.com