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In recent years, many corporate attorneys have tried to function not merely as legal adviser to their clients, but as business consultants to them, and even as investors in their enterprises. During the “Dot-Com” boom of the late-1990s, this phenomenon led to the widespread practice of law firms taking equity in lieu of, or in addition to, their traditional legal fees. But when a corporate attorney’s financial well-being becomes too closely tied to the success of a transaction in this way, her ability to exercise her independent professional judgment regarding the matter can be compromised. Recent financial scandals have aroused suspicion of the corporate world generally, and although public wrath has thus far focused primarily on the misdeeds of accountants and investment analysts, scrutiny could turn next to the propriety of relationships between corporations and their attorneys. Professor Hurt argues that, at least in part because of the prevalent and questionable practice of taking equity in lieu of fees from a client, the legal profession is now susceptible to the embarrassment of an Enron-like scandal.

The author first describes some of the ways that corporations have sought to structure legal fee arrangements so that their attorneys are more effective at achieving results beneficial to the corporation. Then the author examines traditional understandings of the corporate attorney-client relationship by focusing on the attorney’s roles as transactional cost engineer, reputational intermediary, and gatekeeper. Next, the author shows how investing in a client adversely affects an attorney’s attempts to fulfill each of these traditional roles. Finally, in order to preserve the independence of corporate attorneys and eliminate any incentive to act unethically, the author suggests that either regulatory agencies should require disclosure of arrangements whereby attorneys “buy-in” to their clients’ enterprises, or the legal profession itself should impose more restrictive limits on this practice.

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I. INTRODUCTION

Imagine a painting, or a cartoon poster in a legal gifts catalog, that depicts the participants in a corporate transaction. Along with figures representing the management of the corporation, the painting would include a stable of professionals: attorneys, accountants, and investment bankers. If this painting truly reflected a transaction consummated in recent years, those three professionals would be virtually indistinguishable from one another. Although the accountant would surely be sitting with his HP 12C calculator, the investment banker with his laptop, ready to run the "model" if necessary, and the lawyer with the now-ubiquitous Blackberry, the three professionals would be giving advice and guidance on the same array of issues arising from the transaction.

Recently, many trends have contributed to attorneys being viewed less as independent counselors and monitors of corporate behavior and more like business consultants, partners, and even investors. First, the nature of corporate transactions has become so complex as to require attorneys to actively create and structure deals, an activity that transcends the traditional realm of legal advice and borders on business advice. In addition, the explosion of multi-disciplinary practice among "Big Five" accounting firms, a phenomenon in which the same firm will provide auditing, consulting and even legal advice, has caused attorneys to rethink the bundle of services that attorneys provide. Finally, corporate clients have recently begun to ask corporate counsel to become partners with them and forsake the traditional billable hour in lieu of sharing in the risks and rewards of the transactions in which such counsel participates.

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1 See, for example, "The Closing," item number 1055, at http://www.forcounsel.com (last visited May 19, 2003), advertising a framed, limited edition lithograph depicting the "dynamism and energy" in the final moments of closing a financial deal.


3 Prior to the conviction of Arthur Andersen on obstruction of justice charges on July 7, 2002, the Big Five accounting firms were Arthur Andersen, Deloitte & Touche, KPMG, Ernst & Young, and PriceWaterhouseCoopers. Currently, the remaining large public accounting firms are referred to as the Big Four.

4 See Peter C. Kostant, Paradigm Regained: How Competition from Accounting Firms May Help Corporate Attorneys to Recapture the Ethical High Ground, 20 PACE L. REV. 43, 44, 48 (1999) (describing accounting firms as providing tax planning, business planning, mergers and acquisitions consulting advice, and litigation support services).

5 See Paul Marcotte, Designer Billing: Lawyers Use Value Billing, Other Hourly Rate Alternatives, A.B.A. J., Nov. 1989, at 38, 39 (quoting Shelby Rogers Jr., Senior Vice President and General Counsel of Texas Commerce Bancshares, Inc., as saying: "Law firms that are willing to experiment, willing to be innovative, will participate in that reallocation. Firms that are not willing to be innovative will not participate.").
Wanting outside counsel to become more accountable and wanting legal fees to correlate more directly to the creation of value, corporate clients have been asking or allowing outside law firms to “buy in” to the clients’ immediate objectives, such as the acquiring of an asset, launching an initial public offering, consummating a merger, or securing financing.\(^6\) To secure this type of loyalty and interdependence, clients, particularly growth-oriented start-up companies, have begun to ask outside counsel to accept part or all of its legal fee as equity in the client company.\(^7\) At the height of the technology boom, some Silicon Valley firms required equity investment opportunities in addition to standard hourly fees.\(^8\) Made culturally acceptable by its widespread use in Silicon Valley, investing in clients is swiftly becoming standard practice for many law firms.\(^9\) These law firms view themselves as not just corporate counsel, but also strategic business partners who advise clients on legal and business matters.\(^10\)

This trend in the legal profession of becoming lawyer, business consultant, and venture capitalist for a client mirrored similar trends in the accounting industry, and both were amiably moving toward becoming more like the investment banking industry and toward a holistic transaction nirvana when one of the largest corporate scandals in recent history forced attorneys and accountants alike to reexamine their traditional roles and their relationships with their clients. In the fall of 2001, Enron Corp. publicly announced that it would take massive charges against earnings and restate its financial statements for the prior four years because of accounting errors.\(^11\) During the deluge of reports of mismanagement, self-dealing, creative accounting and disclosure problems, fingers began pointing at both the accountants involved and the outside

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\(^6\) See Peter D. Zeughauser, *The Use of Alternative Fee Arrangements to Achieve Smart Results and Improve Outside Counsel Relationships*, 871 PLI/CORP. 47, 54 (1994) (stating that clients want an attorney to “put his or her money where his or her mouth is”).


\(^8\) See infra Part III.

\(^9\) See Baker, supra note 7, at 39 (remarking that taking equity in clients is “standard operating procedure” in Silicon Valley).

\(^10\) See id. at 41 (quoting Craig Johnson, founder of Venture Law Group, as saying: “Think of VLG as a combination of a very good corporate/Securities law firm, a consulting firm, a venture capital fund and an investment bank, and you’ll be close to what we really do”); D.M. Osborne, *When Is a Law Firm Not a Law Firm?*, Inc., May 1, 1998, at 82 (profile of VLG).

\(^11\) The *SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIRS. OF ENRON CORP., REPORT OF INVESTIGATION*, 2002 WL 198018, at *9 (Feb. 1, 2002) [hereinafter ENRON REPORT] (detailing how on October 16, 2001, Enron reported it would take a $544 million after-tax charge against earnings and a $1.2 billion reduction of shareholder equity, followed by a complete restatement of financial statements from 1997 to 2001 that reduced reported net income by hundreds of millions of dollars).
attorneys. These groups were named in lawsuits against Enron Corp. and its officers. In addition, Arthur Andersen, one of the most venerable of the large, public accounting firms, was convicted in June 2002 of obstruction of justice for shredding documents related to Enron Corp. Suddenly, investors, legislators, and regulators have begun scrutinizing these third-party professionals with a zeal reminiscent of the fallout after the savings and loan scandals of the late 1980s. Legislation has been introduced and passed in an attempt to make both accountants and attorneys more independent from clients. This new-found suspicion of interdependence has even led to scrutiny of investment banks, brokers, and analysts.

In the aftermath of the Enron scandals, the legal profession must reexamine how closely connected it should be to its corporate clients. Certainly the public has begun to question the activities of attorneys as well as accountants and

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15 See Jason Hoppin, Coalition Is Seeking Aid and Abet Liability for Lawyers, Accountants, RECORDER (San Francisco), May 22, 2002, at 1.


18 See, e.g., Michael Schroeder & Randall Smith, Massachusetts Probe into CFSB Funds Pressure on Stock Analysts, WALL ST. J., Sept. 6, 2002, at C1 (detailing investigations into Credit Suisse First Boston’s analysts’ practices by Massachusetts securities regulators, the New York Attorney General, the SEC, and the National Association of Securities Dealers); Charles Gasparino, NASD Plans to File Charges Against Salomon, Grudman, WALL ST. J., Sept. 20, 2002, at A1 (reporting on the NASD’s investigation of conflicts of interest arising from Salomon & Smith Barney’s relationship with Winstar Communications, Inc., and research analyst Jack Grubman’s research reports on the same company); Randall Smith & Charles Gasparino, Analyst Inquiry May Cost Wall Street up to $2 Billion, WALL ST. J., Oct. 28, 2002, at C1 (predicting that investigations by the New York attorney general and the SEC into investment banks’ independent stock research reports could lead to an unprecedented legal settlement).
analysts that are perceived to be too close to their clients. The legal profession must then decide what is the proper rule of a corporate attorney. Is an outside attorney a gatekeeper? A counselor? A monitor? An advocate? Can a corporate attorney adequately maintain the balance between independent counsel and business partner when his financial well-being is closely tied to the consummation of a client’s proposed transaction and the performance of a client’s stock? Even if the most ethical attorney could ignore her own economic interests, to the outside world this interest makes the entire transaction or representation suspect. By “buying in,” an attorney can easily be seen as “selling out.” Therefore, the legal profession should take steps to restore the independence of corporate attorneys by instituting and enforcing rules either prohibiting or disclosing these conflicts of interest before the legal profession suffers the same reputational disaster now plaguing the accounting industry.

Section II will briefly outline the recent growth of alternative fee arrangements in the legal profession and the rationales behind them. Section III will further spotlight the recent rise of attorneys investing in their clients, particularly in the Silicon Valley in the late 1990s. Section IV of this article will detail the historical roles of corporate attorney and client, in particular the roles of transaction cost engineer, reputational intermediary, and gatekeeper, and Section V will discuss whether these equity investments help or hinder an attorney in fulfilling the roles of transaction cost engineer, reputational intermediary, and gatekeeper. Section VI will discuss how both the appearance and existence of conflicts in the attorney’s fulfillment of these roles can lead to increased liability for malpractice, breach of fiduciary duty, and securities fraud. Section VII will compare the trends in the legal profession with the rise and fall of multidisciplinary practice in the accounting profession, and Section VIII will propose that either the legal profession institute rules that prohibit the practice of attorneys investing in clients or that other regulatory agencies institute rules that require disclosure of such arrangements. Section IX will conclude that members of the practicing bar should avoid the economic pressure to act like investment bankers or venture capitalists and restore independence to the legal profession.

II. THE ULTIMATE CARROT: ATTORNEYS’ FEES

This article will explore the proper roles of a corporate attorney and whether investing in a client enhances or impairs the ability of the attorney to fulfill those roles. An attorney’s motivation and ability to function in these roles are closely tied to the ability to and method of charging a fee for those functions. Therefore, a brief discussion of how clients have sought to make attorneys more effective in these roles through alternative fee arrangements is necessary.
A. Background

The debate over how to value legal services is as old as the legal profession itself. In early Rome, legal advocates contributed their services free of charge and laws were passed against the peddling of legal services for monetary gain.\(^{19}\) Even after Emperor Claudius issued a decree allowing for the payment of legal fees up to a maximum amount, an attorney did not have a right to collect those fees if the client declined to pay.\(^{20}\) Although attorneys' fees in the United States are definitely a matter of course and both blessed and prescribed by law, attorneys, especially attorneys at large law firms, are still loath to discuss the matter of fees with clients.\(^{21}\) Although most lawyers have new clients sign representation agreements, lawyers prefer not to focus on fee matters when counseling clients, much like a physician treats a patient in an examination room without any mention of the cost of the office visit. Because of the desire to be part of a profession, not a vocation, many attorneys in this century have avoided talking about fees until the end of a representation and then simply have sent a bill for "legal services rendered."\(^{22}\)

In the latter half of this century, hourly billing became the convention among most U.S. attorneys.\(^{23}\) The practice has been an integral part of life at traditional law firms where leveraged young associates, hoping to one day be partners, used to toil for the benefit of current partners on work steadily and loyally provided by long-term clients. However, this type of law practice is slowly vanishing from the horizon.

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\(^{20}\) Id. In England, this legal oddity still continues and contingency fees are considered champertous and illegal. Id. Perhaps this attitude is why the "English Rule," wherein the loser in litigation pays all fees, is so popular. Why should innocent parties, forced to retain counsel, pay for those services?

\(^{21}\) See Robert E. Litan & Steven C. Salop, Reforming the Lawyer-Client Relationship Through Alternative Billing Methods, 77 JUDICATURE 191, 191 (1994) ("The topic of legal fees once was one of those subjects lawyers didn't discuss in polite company.").

\(^{22}\) See Charles S. McCowan, Jr. & Esteban Herrera, Jr., Alternative Fee Arrangements: Time for Consideration, 43 LA. B.J. 466, 466 (1996) (stating that historically, clients were presented with a one-page invoice that said only "for legal services rendered").

B. Who Moved My Fee? The Changing Legal Industry

1. The Client's Point of View

In the last twenty years, however, the legal industry has changed. The profile of the industry evolved from one of stable, homogenous law firms servicing long-standing, loyal clients to an industry in which lawyers, both associates and partners, move easily between law firms. Clients began moving even easier, moving from long-term relationships with law firms to project-specific relationships with many firms. More disturbingly, some clients even began shopping around for legal services, asking attorneys to make proposals for certain types of legal work and to compete with cross-downtown rivals. Clients became consumers; legal services became a consumer good.

As clients began to see legal services as a product, clients began to question the use of the billable hour to calculate the value of that product. Clients do not buy cars or computers based on the number of hours spent to create that car or computer. In fact, flat pricing of such products has led manufacturers to shorten the amount of hours necessary to create the product. Business clients who had become indoctrinated with the theory of “total quality management” wanted

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24 See Litan & Salop, supra note 21, at 193 (stating that the 1980s marked the beginning of attorney exodus and decreased firm loyalty).

25 See id. (describing lateral movement of partners between firms); see also Richard B. Schmitt, Miller to Leave Weil Gotshal, WALL ST. J., July 10, 2002, at C4, available at 2002 WL 3400234 (reporting the departure of Harvey R. Miller from the department he created at Weil, Gotshal & Manges to an investment banking boutique, joining leagues of lawyers who have “doubled or tripled their income” by making the same move).

26 See Litan & Salop, supra note 21, at 193–94 (making a connection between corporate merger frenzy and the “major reshuffling of legal relationships”). The next logical step was the unthinkable: law firms began to merge, reshuffling clients and practice areas even more. See Wendy M. Becker et al., Lawyers Get Down to Business, MCKINSEY Q., Mar. 22, 2001, at 45 (describing the mega law firm mergers of 2000 and noting how these restructurings disrupted long-standing attorney-client relationships).

27 See Edward Felsenthal & Paul M. Barrett, Clients and Changing Times Rein in Runaway Legal Fees, SAN DIEGO UNION-TRIB., June 13, 1998, at A22 (detailing the process by which Charter Behavioral Health Systems reduced legal expenses 35% by holding a “beauty contest” among ten law firms before choosing Alston & Bird to handle its medical malpractice defense cases).

28 See Peter D. Zeughauser, Preparing Successful Responses to Requests for Proposals, in WIN-WIN BILLING STRATEGIES: ALTERNATIVES THAT SATISFY YOUR CLIENTS AND YOU 211 (Richard C. Reed ed., 1992) (providing ideas for drafting bids in “beauty contests” where clients evaluate and choose outside counsel for a specific transaction).
outside legal counsel to undergo the same metamorphosis and become lean, mean legal machines.  

In addition, clients wanted to bring the legal vendors into the management team. Although large companies created substantial in-house legal departments, most companies continued also to use outside law firms for specific projects. The traditional representation had entailed the corporate client virtually giving the attorney a blank checkbook and the attorney determining in what ways and how quickly the checks were to be spent, but now clients became intent on ensuring that the motivations of outside counsel were aligned with the motivations of the clients. At worst, clients were concerned that hourly billing gave outside counsel the opportunity to misrepresent actual time spent on projects and thus to overbill for services. At best, clients were very suspicious that hourly fees incentivized even the most honest lawyers to spend more time on projects than necessary; take on ancillary projects that had little marginal utility; anticipate and complete projects that were never used; staff projects with more lawyers than necessary; and, for training purposes, layer projects with inexperienced lawyers supervised by other lawyers. Hourly fees did not motivate attorneys to consider the benefit to the client of each hour worked in relation to the cost to the client of each hour.

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29 See Richard C. Reed, Billing Innovations: New Win-Win Ways to End Hourly Billing 83–84 (1996) (noting that companies that applied TQM techniques to other departments eventually focused those techniques on the legal department, pressuring managers to reduce the legal budget and to improve the return on that budget).

30 See Mary C. Daly, The Cultural, Ethical, and Legal Challenges in Laywering for a Global Organization: The Role of the General Counsel, 46 Emory L.J. 1057, 1059 (reporting that between 1962 and 1982, the number of in-house lawyers quadrupled, and that from 1980 to 1991, the number increased by 33%, an increase that mirrored corporate managers’ desire to have attorneys with a more intimate knowledge of their businesses).

31 See id. at 1061–62 (noting that one of the main functions of in-house attorneys is to monitor outside counsel).

32 See Stephen W. Jones & Melissa Beard Glover, The Attack on Traditional Billing Practices, 20 U. Ark. Little Rock L. Rev. 293, 293 (1998) (“Clients may not know exactly what type of billing they want, but they know exactly what they do not want—a billing method that gives the attorney the ability to determine the costs with no added incentive for the attorney to be efficient with the clients’ resources.”).

33 See id. supra note 21, at 192 n.5 (citing a survey that concluded that 56% of corporate counsel respondents believed that outside counsel inflated hours on invoices).

34 See id. at 192 (detailing examples of attorney tasks and staffing methods a fully informed client would not condone).

35 See id. (recognizing that although attorneys do not discuss this mindset, clients “routinely attempt to make tradeoffs between the costs of legal services and the quality of work”). Again, attorneys like to think of themselves as legal physicians. Most attorneys would not expect a physician to suggest a low-cost course of treatment that was in any way less effective than the optimal course of treatment.
The first technique clients used to make outside counsel more responsive to client objectives was monitoring, a technique historically used by principals to ensure that their agents use firm resources to advance the goals of the principal.\(^{36}\) Basic monitoring may have already been instituted by in-house legal counsel who supervised the outside law firms.\(^{37}\) Advanced monitoring, in the form of auditing detailed billing statements and outcomes,\(^{38}\) proved to be very time-consuming and costly, and many times the effort expended outweighed the benefit derived from the monitoring.\(^{39}\)

Although monitoring led to some reforms, some corporate clients remained unconvinced that outside counsel were efficiently supervising their legal budgets. Even if law firms had to submit heavily documented invoices, “timekeepers” became adept at wording tasks in those invoices so as not to raise flags with reviewers of those invoices.\(^{40}\) Moreover, monitoring had its shortcomings; even if the bill was an accurate reflection of the time spent on a project, that time may not have been spent efficiently.\(^{41}\) Clients then resorted to another strategy that owner-shareholders use to align the interests of managers: compensation schemes.\(^{42}\)

\(^{36}\) See id. at 192–93 (describing the client-attorney relationship as analogous to another principal-agent relationship, the one between shareholders of a firm and management, and comparing monitoring techniques used in each to solve the “moral hazard” problem).

\(^{37}\) See REED, supra note 29, at 84 (describing changes that occurred during the recession of the late 1980s and early 1990s to cut costs that resulted in a situation in which “outside lawyers who previously had dealt with the president of the corporation (who may not have been a lawyer) now found themselves dealing with general counsel who knew exactly how the hourly billing game was played”).

\(^{38}\) See Litan & Salop, supra note 21, at 193 (describing how some companies hired third-party auditors to review invoices).

\(^{39}\) See id. (warning that excessive micro-management and second-guessing of outside counsel wastes both client and attorney resources and destroys the trust necessary for a successful relationship). However, many changes in the legal profession are a definite outgrowth of client monitoring. Some notable client audits shed light on some billing practices that had long gone unnoticed: two attorneys in the same firm both billing the client for interoffice conferences with each other; billing several clients for the same time spent performing the same task; billing one client for working on its file while simultaneously traveling for and billing a second client; and charging a premium for services such as copying, catering, word processing, and faxing. See Sonia S. Chan, Note, ABA Formal Opinion 93-379: Double Billing, Padding and Other Forms of Overbilling, 9 GEO. J. LEGAL ETHICS 611, 633–35 (1996) (chronicling how Citicorp forced its outside counsel to reform its billing practices). Court battles and media attention surrounding these audited fee statements made corporate clients demand that law firms reform their own practices. See Felsenthal & Barrett, supra note 27 (describing how one client stopped tolerating the industry practice of inflating such charges).

\(^{40}\) See Chan, supra note 39, at 624 (noting that attorneys will always be able to justify time spent because attorneys are masters at rationalization).

\(^{41}\) See Litan & Salop, supra note 21, at 193.

\(^{42}\) See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 169–70 (8th ed. 2002) (describing executive compensation schemes such as
changing the method of calculating legal fees, clients could better ensure that outside counsel were using client resources to achieve client goals in the most efficient manner.43

2. The Attorney’s Point of View

As clients began to question the billable hour as a method of determining value of legal services, technological and cultural developments caused attorneys to question hourly billing as well. Research that had taken days now took hours on an electronic database, such as Westlaw or LEXIS-Nexis.44 Common court documents that had previously taken hours to create from whole cloth could now be prepared in minutes by retrieving those same documents prepared for other clients from a firm’s network database.45 Even large, negotiated contracts could be roughed out quickly by electronically revising “precedents,” or similar documents used in prior transactions.46 At first, attorneys began to use technology to enable them to increase billable hours. A quick reproduction of research that had taken thirty hours last month for a different client was again billed out at thirty hours for the new client.47 Law firms began passing on technological costs, such as fees charged by electronic databases, faxing and copying at a high premium.48 However, clients protested these “innovations,”49 and in the case of

compensatory stock options and golden parachutes as methods used to align the interests of managers with the interests of shareholders).

43 See Litan & Salop, supra note 21, at 194 (noting that certain alternative billing methods may encourage attorneys to “internalize the sensitivity to cost” of the client); REED, supra note 29, at 89 (reporting that Peter D. Zeughauser, general counsel of the Irvine Company, was “[a] realist” and “keenly aware that the choice of billing methods can be used to align the interest of the client and outside counsel”).

44 Linda J. Ravdin & Kelly J. Capps, Alternative Pricing of Legal Services in a Domestic Relations Practice: Choices & Ethical Considerations, 33 Fam. L.Q. 387, 388 (1999) (stating that technology has reduced the time required to produce many documents).


47 See id. at 25 (noting that ABA Formal Opinion 93-379 was an effort to eliminate practices such as recycling work product).

48 See Jones & Glover, supra note 32, at 298–99 (describing the conundrum faced by an attorney incurring additional expenses for doing online research that reduces the number of billable hours required to perform a task who cannot pass on those costs to the client).

49 See id. at 300 (“[M]any companies flatly refuse to pay for internal costs such as copying or online research.”).
double-billing, the courts supported their protests. Attorneys then raised the hourly rates, but again rates could only increase a certain amount before clients voiced concern. Some attorneys began to realize that technology was making them more efficient, but less profitable at the same time. Only by changing the hourly billing method could attorneys profit from being technologically efficient.

In addition, as more attorneys searched for a better lifestyle and a balance with work and family, the controlling billable hour proved to be an obstacle. If the only way to increase one’s income was to increase the number of hours worked, then an attorney’s income was effectively capped. The billing method that had created a lucrative profession was in danger of sentencing the same profession to a never-ending accumulation of more and more hours worked.

3. Trial and Error

In addition, in the late 1980s and early 1990s, times of corporate belt-tightening, clients began to demand alternative billing arrangements, such as flat fee billing, contingent fees, and hybrid arrangements tailored to specific legal work. Some law firms were quick to adapt, but most were more reluctant to abandon the reliable source of steady income, the billable hour. Part of this intransigence probably stemmed from attorneys’ reluctance to discuss fees with clients at all. Proposing an alternative fee would, at the very least, require a

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50 See ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 93-379 (1993) [hereinafter 1993 ABA Op.] (“The practice of billing several clients for the same time or work product, since it results in the earning of an unreasonable fee, therefore is contrary to the mandate of the Model Rules.”).

51 See Ravdin & Capps, supra note 44, at 387–88 (hypothesizing that hourly billing rates cannot be increased much more for the sake of profitability). In addition, if a lawyer’s hourly rate is raised to account for technological efficiencies, some hours spent in an old-fashioned way will be overpriced, such as hours spent in a deposition or negotiating a document. See id. at 390.

52 See also Becker et al., supra note 26, at 49 (hypothesizing that technology such as Westlaw and LEXIS-Nexis allowed for “low-value-added” legal work to be shifted away from large law firms).

53 See Ravdin & Capps, supra note 44, at 390 (stating that straight hourly billing undervalues the attorney’s efficiency and investment in technology).

54 See McCowan & Herrera, supra note 22, at 466 (encouraging lawyers to consider alternative fees to be competitive in a buyer’s market).

55 See Wendy R. Liebowitz, Not Snow, Nor Sleet, Not Gadget Boom Will Kill the Billable Hour, NAT'L L.J., Aug. 31, 1998, at B13 (reporting that although analysts predicted that technology would cause attorneys to abandon hourly billing, inertia and fear keep most attorneys loyal to the billable hour).
conversation about fees. In addition, many older law firms would see changing the fee structure as acknowledging that they are in a commercial business of providing legal services; no longer could they operate under the legal fiction that lawyers provide legal services as a public service and that grateful clients then reward those lawyers by paying a gratuitous fee. However, some law firms, both newer, smaller law firms and more innovative established firms, thrived in this market by offering alternatives to their current clients and by attracting new clients with a more “value-based” billing approach.

Attorneys experimented with many alternative billing approaches, including contingent fees, reverse contingent fees, flat fees, value billing, and hybrid approaches that combined one or more of these alternatives with hourly billing. Each billing system has its own inherent problems. Each practice, like hourly billing, will have a tendency, in certain scenarios, to create a conflict of interest in the motivations of outside counsel and the client. Contingent fees, although accepted in most types of litigation, can create conflicts in the transactional realm if the transactions are large and time-intensive and the entire fee is contingent on the closing of the transaction. Contingent fees can work, however, if the outside attorney has numerous small transactions for the same client. Although flat fees are beneficial to the client because legal costs will be

56 MODEL RULES OF PROF’L CONDUCT R. 1.5(b), (c) (1984) (requiring fee arrangements with clients other than long-term clients to be agreed upon at the beginning of a representation, preferably in writing, and requiring all contingent fee agreements to be in writing).

57 See Jason M. Klein, No Fool for a Client: The Finance and Incentives Behind Stock-Based Compensation for Corporate Attorneys, 1999 COLUM. BUS. L. REV. 329, 357 (noting that lawyers will become more willing to consider alternative billing arrangements when lawyers are willing to talk about fees and accept that the practice of law is a business).

58 See Marcotte, supra note 5, at 38 (noting that Stephen Susman, LLP, a name partner in a very successful Houston-based firm, employs four types of billing methods).

59 See Ravdin & Capps, supra note 44, at 415 (stating frankly that any billing system will be arbitrary to some degree and will be able to be abused by unethical lawyers).

60 See id. (noting that although hourly billing methods create an incentive for attorneys to perform unnecessary work, flat and contingent fees give attorneys incentives to perform the least work, and the client’s motivations are equally opposite and misguided for each).

61 MODEL RULES OF PROF’L CONDUCT R. 1.5(d) (prohibiting contingent fees in certain representations, such as domestic relations and criminal defense).

62 See Furlonger, supra note 19, at 97 (noting that the quicker a transaction is closed, the more likely it is that the corporate lawyer did not fulfill her duty to protect her client and also noting that the more substantial the contingent portion of the fee, the more likely an corporate attorney will be to ignore potentially problematic issues that arise in the transaction).

63 ABA Comm. on Lawyer Bus. Ethics, Business & Ethics Implications of Alternative Billing Practices: Report on Alternative Billing Arrangements, 54 BUS. LAW. 175, 185 (1998) (advising that contingent fees for transactional matters can be economically feasible if the attorney is engaged in numerous projects for the client and if some of those projects are likely to successfully close).
predictable, if the assumptions made in calculating that fee fail, then either the client or the attorney will have a windfall, and the other may incur a hardship. Value billing, where the client and attorney agree to a fee based on the value added by the attorney, was not realistic for clients who need predictable legal costs and do not wish to spend a lot of time negotiating with outside counsel. Some hybrid arrangements, with certain phases of representation being performed for a fixed fee, with some portion of the fee contingent on performance, have worked successfully for some parties.

III. THE NEW, NEW THING

A. Buddy, Can You Spare a Million?

During this transitional period, the economy changed. All of a sudden in the 1990s, the richest individuals in the United States were not lawyers and doctors, but entrepreneurs. The technology boom ushered in the New Economy, where an ordinary person with an idea in the garage could become a millionaire, then a billionaire. Almost everyone knew someone (or knew someone who knew someone) who had become rich with the new currency: stock options. In days, or hours, or minutes, someone who held stock options in a company launching an

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64 See Reed, supra note 29, at 89 (citing the ABA Section of Litigation's Committee on Corporate Counsel surveys, which indicate that most clients are willing to pay a premium in exchange for a predictable fee).

65 See Furlonger, supra note 19, at 97 (noting that if either party's assumptions are wrong, then one party may have windfall profits, the client may refuse to pay the bill, or the attorney may be underpaid).

66 See id. ("[I]t is preferable from the client's point of view to be aware of legal costs before the actual provision of legal services, rather than receive an unpleasant surprise following the completion of the lawyer's task.").

67 See id.

68 One of the entrepreneurs most frequently mentioned is Michael Dell, who dropped out of college in 1984 to found Dell Computer from his home. In 2000, Dell Computer was listed as the United States' largest computer seller, and Mr. Dell was reported as having a net worth of $16 billion. The Forbes 400, FORBES, Oct. 9, 2000, at 185. Fellow Texans in Austin who were enriched by buying Dell stock earned the name "Dellionaires." See Winners & Losers of '98, WALL ST. J., Dec. 30, 1998, at T1 (reporting that in 1998, Dell Computer stock increased in value 255%); see also David Howard, Dot-Com Scams, SMART BUS. FROM ZD WIRE, Sept. 1, 2000, 2000 WL 2000520 ("[T]he home runs being hit by these technological companies have got just about everybody in the U.S. trying to figure out how to become a billionaire.").

69 See Francy Blackwood, Lawyers Take Long View and Put Stock in Clients, S.F. BUS. TIMES, June 16, 2000, at 22 (referring to stock options as "coin of the realm" and "the New Economy Currency").
initial public offering ("IPO") could see those options become worth millions.\(^{70}\) The new economic input became not time, not knowledge, not even value, but risk. If someone was willing to take risk, then that person could benefit greatly.

This shift in the economy, added to the fact that law firm revenues were beginning to falter,\(^{71}\) resulted in attorneys suddenly becoming much less wealthy than their clients.\(^{72}\) Clients who had shown up months before in blue jeans with nothing but a patent or a website were now far richer than most attorneys could ever become. Law firms saw associates, and even partners, lured away to start-up companies by the promise of stock options and cutting-edge legal work.\(^{73}\) Attorneys suddenly realized an economic truth: if income is based on the number of hours worked multiplied by a certain number, then income is forever restricted.\(^{74}\) A day has only so many hours, after all. In addition, attorneys were energized by the exciting technology boom and wanted to become more involved in the business side of bringing companies to the capital markets.\(^{75}\) Attorneys saw even accounting firms expand into business consulting and begin enjoying the lucrative buzz of wheeling and dealing.\(^{76}\) Silicon Valley attorneys, who had strong ties to both the venture capital and entrepreneur community in that region,

\(^{70}\) See Joseph I. Rosenbaum, *Dot-Com Crash Has Not Erased Legal Work*, N.Y. L.J., Sept. 17, 2001, at S3 (describing "the seeming ease with which one could become an IPO (Initial Public Offering) millionaire with a dollar and a dream").

\(^{71}\) See Felsenthal & Barrett, *supra* note 27 (stating that law firm revenues showed little growth after large increases during the 1980s).

\(^{72}\) See *id.* (describing attorneys as becoming "bit players in the economy"); Jeff Manning, *Ethics & Economics: The Technology Boom Entices Many Lawyers into Becoming Shareholders as Well as Advisers to Corporate Clients, but Such Arrangements Raise Worries*, *Stock*, PORTLAND OREGONIAN, Feb. 27, 2000, at C1 (assigning to young associates the notion that their six-figure salaries were "chump change" compared to "stock-option windfalls enjoyed by young turks of technology").

\(^{73}\) Even in-house counsel, whom lawyers in private firms have generally considered to have traded in long hours for lower pay and prestige, were becoming millionaires overnight. See Adam Lashinsky, *Silicon Valley: The Lawyers Got Screwed Too*, FORTUNE, May 27, 2002, at 133, 136 (telling the story of an entry-level associate and a partner who left Cooley Godward to be in-house lawyers at eBay and then became millionaires, in the case of ex-partner turned general counsel, seventy-five times over).

\(^{74}\) See *id.* (citing Mark Tanoury of Cooley Godward as realizing that increasing fees from an average of $200 to $300 an hour was not moving the firm any closer to sharing in the economic boom of Silicon Valley).


\(^{76}\) See Nikhil Deogun & Elizabeth MacDonald, *Winning by the Numbers: Bean Counters Now Figure Big in Merger-Advisory Game*, WALL ST. J., Feb. 10, 2000, at C1 (reporting that in 1999, KPMG International advised on more mergers and acquisitions than any other firm, including investment banking giants Goldman Sachs, Morgan Stanley, and Merrill Lynch).
were uniquely situated to offer more for their clients than just legal services.\textsuperscript{77} Attorneys suddenly became much more interested in partnering with their clients and in taking part of their clients' risk in return for the possibility of a payoff.\textsuperscript{78} Now attorneys added a new pricing mechanism to the table: equity.

The technology boom of the 1990s altered law firms' conservative outlook on investing in clients.\textsuperscript{79} In certain areas of the country, particularly Northern California and the Pacific West Coast, law firms began being very aggressive about accepting,\textsuperscript{80} and in some cases demanding\textsuperscript{81} equity from new clients. The four law firms mentioned most often as accepting equity in clients are Venture Law Group ("VLG"),\textsuperscript{82} Wilson, Sonsini, Goodrich & Rosati,\textsuperscript{83} Brobeck, Phleger & Harrison LLP,\textsuperscript{84} and Cooley Godward LLP.\textsuperscript{85} In most cases, the clients being accepted under this type of arrangement were start-up companies that would

\textsuperscript{77} See Suchman & Cahill, supra note 75, at 700 (ascribing the success of Silicon Valley firms in retooling as business consultants to their knowledge of the informal business norms of venture capital funds in that region).

\textsuperscript{78} See Manning, supra note 72 (stating that law firms implemented ambitious investment programs to share in the technology-generated economic boom); Krischer Goodman, Some Entrepreneurs are Replacing Cash with Equity When Seeking Legal Help, SAN DIEGO UNION-TRIB., June 11, 2000, at 13 (noting that attorneys realize that billing by the hour does not allow a law firm to share in any economic upside).

\textsuperscript{79} See Howart, supra, note 68 (“[T]he equity windfalls have been substantial enough to prompt most firms to soften or throw out their rules against investments in clients.”); Lashinsky, supra note 73, at 136 (reporting that in 1999, Cooley Godward adopted a policy requiring start-up clients to make up to one percent of their equity available to the firm in pre-IPO stock in addition to its regular fees).

\textsuperscript{80} See Scott Wooley, Law Firm Takes Equity in Lieu of Fees, ORANGE CO. BUS. J., Dec. 14, 1993, at 3 (describing Palmieri, Tyler, Wiener, Wilhelm & Waldron as one of two law firms who were making a habit of accepting client equity).

\textsuperscript{81} See Lashinsky, supra note 73, at 136; Susan Beck, In Silicon Valley Dealmaker Mark Tanoury's World, the Companies are Tiny, the Payoffs are Enormous, and the Clients Beg for Attention, AM. LAW., Apr. 2000, at 64 (reporting Mark Tanoury of Cooley Godward as stating that at a minimum, the firm required equity from new clients).


\textsuperscript{83} See Homepage, Wilson Sonsini Goodrich & Rosati, at http://www.wsgr.com (last visited May 19, 2003) ("Your strategic business partner.").

\textsuperscript{84} See Why Brobeck?, Brobeck, Phleger & Harrison LLP, at http://www.brobeck.com/why_brobeck (last visited Mar. 14, 2003) ("Clients benefit from creative billing arrangements and access to their attorneys around the clock.").

\textsuperscript{85} See Overview, Cooley Codward LLP, at http://www.cooley.com/firmprofile_content.ixe?section=Overview (last visited Mar. 14, 2003) ("We are counselors, strategists and advocates for today's and tomorrow's leaders of the New Economy.").
eventually engage in an IPO. During a time when these law firms had more than enough business and were turning away clients, lawyers evaluated clients on the equity offered and the “upside” of that equity. At the height of the IPO bubble, even law firms representing the venture capital players in an IPO were requiring stock of the issuer as compensation.

This hunger for equity was not generalized; attorneys were not asking Fortune 500 companies for equity instead of or in addition to attorneys’ fees. Equity is a currency that is only valuable if you buy low, sell high. Asking for $50,000 worth of GE stock instead of a legal fee is possibly prudent, but very conservative. The same stock will be worth $50,000 plus a modest increase next year. However, asking for $50,000 worth of stock options or founders stock from a company that is in the start-up phase is risky, but potentially very lucrative.

Therefore, the law firms that engage in this practice of investing in clients focus on start-up clients who are working toward an initial public offering or possibly being acquired by a large competitor, not traditional Fortune 500 companies who need someone to do a 10-Q or a private placement.

From the client’s perspective, having outside attorneys as investors seems to make sense. The attorney would have the same motivations as the client liaison in seeing the company’s goals come to fruition. In a start-up scenario, the liaison contacting the attorney is usually a founder, the owner who started the company, and is in some ways acting as both principal and agent. The only other principals may be co-founders or investors such as friends and family. The liaison’s goals are aligned with the company’s goals. Having an attorney as an investor seems to align the attorney’s goals with that of both the liaison and the company and

86 See About Venture Law Group, Venture Law Group, at http://www.vlg.com/About (last visited May 19, 2003) (“We have helped hundreds of prominent technology companies get started, funded and grow and then go public or be acquired.”).

87 See Beck, supra note 81, at 66 (quoting Mark Tanoury of Cooley Godward as stating that an upside of ten times its investment in a potential client was “borderline” in terms of deciding whether to accept the client).

88 See id. at 67 (reporting that Cooley Godward received issuer equity almost every time the firm requested it when representing venture capital clients).

89 See id. at 69 (noting that among big Silicon Valley firms, big public companies are not desired clients).

90 See Lashinsky, supra note 73, at 134 (“The true path to riches was equity, particularly stock options in just-formed technology companies.”).

91 Sweet Valley High, LAWYER, Jan. 29, 2001, 2001 WL 11471306 (noting that VLG only represents start-up companies because that work is “more fun” and “more lucrative”).

92 But see Howard, supra note 68 (quoting the CEO of Epinions.com as having “an allergic reaction” when VLG demanded equity as part of its compensation for legal services, but acquiescing due to VLG’s success in representing technology start-ups).
signals to the client that the attorney is a team player.\footnote{See Manning, supra note 72 (quoting Jeff Harmes of Portland’s Tonkon Torp law firm as saying: “[I]t’s almost to the point that if your lawyer isn’t willing to put a little skin in the game, maybe you have the wrong lawyer.”).} In addition, cash-poor start-up companies looking for venture capital are happy to pay in equity, which is “free” to them now or, alternatively, happy to give equity to corporate counsel in exchange for a much-needed infusion of cash.\footnote{See id. (noting that clients have begun to view equity investments by outside attorneys as a key piece of “seed financing”).} Finally, these liaisons have retained all of the risk and all of the control of the company; in ceding control to an outside attorney, they are also spreading some of that risk.\footnote{See Ravdin & Capps, supra note 44, at 391 (stating that straight hourly billing creates a situation in which the client retains all the risk, but the attorney has all the control).} 

B. A Fee by Any Other Name

Although the practice of attorneys taking or purchasing equity in clients is not entirely new,\footnote{See Renee Deger, Taking Stock: Hitting the Jackpot, RECORDER (San Francisco), Jan. 6, 2000, Silicon Scene, at 1 (noting that Wilson Sonsini has been investing in clients since the 1960s); Manning, supra, note 72 (stating that Perkins Coie has been taking equity in clients since the mid-1980s).} the frequency of this practice and the windfall results that have occurred are definitely novel. Historically, law firm policies on the practice of investing in clients have been varied, with many firms having strict disclosure procedures or prohibiting the practice entirely and some firms letting individuals invest on a case-by-case basis.\footnote{See Lashinsky, supra note 73, at 134 (noting that although Cooley Godward had always allowed partners to invest in a separate fund voluntarily, before the boom the sporadic disbursements were very modest, usually in the $5000 range).}

Law firms negotiate for this equity in different ways. One way is to receive equity in lieu of legal fees in exchange for legal services.\footnote{See infra Part III.B.1.} Another mechanism is for the law firm to charge ordinary hourly fees, but receive equity in addition to that fee.\footnote{See Howard, supra note 68 (reporting that many firms charge the ordinary premium rate in addition to demanding equity shares).} Thirdly, in addition to hourly fees, the attorney can require that the
client allow the law firm or individual lawyers to purchase equity in the client during the formation stage.\textsuperscript{100}

1. Equity in Lieu of Fees

Obviously, the riskiest practice is for the law firm to receive all or a portion of its legal fee in company stock.\textsuperscript{101} Accordingly, more conservative firms that engage in this practice restrict the percentage of the fee they will accept in the form of stock.\textsuperscript{102} Because the majority of this stock will be given before the company goes public, the value of the stock is an unknown variable. If the company, helped by the law firm, successfully completes an initial public offering, then the value of the stock could skyrocket and literally be worth millions. Legal representation that would have garnered a legal fee in the hundreds of thousands could easily yield ten times that amount or more.\textsuperscript{103}

However, equity in lieu of fees is closely akin to a contingent fee. The equity fee may actually be contingent on the completion of a transaction, or it may realistically be so.\textsuperscript{104} For example, if a company is unconditionally paying a law firm for preparation of an IPO, and the IPO does not materialize, then the stock may be virtually worthless to the law firm.\textsuperscript{105} Of course the company, and the stock that reflects ownership of that company, will have some value, but that

\textsuperscript{100}See Susan Orenstein, Lawyers Need Equity, Too, \textit{Industry Standard}, Apr. 10, 2000, \url{http://www.thestandard.com/article/0,1902,13463,00.html} (stating that for VLG, client equity was not “barter” for legal services because VLG invested its own money in clients, up to $250,000); see also Blackwood, \textit{supra} note 69 (noting that between 1996 and 2000, Cooley Godward paid cash for founder’s stock, warrants or options from one hundred clients and that when that stock is sold, it is treated as firm income and distributed according to the partnership agreement).

\textsuperscript{101}See Blackwood, \textit{supra} note 69 (reporting that Brobeck, Phleger stopped accepting equity in lieu of fees in 1998 because of the potential for cash flow problems). But see Manning, \textit{supra} note 72 (citing Stoel Rives as refusing to defer legal fees but choosing instead to accept stock in lieu of those fees).

\textsuperscript{102}See Cameron Stracher, Beyond Billable Hours, \textit{Wall St. J.}, Feb. 12, 2001, at A26 (stating that New York’s LeBoeuf, Lamb, Green & MacRae would accept only 30% of its fee in stock, and Shearman & Sterling, 50%).

\textsuperscript{103}See Lashinsky, \textit{supra} note 73, at 136 (comparing Cooley Godward’s usual legal fees of $250,000 collected in connection with an IPO to the additional $5 to $10 million it also receives in stock). However, this comparison may be misleading in situations in which the law firm represents the company from inception and bills the company an amount approaching or exceeding $1 million or more over the life of the representation.

\textsuperscript{104}See Ass’n of the Bar of the City of N.Y. Comm. on Prof’l & Judicial Ethics, Formal Op. 2000-3 (2000), \textit{available at} \url{http://www.abcny.org/eth2000.htm#20003} [hereinafter ABCNY Op.] (last visited May 19, 2003) (noting that some jurisdictions have concluded that securities given to an attorney pursuant to a public offering are in essence a contingent fee).

\textsuperscript{105}See Manning, \textit{supra} note 72 ("[T]he firms could wind up losing their entire stake in the young companies if they go nowhere.").
value is discounted if no ready market exists to purchase those shares. In addition, many of the fledgling companies paying their attorneys in stock in the 1990s were technology companies with few capital assets, making valuation of non-public stock even less certain.

2. Equity in Addition to Fees

One variation of receiving stock in lieu of fees is for attorneys to receive a customary legal fee, usually calculated in the traditional manner as billable hours multiplied by an hourly rate, and equity shares in addition to that hourly fee. The receipt of the equity shares may be conditioned on certain performance milestones or on the completion of a transaction, but the shares may simply be another component of the total fee. The receipt of equity in this circumstance may induce the law firm to defer billing of traditional legal fees until financing is obtained.

3. Investment Opportunities in Addition to Fees

A third variation that grew in popularity during the technology boom is to require the client to allow the law firm to buy equity in the client. A law firm has to actually make a payment to the client for the value of the stock, but this stock is bought very cheaply. Even if the law firm pays the same price as other early investors, the stock will be cheap compared to what the same stock would be at the time of a subsequent IPO.

106 See Goodman, supra note 78 (giving the opinion of Eliot Abbot, partner at Miami's Klugler, Peretz, Kaplan & Berlen, that a law firm should ensure that the company has more than one exit strategy, not just an IPO plan, to guarantee that the law firm will be able to cash out).


108 See Manning, supra note 72 (stating that Portland's Ater Wynne law firm prefers not to invest its own cash in its clients, but to receive founder's stock in return for deferring payment of its fees, which are collected once financing is obtained).

109 See Goodman, supra note 78 (reporting that VLG defers fees until financing is obtained in return for the opportunity to invest in the client).

110 See id. (describing company stock as cheap at the idea stage, the pre-IPO stage).

111 See Baker, supra note 7, at 38. However, recipients of “cheap” stock will point out that the price paid is the fair market value of the stock, which reflects the risk inherent in non-public stock. Another flag is raised if the attorney is an active participant in setting the price of the stock. See Antonella T. Popoff, Lawyers Taking Equity Interests in Internet Companies Must Be Alert to Special Ethical Risks, N.Y. ST. BAR J., Oct. 2002, at 19, 21 (2002) (listing “investing in a private placement and participating in the price negotiations between the client and independent, third-party investors” as one of several “Questionable Practices”).
Law firms have chosen to make these investments in several ways. Some law firms have created separate funds in which stock is held in the name of the firm. Investments are held in common, and law firm partnership agreements or investment agreements prescribe how gains will be distributed. At Venture Law Group, the partnership agreement requires the partners to make minimum investments in opportunities given to them by clients. The gains from these investments are shared in differing proportions among all employees, attorneys, and staff. Some law firms with investment funds also allow individual attorneys to hold investments in clients. For firms without investment funds, all investments are held individually. One reason cited for having a separate investment fund is to maintain sufficient diversification so that no one stake is significant in the economics of the firm. In addition, some law firms report that having defined investment policies prevents misunderstandings later from attorneys who feel excluded from profits. Amazingly, the investment funds at some law firms have grown so large as to raise Investment Company Act issues.

112 The Cooley Godward twenty-year-old investment fund operates by partners making voluntary contributions to the fund, with the proceeds being distributed to those contributors in proportion to the individual investment amounts. Associates who have been at the firm for five years may also invest, but by contributing a promissory note instead of cash. This note is due and payable when the associate makes partner. The firm also maintains a bonus plan for associates and staff that is payable from the proceeds of the fund. In contrast, Brobeck, Phleger instituted a similar fund in 1998 that is funded with partnership profits. Gains are distributed to partners, associates, and staff. Blackwood, supra note 69.

113 See id. (describing how investment vehicles may cause internal disruption in law firms among attorneys).

114 See Miller, supra note 107, at 440 (reporting that the VLG partnership agreement requires partners to take 10% to 20% of the equity opportunity).

115 See Deger, supra note 96 (noting that some funds have vesting schedules that entice associates to remain at the firm).

116 See Howard, supra note 68 (reporting that VLG allows an individual lawyer who brings in a new client to invest the lawyer’s own funds in that client).

117 See id. (stating that law firms without investment funds allow attorneys to invest individually, but in modest amounts).

118 See id. ("Most firms keep a vast portfolio and take equity in small enough amounts that the investment wouldn’t seem likely to cloud their judgment.").

119 See Deger, supra note 96 (stating that some associates grumble over how windfall equity profits are distributed); see also Janet L. Conley, Applying RICO, Lawyer Sues Ex-Firm for Fraud, RECORDER (San Francisco), Mar. 16, 2001, at 3 (reporting that an associate, whose offer letter promised him the opportunity to benefit from an investment fund that was in the process of being established but who was fired before the fund was created, attempted to sue the firm, Red Hot Law Group, under the RICO statute for his lost opportunity costs).

Regardless of which form the equity takes or when it is paid, the equity is part of the fee. Although some attorneys prefer to say that none of the equity received is in lieu of a fee, if the receipt of equity or opportunity to invest is negotiated as a condition to accepting the representation, then the equity is part of the fee. The client would not consider giving the attorney stock or the opportunity to buy stock unless the attorney was also going to provide services for the client. In addition, if the giving or selling of equity were barred by law or circumstances, the attorney would in all likelihood charge a higher monetary fee. Also, all equity shares given to the attorney before a market is created for that equity are analogous to a contingent fee. Therefore, no matter what form the transfer of equity takes, if a law firm purchases or accepts stock in a start-up company in the course of representing that client in an IPO, the result is equity in lieu of a fee that for all practical purposes is contingent on the closing of a certain transaction, generally a public offering.

C. Who Needs the Lottery? Law Firms Hit the Big One

In the litigation context, onlookers gape at the amount of attorneys' fees awarded in personal injury cases, such as the state by state tobacco litigation that earned many winning attorneys millions of dollars. Although large personal injury awards and attorneys' fees are highly publicized, these fees are generally outliers, with only a few attorneys receiving them in only a few cases during their careers. In fact, most personal injury lawyers survive economically by having a portfolio of cases: some of the cases go to trial and are lost; some cases are settled for small, medium, or large amounts; and some cases go to trial and result in small, medium, or large judgments. This diversification of risk causes a personal injury plaintiffs lawyer to be seen as playing the lottery each time he accepts a client's case. However, at least for awhile, many Silicon Valley law firms were hitting the lottery every time they played.

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121 See Miller, supra note 107, at 440 (remarking that although firms say that they are not taking equity as fees, the promise of equity induces firms to delay billing and the returns on the equity are a large part of partner profits).

122 See Michael Orey, Assuming the Risk: The Mavericks, the Lawyers, and the Whistle-Blowers Who Beat Big Tobacco 360–61 (1999) (retelling how in the Mississippi tobacco cases, a panel of arbitrators awarded the winning attorneys $1.43 billion, with the lead attorney receiving ten percent of that award, or $143 million).

123 See Herbert M. Kritzer, Contingency Fee Lawyers as Gatekeepers in the Civil Justice System, 81 JUDICATURE 22, 22 (1997).

124 See id. at 23 (describing contingent fee lawyers as portfolio managers, evaluating the risk of each case in relation to the potential return).
The profits made by Silicon Valley law firms seem staggering when viewed both individually and in the aggregate. One often-cited example is Wilson Sonsini’s representation of VA Linux in its initial public offering in December 1999. VA Linux stock was valued at $30 per share at the opening of the market, but closed that day at over $239 per share.\textsuperscript{125} In one day of trading, the value of Wilson Sonsini’s 102,584 shares rocketed to $24.5 million.\textsuperscript{126} However, VA Linux was not the only winning card Wilson Sonsini held that year. The Palo Alto law firm also took Webvan public, and at the end of the first day of trading, the firm’s shares in its client were worth more than $51 million.\textsuperscript{127} According to public securities filings, and not including any shares that may have been sold, shares held by Wilson Sonsini partners at the end of 1999 from clients they took public that year totaled $230 million.\textsuperscript{128} Moreover, the year 2000 did not have doomsday consequences for Wilson Sonsini; in February 2000, the firm took Avanex Corp. public. One month later, its shares were worth $109 million.\textsuperscript{129}

VLG was not far behind. With fewer partners to divide among than Wilson Sonsini, its total holdings in IPO client equity at the close of 1999 totaled $62 million.\textsuperscript{130} VLG took stock in all seventeen IPO clients it represented in 1999.\textsuperscript{131} In each of six of those companies, VLG’s take-home after one day of trading was over $1 million.\textsuperscript{132} In 2000, VLG represented twenty-five new companies in IPOs.\textsuperscript{133}

In 1999, law firms in Silicon Valley midwifed 173 clients in IPOs and owned equity in ninety-nine of those clients.\textsuperscript{134} The practice of acquiring equity in clients was not limited to a handful of Silicon Valley firms, however. According to the American Bar Association, one-third of IPOs in 1999 involved attorneys who held pre-IPO stock in the issuer.\textsuperscript{135} More interestingly, established law firms who historically had banned the practice of investing in clients embraced this new profit machine.\textsuperscript{136}

\textsuperscript{125} Baker, supra note 7, at 36.
\textsuperscript{126} Id.
\textsuperscript{127} Id. at 39.
\textsuperscript{128} Beck, supra note 81, at 66.
\textsuperscript{129} Id.
\textsuperscript{130} Id.
\textsuperscript{131} Baker, supra note 7, at 41. But see Deger, supra note 96 (reporting the number as sixteen out of eighteen IPO clients).
\textsuperscript{132} Baker, supra note 7, at 41.
\textsuperscript{133} Lashinsky, supra note 73, at 134.
\textsuperscript{134} Deger, supra note 96.
\textsuperscript{135} See Howard, supra note 68.
Admittedly, the euphoria of IPO day sometimes wears off, and law firms may have to watch the stock price drop while being prevented from selling their shares. Depending on when the law firms acquired the equity, they are usually required to hold the shares for 180 days after the offering\textsuperscript{137} and may be prevented from trading the shares for one or two years from receipt of the shares.\textsuperscript{138} However, many IPOs can maintain high stock prices for six months or longer.\textsuperscript{139} For example, Wilson Sonsini represented Commerce One in its July 1999 IPO, in which its offer price of $21 nearly doubled.\textsuperscript{140} Six months later, the shares were worth over ten times the offer price.\textsuperscript{141} VLG took Foundry Networks public in September 1999, and in seven months VLG’s shares continued to increase in value from $8.4 million to $16 million.\textsuperscript{142} Some companies, and a law firm only needs some of such clients, continue to grow following an IPO. Cisco, a client of Brobeck, Phleger, enjoyed a 15,191% return on its share price from its 1990 IPO to 2000.\textsuperscript{143} In addition, because much of the stock the law firm receives is free or extremely discounted, a wise law firm, which handles its investments in a way to minimize exposure, can maintain a winning portfolio.\textsuperscript{144}

IV. NOW, WHAT DO YOU DO AGAIN? 
THE ROLE OF TRANSACTIONAL LAWYERS

The next portion of this article will analyze the potential conflicts of interest created by holding equity in a client in the context of the corporate attorney’s roles as a transactional engineer, a reputational intermediary, and a gatekeeper. To do so, these roles must first be described. The next section will then analyze how

\textsuperscript{137} See Howard, supra note 68 (citing the 180 day lock-up period as a restriction on the motivation of an attorney-investor not to scrutinize a prospectus just to bolster the offering price of a new security).

\textsuperscript{138} See D.M. Osborne, Start-up Fever, AM. LAW. July/Aug. 1996, at 73, 76 (pointing out that most shares that law firms receive are “restricted securities” and cannot be sold for up to two years from receipt of those shares).

\textsuperscript{139} See also Deger, supra note 96 (describing Wilson Sonsini’s portfolio as increasing from $143 million as of opening day to $230 million as of December 31, 1999).

\textsuperscript{140} Baker, supra note 7, at 43.

\textsuperscript{141} Id.

\textsuperscript{142} Orenstein, supra note 100, at 148.

\textsuperscript{143} See Stracher, supra note 102 (noting that Brobeck, Phleger received a “lucrative equity share” for taking Cisco public).

\textsuperscript{144} See Howard, supra note 68 (noting that most lawyers pay the deeply discounted rate the venture capitalists pay, if the firms pay for the stock at all). Of course, the issue of investments begs the question whether lawyers or law firms are qualified to handle huge portfolios for themselves or their firms. See Beck, supra note 81, at 69 (reporting Mark Tanoury of Cooley Godward as admitting that he imprudently sold stock in Qualcomm, Inc., Broadvision, Inc., and Metricom, Inc. shortly before each stock increased in value over 1000%).
the conflicts that arise in each of these roles may subject a corporate attorney to liability under ethical rules, professional malpractice law, and securities fraud.

Most Americans could describe to you what a trial lawyer does based on watching an hour or two of television a day.\textsuperscript{145} Many litigators in a large firm, however, could not tell you what their counterparts on the “Corporate” or “Business” or “Finance” floors do to fill their hours. Even without an Ally McBeal to rally behind, transactional attorneys have very quietly been the lucrative backbone of the largest firms in the United States. These are the attorneys who draft the contracts that may eventually get litigated by the commercial litigators; the attorneys who negotiate the mergers and acquisitions that the trial lawyers did not succeed in trying to stop; the attorneys who prepare the documentation for the securities offerings that may someday be scrutinized by plaintiffs lawyers looking to file a shareholder derivative suit; and the attorneys structuring complicated financing vehicles that will hopefully withstand future scrutiny by investors and regulators.

If popular culture has largely ignored the corporate attorney,\textsuperscript{146} so have the agencies that regulate attorney conduct. In the United States, the American Bar Association promulgated the Model Code of Professional Responsibility in 1969 and the Model Rules of Professional Conduct in 1983,\textsuperscript{147} but leaves adoption and enforcement of these rules to state agencies supervised by state supreme courts.\textsuperscript{148} These rules have historically focused on the stereotypical representation of an individual client by an individual attorney in an adversarial proceeding.\textsuperscript{149} Although a section purporting to address the representation of organizational clients was included in the Model Rules, the typical transactional representation

\textsuperscript{145} See generally Law & Order: General Info, TNT, at http://www.tnt.tv/Title/View4/0,5878,333808[525][602][00].html (last visited May 19, 2003) (listing Law & Order, the country’s longest-running legal police drama, as appearing on its network at least three times a day each weekday).

\textsuperscript{146} See JAY MCINERNY, BRIGHTNESS FALLS 11 (1992) (describing a guest at a dinner party among stock brokers, literary types, a Hollywood producer, and a model as a “corporate lawyer” who “thankfully never talked about it”).


\textsuperscript{148} See id. at 640 (criticizing the fact that the time and attention given to legal ethics at the ABA level is duplicated in each state). Therefore, each state bar association adopts disciplinary rules based either on the Model Rules or their predecessor, the Model Code, and enforces them through disciplinary proceedings. See id.

\textsuperscript{149} Peter C. Kostant, Exit, Voice and Loyalty in the Course of Corporate Governance and Counsel’s Changing Role, 28 J. Socio-Econ. 203, 213 (1999) (asserting that the Model Code provided as a model client a living individual and that the Model Rules did little to change this paradigm).
of a large corporate client by attorneys who are part of a large law firm is not realistically reflected in that section.\textsuperscript{150}

A. Who Is the Client?

Atticus Finch always knew who his client was.\textsuperscript{151} His client was the individual sitting next to him in court. Atticus was representing his client against the prosecutor, an individual representing the state government; Atticus never represented the prosecutor or the state government. If Atticus needed to know what his client wanted to do in a situation or what his client’s long-term objectives were, all he had to do was turn and ask him. This scenario does not apply to the transactional attorney who has a business entity as a client.\textsuperscript{152}

In a typical securities offering, financing, or other corporate transaction, the attorney’s client is defined by the Model Rules as the corporate entity.\textsuperscript{153} However, the voice on the other end of the telephone asking the attorney to begin work on a particular project is not the voice of “the entity.”\textsuperscript{154} Unfortunately, a corporate attorney is unable to turn to one specific individual and receive instructions from the corporate entity, although the Model Rules seem to anticipate that many persons may make decisions for the corporation.\textsuperscript{155} Unless these decisions violate the law, the Model Rules direct the attorney to accept the decisions as the will of the corporation, even if “their utility or prudence is doubtful.”\textsuperscript{156}

\textsuperscript{150} See id. (revealing how Rule 1.13 describes the client as an entity, but then directs an attorney’s loyalties to management).

\textsuperscript{151} See HARPER LEE, TO KILL A MOCKINGBIRD (1960) (presenting the character of attorney and single father Atticus Finch, who must face the fierce prejudices of his community when he zealously represents an African-American man falsely accused of rape).

\textsuperscript{152} For purposes of this article, I am using a corporation as an example of a business client, although the same ethical dilemmas arise during the representation of a partnership, limited liability company, joint venture, or other organization.

\textsuperscript{153} MODEL RULES OF PROF’L CONDUCT R. 1.13(a) (1983) (“A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.”).

\textsuperscript{154} See KLEIN & COFFEE, supra note 42, at 110–11 (describing law’s reification of the corporation as “abstract and potentially misleading” in attempting to describe in simple terms something as complex as a corporation); see also MODEL RULES OF PROF’L CONDUCT R. 1.13 cmt. 1 (recognizing that an organizational client can only act through its officers, directors, employees, shareholders, and other constituents).

\textsuperscript{155} MODEL RULES OF PROF’L CONDUCT R. 1.13 cmt. 1 (naming as constituencies of the organization the officers, directors, employees, and shareholders); see also Kostant, supra note 4, at 213 (criticizing the Model Rules for creating a presumption that inside managers act in the best interest of the corporation).

\textsuperscript{156} MODEL RULES OF PROF’L CONDUCT R. 1.13(a) (1983).
A corporate entity may be seen as an agency mechanism among the shareholders as principals and the managers as agents. Alternatively, other theorists have built on the agency model and viewed a corporation as a nexus of contracts between the constituencies of shareholders, officers, and directors. Most recently, corporate theory has begun to describe a corporation as a team of various constituencies, whereby the shareholders have ceded control to an independent board of directors. Under any theory, the agendas of officers, directors, and shareholders are very different. Officers, who are usually employees of the company, usually strive to maintain their own positions and the viability of their own projects. Different shareholders have different objectives, with some shareholders willing to sacrifice long-term stability for short-term gain and others preferring to forego present risk to assure the company's continued growth. Directors have historically been seen as the most closely aligned with the perceived objectives of "the entity," striving to make decisions that are in the long-term best interests of the continued viability of the company.

In both the agency theory and the closely related contractarian theory, the directors and officers owe fiduciary duties to the shareholders, who own the entity. However, under recent economic theory and jurisprudence, the directors...

157 See Adolph A. Berle Jr., Corporate Powers as Powers in Trust, 44 Harv. L. Rev. 1049, 1049 (1931) (describing the separation of ownership and control in a corporation and analogizing a corporation as a trust for the benefit of the shareholders, with management as the trustees with fiduciary duties to those shareholders). But see E. Merrick Dodd, For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145, 1146 (1932) (stating that the corporate entity is a reality, not a legal fiction, and that the managers of the corporation have fiduciary duties toward the entity, not toward the individual stockholders).

158 See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ. 305 (1976); Klein & Coffee, supra note 42, at 173–74 (describing the "neo-classical" theory that the market will cause corporate constituencies to contract with one another so as to minimize any agency costs).

159 See Kostant, supra note 149, at 222–28 (describing the Team Production Model).

160 See Klein & Coffee, supra note 42, at 174–75 (describing the "managerialist" view that managers will sacrifice profit maximization to increase the size of the corporation, thus enlarging their empire and their salaries and thwarting takeover attempts).

161 But see Henry Hansmann, Ownership of the Firm, 4 J.L. Econ. & Org. 267, 283 (1988) (suggesting that differences in risk preferences among shareholders can be eliminated to the extent that shareholders select which firms to own).

162 See Kostant, supra note 149, at 225 (hypothesizing that legislatures have accepted the theory that the board of directors is more independent and opportunistic than inside managers, and that this difference is why some state statutes allow directors, but not managers, to be indemnified for certain acts). But see Klein & Coffee, supra note 42, at 128–29 (recognizing that although directors are not agents of the shareholders but of the entity, the business of the entity is primarily to maximize the return to shareholders; however, directors have "great discretion" as to the method of profit maximization).

163 See Oliver E. Williamson, Corporate Governance, 93 Yale L.J. 1197, 1210 (1984) (stating that the purpose of the board of directors should be viewed as protecting the investment
and officers owe fiduciary duties only to the entity itself and consider other constituencies besides shareholders in making decisions.\textsuperscript{164} This model argues against the law and economics theory that officers and directors have a duty only to maximize shareholder wealth.\textsuperscript{165} Regardless, passive shareholders are commonly believed not to have fiduciary duties to the entity or any other constituency.\textsuperscript{166}

Because the various constituencies have differing short-term and long-term objectives, identifying the objectives and best interests of the entity can be difficult for outside counsel. Unfortunately, the Model Rules give little guidance in this regard. Most likely, the person engaging the attorney is an in-house attorney at the corporation.\textsuperscript{167} If the corporation is smaller or the attorney has a relationship with the company, the primary contact may be a manager of the company, who may also be an officer of that company.\textsuperscript{168} The other constituencies of the corporation, the shareholders and the directors, will most likely not be a part of the conversation. During the course of the representation, the attorney will work closely with senior management of the company and any in-house legal counsel. At the end of the month, or the end of the project, the attorney will send a bill to the corporation, probably to the general counsel, if any, or one of the senior managers, who will then submit the bill to be paid. If the work is satisfactory to the managers of the company, then the attorney may be sent more legal work in the future.\textsuperscript{169}

\textsuperscript{164} See Roberta S. Karmel, \textit{Implications of the Stakeholder Model}, 61 GEO. WASH. L. REV. 1156, 1162–63 (1993) (describing how over half the states have passed statutes allowing directors to consider short-term and long-term interests of the corporation and take into consideration groups such as employees, suppliers, customers, and creditors, not just shareholders).

\textsuperscript{165} See Kostant, supra note 149, at 227 (asserting that directors are empowered under some state statutes to prevent self-interested shareholders from receiving short-term profits by killing the “corporate golden goose”).

\textsuperscript{166} But see KLEIN & COFFEE, supra note 42, at 170 (noting that generally only officers and directors have fiduciary duties to the corporation, but that in cases where a shareholder is a controlling shareholder, that shareholder may have a fiduciary responsibility to the minority shareholders and the corporation).

\textsuperscript{167} See Daly, supra note 30, at 1061–62 (describing as one function of a general counsel to manage and review work of outside counsel).

\textsuperscript{168} See Kostant, supra note 149, at 213 (noting that traditionally, corporate attorneys gave allegiance to senior managers who controlled the representation).

\textsuperscript{169} See id. at 231 (noting the practical reality that although lawyers have legal duties only to the corporate entity, “corporate lawyers have traditionally been the loyal servants of management”).
In an ideal world, outside counsel would communicate with senior managers or in-house counsel, who would instruct the attorney as to the objectives of the company without revealing any opportunistic goals of the liaison, however slight. The attorney would perform the representation with only those goals in mind, ignorant of the individual agenda of the liaison. Other members of management would work with the attorney to provide sufficient information, whether or not that information impacted on any individual goals of that individual. In reality, however, the outside counsel becomes friends with or becomes professionally dependent on that liaison, and that liaison often has an individual agenda. For example, the business manager who secures the representation for a certain transaction may let the attorney know that the transaction should be closed by a certain date in order for the liaison to receive a large bonus in a certain fiscal year. Or, members of management charged with supplying information to the attorney may have substantial stock options that will be very valuable following the closing of a securities offering.

The realities of representation are often murky. Outside counsel are often caught between the politics of business managers and the legal department; between the long-term objectives of the board of directors and the short-term objectives of management; and between the far-reaching legal position of the entity and the pressing financial and career positions of the liaisons.

B. The Value of a Transactional Attorney

The role of a transactional attorney is very elastic, and the most successful attorneys tend to stretch their capabilities to suit their clients. For example, if a corporate client wishes to finance the building of a capital asset, such as a petroleum refinery, an attorney may have various roles in that transaction. Two straightforward and traditional roles will be to draft the agreements and to negotiate the terms of those agreements once the client has decided who will provide the financing. As part of that role, the attorney may be part of early discussions in which decisions are made as to the nature of the financing; the

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170 See Litan & Salop, supra note 21, at 193 (divulging that inside attorneys may ask outside counsel to engage in certain practices to preserve their own status or to maximize their own budgets).

171 Cf. Ronald J. Gilson & Robert H. Mnookin, Foreword: Business Lawyers and Value Creation for Clients, 74 OR. L. REV. 1, 12 (1995) (describing a merger scenario in which both the manager of a target company and its outside counsel, who both may lose their livelihoods following the merger, may have individual goals inconsistent with the best interests of the company).

172 See Kostant, supra note 149, at 233 (comparing the difficulties of representing an individual and representing a corporation and concluding that "the corporate attorney has the profoundly more difficult problem of representing an entity comprised of potentially warring constituencies of unequal power and influence, none of whom is her client").
attorney may help the client determine whether the client should borrow from a commercial lender, issue debentures or securities, or do a mixture of both. The attorney may also help the client decide whether to finance the project at the parent level or at a subsidiary level and whether to approach a potential joint venturer about the project. Depending on the business acumen and inclination of the attorney, and the relationship the attorney has with the client, the attorney may have also counseled the client about which commercial banks or underwriters to approach concerning financing. Many times, a seasoned attorney can instruct a client on what is customary or “market” for certain transactions: what pricing and restrictions a client can expect a lender or investor to require. During the negotiations, the attorney will counsel the client on what materials to make available to the other party and on what representations and warranties to provide based on those materials. Depending on the structure of the financing, the attorney may have to prepare an offering memorandum or a prospectus with certain disclosures and financial information. At the closing of the transaction, the attorney will usually be asked to provide a legal opinion, in writing, that the transaction satisfies the parties’ desires for a specific result and that specific documents effectuate that result and are enforceable.

In these roles, the corporate attorney acts as a counselor, a wordsmith, and a negotiator, but also a transaction cost engineer, a reputational intermediary and a gatekeeper. As a transaction cost engineer, attorneys work to add value to transactions by eliminating two obstacles to maximizing gain: transaction costs and lack of informational symmetry. In this role, the attorney tries to minimize the transaction costs by maneuvering clients through regulatory schemes, facilitating the creation and provision of information, and creating structures in the operative documents that give comfort to the parties, who are aware that they are operating under imperfect knowledge about past, 

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174 See id. at 254–55 (hypothesizing that a business lawyer’s role is to reduce transaction costs, therefore reducing the invalidity of two of the assumptions underlying the capital asset pricing theory: (1) there are no transaction costs and (2) all information is freely available).

175 See id. at 288–93 (describing how parties overcome any final discomfort regarding asymmetry of information by having the disclosures and representations of one party verified by a third-party: the representing party’s prestigious attorney); Karl S. Okamoto, Reputation and the Value of Lawyers, 74 OR. L. REV. 15, 18 (1995) (proposing that one reason for the ongoing success of law firms in the face of competition from in-house legal departments is that only outside law firms can serve as a reputational intermediaries for clients).


177 See Gilson, supra note 173, at 255.
current and future events. As a reputational intermediary, an attorney effectively “rents” the reputation of her law firm and vouches for the integrity of her client and for the integrity of information provided by that client, usually in a written legal opinion.\(^\text{178}\) Although the client may be unknown to the other party, the law firm is a repeat player whose long-term professional success depends on its ability to continue renting its reputation as a third-party intermediary.\(^\text{179}\) An attorney’s gatekeeping function is closely aligned to its reputational intermediary function. By refusing to represent clients that the attorney will not vouch for and by requiring certain actions of a client before continuing a representation or issuing a legal opinion,\(^\text{180}\) a corporate attorney can assure other parties that the client appearing at the closing table is trustworthy.

Moreover, all three of these important functions require that the attorney be independent from the client.

1. Transaction Cost Engineer

At first glance, an attorney’s independence may not seem so critical when the attorney is in the role of transaction cost engineer. A client and its attorney should have the same goals and objectives toward minimizing transaction costs and negotiating solutions designed to move transactions forward. As long as the attorney has no conflict of interest with other parties in the transaction and is not increasing the transaction costs with unnecessary legal work, the parties’ desires seem well-aligned. In this scenario, an attorney might not be concerned with giving the appearance of being captured by the client. In fact, in-house counsel, who are by definition captured, often function as transaction cost engineers for corporations.\(^\text{181}\)

However, the transaction cost engineer function is closely related to the reputational intermediary function of the corporate attorney. A large part of how well an attorney functions as a minimizer of transactional costs depends on the value of that attorney’s reputation with other parties. When other parties obtain a higher comfort level with the motivations of a client based on the reputation of the client’s counsel, then parties tend to move the transaction along and not get mired

\(^{178}\) See id. at 290.

\(^{179}\) See Okamoto, supra note 175, at 22–23 (noting that for many clients, the subject transaction is very important economically, and so the temptation for clients to “cheat” is very large; therefore, only an outside law firm for whom this representation is just one of many can be relied on to make the necessary reputation capital investment).

\(^{180}\) See Bernstein, supra note 176, at 248 (theorizing that lawyers screen out would-be clients who are not willing to abide by business community norms); Wilkins, supra note 16, at 1164 (describing the gatekeeping function of preventing potential violations of clients).

\(^{181}\) See Daly, supra note 30, at 1061 (asserting that in-house attorneys are called upon to facilitate complex transactions, adding value by being intimately knowledgeable in the business goals of the client and by being immediately available).
down in details. Therefore, if an attorney's interdependence with the client creates a conflict of interest, then the attorney's value as a transactional cost engineer may be reduced.

2. Reputational Intermediary

One of the clearest value-adding functions of the corporate attorney is to act as a reputational intermediary for the client. If individuals are known for the company they keep, then clients are certainly known for the attorneys that they hire.\textsuperscript{182}

Many times in a transaction, one party will be called on to rely on another party's representation that something is true or that something will or will not happen. If one party cannot give assurance through a contractual term or reference to controlling law, the other party will have difficulty in "getting comfortable" with an unknown.\textsuperscript{183} A reputational intermediary who is an independent third party such as an accountant or an attorney gets parties over this hurdle.\textsuperscript{184} The party's own attorney will advise that he or she "is comfortable" when a certain law firm is giving the assurance. This attorney knows the reputational law firm, knows the law firm has its future livelihood and prestige at stake, and feels assured that the law firm would not risk its name unnecessarily.\textsuperscript{185}

In addition, in a transaction in which one party may be a one-time player, such as the seller of a business, that party may have incentives to "cheat," or not disclose certain information.\textsuperscript{186} The attorney, on the other hand, will remain in the corporate world after the seller has exited, so the attorney has a stake in making sure that the seller discloses that information.\textsuperscript{187} The attorney can counsel the seller to make the disclosure, but she can also remind the seller that the attorney

\textsuperscript{182} See Gilson, \textit{supra} note 173, at 291 (noting that parties often ask who the attorneys are on the other side, if the party on the other side is unfamiliar); \textit{see also} ROBERT W. HAMILTON & RICHARD BOOTH, CORPORATION FINANCE 882 (3d ed. 2001) (stating that a buyer may refuse to accept a legal opinion from an unknown law firm, and that the more prestigious the law firm, the more weight that law firm's opinion will be given).

\textsuperscript{183} See Gilson, \textit{supra} note 173, at 288–89 (describing "final-period problems" in which parties cannot guarantee that the possibility of misleading statements has been eliminated).

\textsuperscript{184} See \textit{id.} at 290–91 (giving accountants and attorneys as examples of third-party reputational intermediaries).

\textsuperscript{185} See \textit{id.} at 291 (explaining that reputational business lawyers will not risk that reputation for one client).

\textsuperscript{186} See \textit{id.} at 288 (describing opportunism of senior management that the verification techniques of the other party may be unable to detect).

\textsuperscript{187} See \textit{id.} at 289 (theorizing that a reputational intermediary will not "cheat" because he expects future transactions in which he will need to pledge his reputation); Okamoto, \textit{supra} note 175, at 45 (noting that repeat players are able to lend their reputations to one-time participants).
will be expected to deliver a legal opinion that will be worded unsatisfactorily if the seller does not comply. In an extreme circumstance, the attorney may feel that withdrawal from the representation is necessary. If the attorney does not persuade the client to disclose or then withdraw, the attorney risks losing value as a reputational intermediary and as a result, future business.

The legal opinion of the reputational intermediary is deemed trustworthy because the parties know that the attorney has a greater stake in its own reputation than in the particular transaction.\footnote{\textit{See} Gilson, supra note 173, at 292–93 (pointing out that a legal opinion adds no new information to the transaction, but it adds the element of reputation to that information).} However, if the attorney is not independent from the seller, and has no greater vested interest in future business from other clients, then the legal opinion becomes suspect.\footnote{\textit{See} Okamoto, supra note 175, at 28 (noting that in-house counsel are “nonreputational” lawyers who have lost independence due to capture).} For example, an in-house corporate counsel is not independent and has a vested interest in the client-employer and in the specific transaction. For this reason, most parties require a legal opinion to be from outside counsel, not in-house counsel. Although companies rely on in-house counsel for some functions, they look to outside counsel in transactions where third-party verification is needed, such as public offerings.\footnote{\textit{See id.} at 31 (stating that of 1617 S-1 filings, 96\% of the legal opinions contained in them were delivered by outside counsel and the majority of the remainder of the filings were not true initial offerings, but spinoffs of substantial parent corporations); \textit{see also} HAMILTON & BOOTH, supra note 182, at 882 (stating that a buyer would refuse to accept a legal opinion from an in-house lawyer); cf. Gilson, supra note 173, at 291 (noting that companies anticipating initial public offerings switch to “Big 8” auditors (now “Big 4”)).}

Another example that reflects the importance of being independent from one’s client in order to maintain value as a reputational intermediary is in the area of governmental regulation. In guiding clients through the maze of governmental controls, a lawyer or law firm does well to have a history of continuous fair dealing with governmental agencies. If an attorney appears to have a pecuniary interest beyond a standard fee in the client’s regulatory pilgrimage, then the attorney may be seen as suspect by the regulatory agency.

3. Gatekeeper

In the litigation context, an attorney has a duty not to let a client give testimony if the attorney knows that the testimony is false.\footnote{MODEL RULES OF PROF’L CONDUCT R. 3.3(4) (1983).} Therefore, if an attorney is trustworthy, the court can assume that any testimony given is true.
unless it is impeached. This role of the attorney is a gatekeeping role. In a transactional context, corporate attorneys also play a gatekeeping role. The public can assume that law firms, especially those with value as reputational intermediaries, are carefully screening the clients that they accept. Potential investors may assume that if a prestigious law firm is representing an issuer, then that issuer is trustworthy. Commercial banks may assume that a certain firm’s client that is seeking financing is also trustworthy.

This gatekeeping function obviously flows from a firm’s function as a reputational intermediary, but it is slightly different in that the law firm is scrutinizing the client because of the firm’s short-term and long-term interests. The law firm is concerned about its continued success in the legal industry, but it is also interested in collecting its fee for the current representation. If the law firm questions the potential client’s ability to guarantee payment of its substantial fee or if the attorney knows the client routinely hires and fires counsel without paying its bills, then the law firm will not accept the representation. Or, if an attorney suspects at the outset of a representation that the client will not be forthcoming, then the attorney may end the representation. In effect, a law firm’s representation of a client says, “I trust that this company will honor its pledges to me, so I can recommend that you trust it as well.”

Independence of the attorney is critical to the gatekeeping function. In order to screen out certain clients, an attorney has to be objective about that client. All attorneys are paid a fee for their services, so the threat of being bought by a client exists in any representation. However, most reputational law firms will have the luxury of choosing clients to accept, so this conflict is somewhat minimized if the fee is relatively equal to the fee paid by other clients. Once one client represents a large percentage of a law firm’s business and the attorney’s interests become too aligned with the client’s, then the attorney no longer appears to vouch for the integrity of the client, but becomes the client’s consigliere.

192 See Kritzer, supra note 123, at 22 (noting that highly lucrative cases are very rare); id. at 24 (noting that because contingent fee lawyers only succeed if the cases they accept succeed, attorneys screen out frivolous lawsuits).

193 See Okamoto, supra note 175, at 29 (“[H]igher reputation firms will act to protect their investment in reputation by limiting their clientele to low-risk clients . . . of the highest caliber.”).

194 A national example of this phenomenon is the perceived capture of former Secretary of State James Baker by the Bush family. See Michael Powell, The Wise Old Men, Leading Us Through Gray Areas, WASH. POST, Nov. 15, 2000, at C1 (comparing independent “wise old men” who historically consulted presidents and regarded “overt partisanship as gauche, not to mention bad for business” with today’s “consiglieres” posing as “wise old men,” such as James Baker, Vernon Jordan, and Bob Strauss). After advising President George W. Bush in the contested presidential election of 2000, Secretary Baker has rarely been mentioned in the media without the “consigliere” epithet. See, e.g., Michael Duffy, Franchise Player, TIME, Dec. 4, 2000, at 49; John Podhoritz, Bush Still Wins: The Supreme Court Was Right, N.Y. POST, Apr.
V. SO WHAT'S WRONG WITH THAT?

At first blush, taking an equity stake in a client may seem a little unattractive or a little unsavory, but not inherently unethical. In fact, the American Bar Association and several state bar associations have recently announced that the practice of taking equity in clients is not per se unethical, meaning the practice does not automatically violate any ethical rules. Inherent in the ABA Opinion and the other state bar opinions, though, is an undercurrent of unease. Commentators all agree that the practice is not prohibited by the rules, but some characterize the practice as problematic. This article contends that problems arise because investing in clients impairs the attorney's ability to effectively perform the roles of a transactional attorney.

A. Attorney-Investor as Transaction Cost Engineer

As stated before, a corporate attorney acts as transaction cost engineer for a client and attempts to reduce transactional costs and to design structures that will minimize the risk of asymmetrical information in transactions. To the extent that an attorney is both aware of the client's goals and incentivized to work toward those goals, the attorney can better fulfill the role of transaction cost engineer. Put simply, an attorney is a better transaction cost engineer when the attorney's and client's goals are more closely aligned.


195 See Manning, supra note 72 (quoting John Gould of Portland's Lane Powell Spears Lubusky as saying: "All I can do is react with repugnance. Putting your money down is reprehensible. That's not our business."); Blackwood, supra note 69 (quoting former chairman of the California State Bar committee on professional responsibility as saying: "As shareholders, can they really give independent advice?").


197 See ABCNY Op., supra note 104:

[W]e state here our conclusion that there is no per se ethical prohibition on the acceptance of shares or other securities, including options, as compensation for legal services to be rendered. We hasten to add, however, our caution that such arrangements can present thorny ethical and other issues that must be resolved prior to entering into an arrangement in which a lawyer is to be compensated in client company securities.

See also John M. Burman, Conflicts of Interest: Business Transactions with Clients, 21 WYO. LAW., Oct. 1998, at 13, 15 ("While the Wyoming Rules of Professional Conduct do not prohibit lawyers from entering into business transactions with clients, they discourage them.").

198 See Suchman & Cahill, supra note 75, at 693–94 (noting that Silicon Valley law firms interpret the ethical rules "less restrictively" than attorneys elsewhere).

199 See supra Part IV.B (regarding attorneys as transaction cost engineers).
Many attorneys that engage in taking client equity advocate that this practice aligns the attorney’s and the client’s goals, and many clients agree. As a billing method, payment in equity alleviates some of the problems inherent in hourly billing. Although an attorney who bills by the hour would prefer that the transaction fill his calendar for a longer time and result in a larger bill, the attorney who is paid in equity is going to get the same percentage of the pie, regardless of whether the transaction takes a few weeks, a few months, or a few years. The equity fee will operate as a fixed fee and motivate the attorney to work more efficiently. In addition, the attorney’s piece of the pie may be worth more as the company is valued more, so the attorney has the same incentive as the client to ensure that the quality of the services performed during the transaction is sufficiently high. This partnering aspect downplays the opposite pressure that the flat fee might otherwise have on the attorney to rush the transaction through and maximize the resulting fee received per time spent. In theory, the attorney will be motivated to work efficiently, to foresee and avoid potential obstacles to the closing of the transaction, and to choose not to clutter the transaction with unnecessary documents, negotiations, and resulting delays. In fact, these were arguments made by law firms engaging in client investment during this period.

However, this theory must be analyzed further by exploring two questions: “Who is the client?” and “What are the client’s true goals?”

According to ethical rules, the corporate attorney’s client is the corporation. The client is not the senior manager hiring the attorney, the in-house counsel supervising the attorney, or even the current or future shareholders of the corporation. This concept becomes especially troublesome when

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200 See Miller, supra note 107, at 452 (theorizing that attorneys are effective when they have a shared conception of value with their clients).

201 See id. at 451 (stating that start-up companies believe that granting equity to their outside counsel motivates the attorney to facilitate the transaction more effectively).

202 See supra Part II.B (discussing the inefficiencies of the hourly billing method).

203 See Manning, supra note 72 (quoting Adrian Russell-Falla, founder of Rulespace, as stating that equity in lieu of fees ensures that attorneys “have an interest in working quickly and efficiently”).

204 One argument can be made that in an IPO situation, the efforts of the issuer counsel will have a negative affect on the stock price. The more disclosures that are made, theoretically the lower the offering price will be. Therefore, the efforts of the attorney should have an inverse impact on the share price, at least short-term.

205 See Ullrick, supra note 46, at 31 (warning that an attorney paid a flat fee may not spend the time necessary on a project if the fee is too low); Laurel L. Burke, Alternative Billing Methods: Not Just by the Hour Anymore, 28 COLO. LAW. 59, 60 (Apr. 1999) (theorizing that an attorney working under a flat fee will be less willing to be creative and more willing to cut corners).

206 See Suchman & Cahill, supra note 75, at 697 (stating that Silicon Valley law firms see themselves as facilitators, not “voices of caution” or “deal-killers”).

207 See supra Part IV.A (discussing the corporate entity as the client).
considered in the context of a start-up company. At the point at which the attorney is contacted, the individual on the phone and the entity he or she represents seem to be one and the same. Ms. Smith has a business plan to publish restaurant reviews on the Internet. She has incorporated a business under the registered name “WorthYourDiningDollar.com.” She is the sole shareholder, the president, and one of the directors. The other officers and directors are family members. In the beginning, the goals of WorthYourDiningDollar.com and Ms. Smith seem to be perfectly aligned. Ms. Smith wants to get the company up and running, and she wants to obtain any necessary consents, intellectual property licenses, and copyright permits for the content of the website. She wants to hire employees who will research the restaurants and write the content of the website. She also wants to obtain venture capital financing for the company. She wants her new attorney to be interdependent, not independent; she wants the attorney to be economically and emotionally invested in what she sees as her project.

However, at some point, the venture capitalists will give the project seed money and become investors. They may even negotiate for slots as outside directors. Ms. Smith may, then, want either to offer shares of the business to investors in a public offering or to have an existing concern acquire her business. Her short-term goals of receiving cash for her shares of the company may become inconsistent with the company’s long-term goals. In addition, Ms. Smith and other early investors may have goals that are inconsistent with future investors. Majority shareholders may have goals that are inconsistent with minority shareholders. Ms. Smith may have goals that are inconsistent with the outside directors. With whose goals will the attorney be aligned?

208 See Suchman & Cahill, supra note 75, at 683 (noting that the “integrative role” of attorneys as “key players in an informal apparatus of socialization, coordination, and normalization . . . becomes most notable in interactions between Silicon Valley lawyers and the region’s high-technology entrepreneurs and venture capitalists”).

209 See Lashinsky, supra note 73, at 136 (citing Craig Johnson of VLG as saying that clients want their outside counsel to make a commitment to the company).

210 See KLEIN & COFFEE, supra note 42, at 131 (describing three types of directors: (1) inside directors, who are also officers or employees; (2) outside directors, who are truly independent; and (3) directors who have an external relationship with the corporation such as outside attorneys and investment bankers).

211 See Suchman & Cahill, supra note 75, at 688 (stating that most venture capital funds demand relinquishment of corporate control by the founder).

212 See id. at 694 (noting the inherent conflict between shareholders and founders).

213 KLEIN & COFFEE, supra note 42, at 170–71 (remarking that because of this conflict, some courts have imposed on majority shareholders fiduciary duties to minority shareholders).

214 See Beck, supra note 81, at 153 (describing a founder of a start-up client of Cooley Godward as concerned that the venture capital fund Cooley paired it with was trying to take control of the board now that the fund had outside directors sitting on the board).
Although making the attorney a shareholder would seem to align the interests of attorney and client, the result is not as clear.\textsuperscript{215} The attorney’s economic interests become that of a shareholder who intends to sell the stake at the earliest opportunity, usually six months. A law firm who receives its fees in company stock cannot hold on to the stock indefinitely, or the firm will face problems of liquidity.\textsuperscript{216} Stock cannot pay the rent on offices or salaries of employees. Therefore, the attorney may have an interest that is aligned only with the venture capitalists, the underwriters, or other early investors and not with the long-term goals of the corporate entity.

For example, assume that WorthYourDiningDollar.com is working toward an initial public offering. The attorney-investor is working on the disclosure statements for that offering. The attorney is concerned about some statements that Ms. Smith and the underwriter have provided. The attorney feels that the statements may be misleading, but without further investigation, the attorney is unsure. If the attorney investigates and has the suspicions confirmed, then the IPO may be delayed indefinitely. If the attorney does not mention anything, then the IPO will be successful and well-timed.\textsuperscript{217} However, future events in the next one to three years may then bring the statements to light and subject the company to scrutiny, lawsuits, and stock price decline. The attorney who risks events of this type has not alleviated the transaction costs for the client and in fact has substituted early, low transaction costs for larger ones in the future. But, as an early investor who wants to sell shares in the next six to twelve months, the economic pressure urges the attorney not to investigate and instead to complete the IPO.\textsuperscript{218} If the equity fee is contingent on the closing of the IPO, the economic pressure is even greater. In addition, the greater the potential payoff, the greater the pressure.\textsuperscript{219} Remember, many law firms have realized gains in the tens of

\textsuperscript{215} Cf. Roberta Romano, \textit{The Shareholder Suit: Litigation Without Foundation?} 7 J.L. ECON. & ORG. 55, 81–82 (1991) (noting that in a study of shareholder suits, more lawsuits were filed against managers with large ownership stakes because inside ownership increases opportunities for self-dealing).

\textsuperscript{216} A law firm that is making an investment in addition to receiving its ordinary legal fees, however, has more control of the timing of selling shares.

\textsuperscript{217} See Suchman & Cahill, supra note 75, at 687 (pointing out that the high-tech industry is a “time-sensitive environment” in which even small delays in getting funding and getting to the market may effectively destroy the commercial viability of a start-up company with a fresh idea).

\textsuperscript{218} Cf. 2000 ABA Op., supra note 196 (describing the circumstance where a lawyer may be called upon to render an opinion in a venture capital transaction in which the lawyer would otherwise advise the client to reveal material adverse financial information, but the disclosure might cause the venture capital party to decline to close the transaction).

\textsuperscript{219} See id. (advising that if the stock of the client is the lawyer’s major asset, then her representation of the corporation would be affected adversely, causing her to withdraw under Model Rule 1.7(b)).
millions on IPO day. Therefore, paying the attorney in stock in lieu of a fee has not aligned the economic interest of the attorney with the long-term goals of the company, but in fact has created a very large conflict of interest. The attorney is not interdependent with the entity, just with the founder and venture capital fund investors. Although the attorney-investor may be an effective transactional cost engineer for certain constituencies who want to take the company public quickly and cash in stock options, the attorney will not effectively be reducing long-term transaction costs for the entity.

This eagerness to close the transaction is not only theoretically possible in the arena of spotting disclosure issues, but it is clearly evident in the fact that Silicon Valley law firms are reportedly doing deals very quickly by drafting documents that are shorter, have looser terms, and are not fiercely negotiated. In fact, Silicon Valley lawyers have a reputation for being not only "efficient," but also "sloppy."

Interestingly, an attorney will be less likely to have a conflict of interest with the client, the corporation, when the attorney holds a small percentage interest, intends on holding that interest as a long-term investment, and that interest is not significant in the attorney's entire portfolio. But in this instance, the client's stated goal of having a "partner" will also probably not be achieved. In sum, a founder of a start-up company wants outside counsel to be a co-founder. However, a corporate attorney cannot realistically be a co-founder. On the one hand, co-founders are thoroughly invested and cannot easily cash out of the enterprise. A law firm is engaged in the practice of law, not in the practice of being patrons to promising ventures. Practically, law firms cannot tie up firm profits in that way. Professionally, a law firm cannot fulfill its role as a transaction cost engineer and be a co-founder at the same time.

220 See supra Part III.C (chronicling huge gains by VLG and Wilson Sonsini from investments in clients).
221 ABCNY Op., supra note 104 (determining that a lawyer's professional judgment would likely be adversely affected so that the attorney would not advise a client to disclose negative information for fear of the transaction not being completed).
222 See Suchman & Cahill, supra note 75, at 696–97 (reporting that Silicon Valley firms reject the “belt and suspenders” approach to documenting transactions and have abandoned “lawyerly caution”); see also Renee Deger, Wilson Settles Client Flap, RECORDER (San Francisco), Oct. 26, 1999, at 1 (reporting that Wilson Sonsini settled a $5 million malpractice claim in which entrepreneurs claimed that the wrong name appeared on final documents in connection with the acquisition of their company, in which Wilson Sonsini owned shares).
224 See 2000 ABA Op., supra note 196 (noting that law firm policies that minimize conflicts with the interests of clients “may include limiting the investment to an insubstantial percentage of stock and the amount invested in any single client to a nonmaterial sum”).
B. Attorney-Investor as Reputational Intermediary

The nature of being a reputational intermediary rests in the attorney’s independence from any particular client.\textsuperscript{225} A reputational law firm is a long-term player in the business industry. This law firm has survived many different business trends and expects to be viable after the current trend is over. With this reputation, a law firm gives a client the needed reputational clout to negotiate with third parties and the government.\textsuperscript{226}

Consider, however, whether the attorney for the buyer in an acquisition with final-period problems would advise his buyer-client that he is comfortable with the assurances of the law firm for the seller if the buyer’s attorney knew that the seller’s law firm had a significant economic stake in the closing of the transaction. In an ordinary transaction, the buyer’s attorney knows that the seller’s law firm will probably be presenting the seller with a bill for hundreds of thousands of dollars, which is probably payable whether or not the transaction closes. The buyer’s attorney knows that the seller may get angry if the transaction does not close and may not hire its law firm again. But, the buyer’s attorney knows that the seller’s law firm has a stable of clients and a fine reputation that continually attracts new clients. The buyer’s attorney knows that the seller’s law firm logically would not risk its own reputation for the seller, one of its many clients.\textsuperscript{227}

Now consider a different scenario. The seller’s law firm has deferred its fees in lieu of equity or an investment opportunity. Therefore, the attorney now knows that the law firm will make between $10 and $50 million if the transaction closes and nothing if the transaction does not close. The attorney also learns that the law firm has begun performing more and more business services for clients, so that it only handles about 15 clients a year. Will the attorney assume that the law firm again will not risk its reputation just to close the transaction?\textsuperscript{228} The law firm has lost its credibility as a reputational intermediary.\textsuperscript{229} Much as an in-house lawyer

\textsuperscript{225} See supra Part IV.B.2 (discussing the nature of an attorney as a reputational intermediary); see also Okamoto, supra note 175, at 28 (describing in-house counsel, with one client, as the clearest case of a non-independent lawyer).
\textsuperscript{226} See Okamoto, supra note 175, at 45 (explaining that because lawyers are “repeat players,” they can benefit clients who, as infrequent visitors to the arena, have no reputation).
\textsuperscript{227} See HAMILTON & BOOTH, supra note 182 (noting that a law firm only operates as a reputational intermediary when the law firm has more to lose by renting its reputation than to gain by cheating).
\textsuperscript{228} See Suchman & Cahill, supra note 75, at 696 (reporting that Silicon Valley firms are acting as insurers and giving legal opinions that “might not be totally 100% right” just to keep the transaction alive).
\textsuperscript{229} In an analysis of U.S. law firms with the highest reputational bonds, and the highest “rent” for those bonds, the law firms with “lock-step” compensation for attorneys have the strongest bonds and can charge premium rent for those bonds. Law firms with entreprenurial
who has her economic future entangled with the company is considered captured and not able to function as a reputational intermediary for that company, the law firm who has partnered with the start-up company and tied its economic success to the success of that start-up may also be perceived as captured.\textsuperscript{230}

Unfortunately, a law firm's reputational value is easy to lose. A law firm may act with utmost integrity and still be seen as captured because the numbers at stake are so high. Knowing that a law firm will receive an unusually high benefit from the closing of an IPO makes the law firm instantly suspect.\textsuperscript{231} Even if the law firm has set up a separate investment fund with a diverse portfolio, the appearance of a conflict will be enough to damage its position as a reputational intermediary. In addition, if even a few law firms with this type of conflict are proven to have acted as poor transaction cost engineers and committed malpractice or securities fraud, the value of any member of the legal profession as a reputation intermediary will be diminished.\textsuperscript{232}

C. Attorney-Investor as Gatekeeper

The third unique role that a corporate attorney plays in the business world is that of gatekeeper. A law firm will only agree to represent clients that it believes it can trust. In a securities offering scenario, a law firm must counsel the client to make certain disclosures required by law. If a law firm, therefore, represents a particular client then that client must be the kind of client that complies with applicable laws.\textsuperscript{233} Therefore, if the law firm has a good reputation, the public

\footnotesize{compensation create incentives for individual lawyers to sacrifice the interest of the law firm for the benefit of a single client. One commentator hypothesizes that this incentive is the reason why firms with that type of compensation structure cannot charge as a high a premium on its reputational bond as lock-step prestige firms. \textit{See} Okamoto, \textit{supra} note 175, at 41-43.

\textsuperscript{230} \textit{See} Gilson, \textit{supra} note 173, at 290 (warning that a reputational intermediary is only valuable if no "final-period problem" is associated with the intermediary's pledge; therefore, if the attorney has the same motivation not to be trusted as the client, then the attorney will not be an effective reputational intermediary).

\textsuperscript{231} \textit{See} Cole, \textit{supra} note 136, at 55 (quoting a former SEC administrator as saying, "If a company is going public, and the law firm representing it is a shareholder, it looks like a conflict. It is not a good thing.").

\textsuperscript{232} \textit{See infra} Part VII (discussing the stigma borne by the accounting industry in the aftermath of accounting scandals surrounding Enron Corp. and WorldCom).

\textsuperscript{233} This gatekeeping function has been codified to some extent by SEC rules promulgated pursuant to the Sarbanes-Oxley Act of 2002. 17 C.F.R. pt. 205 (2003). These rules, which received substantial feedback during the comment period, require an attorney representing a corporation to report evidence of "material" securities violations "up the ladder," and then allow that attorney to reveal confidential information regarding those violations if necessary. \textit{See id.} § 205.3(b) (outlining steps an attorney must take when she "becomes aware of evidence of a material violation by the issuer, or by an officer, director, employee, or agent of the issuer."). Proposed rules that would create a "noisy exit" of fired or withdrawn attorneys are currently}
will see those clients as trustworthy, too.\footnote{234}{See Wilkins, \textit{supra} note 16, at 1164 (discussing the role of lawyers in counseling clients to avoid prohibited conduct).} However, once a law firm loses either its independence or its reputational status, it cannot adequately function as a gatekeeper. By taking substantial equity positions in its clients and partnering with them as seed investors, a law firm will not be seen as a gatekeeper. To the public, the law firm will be seen as renting its reputation to the highest bidder. In litigation parlance, the law firm has become a "hired gun," and its clients will not benefit from the law firm’s position in the community. The law firm will be seen as selecting its clients on the basis of "upside" alone, and not on trustworthiness.

Proponents of attorneys investing in clients argue that law firms do provide a gatekeeper role precisely by choosing to become investors.\footnote{235}{See Suchman & Cahill, \textit{supra} note 75, at 697–98 (naming gatekeeping, proselytizing, and sorting as corporate attorney’s roles in Silicon Valley).} Why, they ask, would the public want to invest in a company when its own lawyers, who have more information, would not make the same investment?\footnote{236}{See Miller, \textit{supra} note 107, at 450–51 (asserting that attorney-investors act as gatekeepers by screening potential clients for fundability and then acting as monitors for venture capital funds).}

First, the lawyer may not be making the same investment as the public. The lawyer may be getting its equity stake at no cost or at a low cost.\footnote{237}{See Orenstein, \textit{supra} note 100, at 146 (reporting that VLG demands "founders stock," inexpensive stock usually reserved for founders).} Most investors would accept free stock or stock for a nominal amount in any company without much scrutiny.

Second, and more important, screening investments is not gatekeeping.\footnote{238}{See Suchman & Cahill, \textit{supra} note 75, at 699 (asserting that firms in Silicon Valley act as gatekeepers by selecting clients based on knowledge of which kinds of business plans go forward and which do not).} The role of the gatekeeper is to keep unscrupulous or untrustworthy players out of the industry. Whether a company is unscrupulous is not always connected to whether someone is willing to bet that its stock will increase from its initial offering price over the next six months. If that is the function of a gatekeeper, then an investment banker, who generally has more education and experience in the area, will serve that function better than an attorney.\footnote{239}{Investment bankers, like accountants and attorneys, also function as reputational intermediaries. Gilson, \textit{supra} note 173, at 299. Unlike attorneys and accountants, however, investments bankers are not seen as independent, but as sellers of their clients. They regularly buy stock in issuer clients, and they make their fees contingent on the launch of that issue. Furlonger, \textit{supra} note 19, at 95–96. The reputational value is therefore different from that of an independent attorney or accountant. Investment bankers do not lend their reputation to overcome final-period problems between two parties, but to add a premium to the stock price in proposed but not final. See \textit{id.} § 205.3(d)) (requiring an attorney who reports evidence of violations to no avail to withdraw from the representation and file a notice with the SEC).}
and vouch to the public that the client is trustworthy, the gatekeeper must be independent. To make a pedestrian analogy, if a friend were "setting you up" with a member of the opposite sex, would you feel better or worse if the friend making the recommendation were the prospect's mother?

Finally, the practice of taking stock in one's client in lieu of a fee has the opposite effect of gatekeeping, even assuming that a function of being a gatekeeper is vouching for a client's creditworthiness. An argument often cited for deferring fees in lieu of equity for start-up clients is that these clients may not otherwise be able to afford good legal representation. Proponents analogize these clients to the meritorious plaintiffs who could not have their day in court if plaintiff's lawyers were not allowed to enter into contingent fee agreements with them. The start-up clients are usually in the process of looking for venture capital and currently do not have cash to pay for many start-up services. Therefore, the mere fact that an attorney is taking equity in lieu of fees could be evidence that the client is not creditworthy. The client may have a great business plan and just be cash-poor, but the client may also not have enough seed money, may not have good business acumen, and may continually have liquidity problems.

\[\text{an offering. To the public, the reputation is secured by the investment bank's long-term interest in maintaining its status as a broker-dealer with the National Association of Securities Dealers and as a repeat player in the capital markets.}\]

\[\text{240 But see Orenstein, supra note 100, at 142 (stating that many Silicon Valley firms required equity from new clients).}\]

\[\text{241 See Miller, supra note 107, at 442-43 (analogizing equity in lieu of fees to contingent fees that "remedy situations where a client cannot bring a meritorious claim because of insufficient resources").}\]

\[\text{242 See Goodman, supra note 78 (interviewing one advertising executive whose agency had accepted equity in return for services in twelve new ventures and one publicist who also had traded services for equity in approximately twelve start-up companies).}\]

\[\text{243 In a way, the market of start-up clients who wish to pay for legal services with stock or stock options may be seen as a "market of lemons." Similar to the market for used cars, which discounts price because the sellers of used cars are a self-selecting group of car owners unhappy with their cars, the market for legal services payable in equity may be made up of self-selected buyers who are generally unable to pay cash for legal services. Although not all used cars are lemons and not all cash-poor legal services buyers are uncreditworthy, the market may view them as so. See generally George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q.J. ECON. 488, 488–90 (1970).}\]

\[\text{244 But see Suchman & Cahill, supra note 75, at 693 (noting that taking equity in lieu of fees increases access to legal services for start-ups who are creditworthy but just have a different "life cycle").}\]
D. Other Roles—Attorney-Investor as Loyal Counselor

Clients and attorneys also argue that giving and receiving client equity as fees increases the attorney's loyalty to the client and enables the attorney to be a long-term counselor. The reality has proven the opposite. A client may think that allowing an attorney to get in on the ground floor of a great business idea and to receive a handsome fee for taking that business public would certainly secure that attorney's loyalty and availability for future representation. However, the actions of the Silicon Valley law firms seem to prove that all that client did was whet the attorney's appetite for representing start-up companies in IPOs. These same law firms decline to continue to represent clients once those companies go public. Busy with other start-up companies that promise "upside," law firms do not have the time to handle the less lucrative, routine legal tasks of public companies. These actions do not support the argument that paying attorneys in equity builds client loyalty.

VI. FINE LINE BETWEEN PLEASURE AND PAIN: LIABILITY CONCERNS OF INVESTING IN CLIENTS

The purpose of analyzing how investing in a client may create conflicts of interest between the attorney and the client and a loss of reputational or gatekeeping ability from the public's perspective is to show that the law firm is facing a risk greater than just the loss of the investment. In a perfect transaction, everyone is happy. If the client has seen the stock price in an IPO go high and stay high, the client will see the attorney's share as a well-spent cost of doing business. The public who bought shares in the IPO will be satisfied, and the Securities and Exchange Commission (SEC) will keep busy with other matters. However, if the transaction goes awry, then these conflicts, which may be molehills, will look like mountains. If the stock price in an IPO goes high then plummets, the shareholders

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245 See Baker, supra note 7, at 37 (stating that clients view attorney investments as a sign of loyalty); Miller, supra note 107, at 452 (asserting that attorneys who invest in clients are developing a long-term relationship with that client as a "partner for life").

246 See Beck, supra note 81, at 69 (noting that in Silicon Valley, big public companies are undesirable and that associates prefer to work with entrepreneurs).

247 See id. at 69 ("It's not uncommon to hear of a valley law firm dumping a client after it goes public and after the firm has scored a bundle on its stock.").

248 See id. at 251 (reporting that the Cooley Godward committee instituted in 1999 to screen new clients also weeded out 100 existing clients in that year); Osborne, supra note 138 (reporting that VLG relegates compliance work after companies go public to in-house counsel or other outside firms).
will look to the issuer. The SEC will look to the issuer. The issuer will look to the law firm, which will cause the shareholders and the SEC to look to the law firm. All of a sudden, the law firm’s ingenious agenda of taking equity in clients will be highly scrutinized.

A. Ethical Rules

Taking stock in one’s client as all or part of a fee does not violate any ethical rule on its face. Rule 1.8 of the Model Rules of Professional Conduct, promulgated by the ABA, states:

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and the terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client 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 in the transaction; and

(3) the client consents in writing thereto.

Accepting equity in a client constitutes a “business transaction” under Rule 1.8. The rules treat accepting equity in lieu of a fee and investing firm funds in the client as the same for purposes of Rule 1.8, as long as the opportunity to invest is offered in connection with the law firm agreeing to provide legal services. Due to growing concern over the trend of lawyers investing in start-up clients, the ABA issued a formal ethics opinion in 2000, advising lawyers that the Model Rules do not prohibit the practice. However, the ABA warns that a lawyer engaging in this practice must conform with Rule 1.8 and disclose the potential conflict to the client, advise the client to seek independent legal advice, and obtain the client’s consent in writing. In addition, the fee must comply with Rule 1.8(a)’s requirement that the transaction be “fair and reasonable to the client.”

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249 See John Pletz, Market Downturn Feeds Lawsuit Boom, AUSTIN AM. STATESMAN, Dec. 10, 2001, at D1 (reporting that twice as many security class action lawsuits were filed in 2001 than in 2000).
251 2000 ABA Op., supra note 196.
252 Id.
253 Id.
254 Id.
255 MODEL RULES OF PROF’L CONDUCT R. 1.8(a) (1983).
and with Rule 1.5(a)'s requirement that the fee be "reasonable." Other jurisdictions have also construed their identical or similar ethical rules to allow lawyers to take equity in their clients given the same safeguards.

In practice, the requirement that the attorney obtain a written consent from the client that outlines the potential conflicts may not be as meaningful as the rules seem to anticipate. In 2000, if a client wanted to hire one of many certain Silicon Valley firms to represent a start-up company and guide the company through an IPO, then that client was required to give up equity to the law firm. In this scenario, the client's written consent may not be meaningful because the client has no other viable option than to give the consent. The client, who is probably not sophisticated or experienced in business or law, is desperate to have representation in an industry with more buyers of legal services than sellers. Another equally realistic scenario is that the client cannot pay in cash, but can only pay for legal services in stock or stock options. In this scenario, a written consent will be easy to obtain from the client, but may not serve the purposes of the rules. To have clients like this waive a legal conflict is much

256 Id. R. 1.5(a).

257 Compare N.Y. CODE PROF'L RESPONSIBILITY DR 5-104(A) (2001) (requiring disclosure if attorney and client will have "differing" interests in a business transaction), with MODEL RULES OF PROF'L CONDUCT R. 1.8(a) (2003) (requiring disclosure for "adverse" interests).

258 See also Passante v. McWilliam, 53 Cal. App. 4th 1240, 1247-49 (Cal. Ct. App. 1997) (voiding an oral promise of a corporation to pay outside attorney an equity interest, which skyrocketed to $33 million in value, reasoning that (1) the promise was not enforceable because it lacked consideration and (2) even if the promise was enforceable, the agreement would then violate Rule 3-300 of the California Rules of Professional Conduct because the attorney did not advise the client in writing to seek the advice of an independent attorney); Weiss v. Statewide Grievance Comm., 633 A.2d 282, 288-89 (Conn. 1993) (upholding reprimand of attorney for receiving an 18% interest in client in exchange for legal services without disclosing that the ownership interest would create "differing interest" and obtaining a written consent pursuant to Disciplinary Rule 5-104(A) of the Code of Professional Responsibility); State v. Bennett, 810 P.2d 661, 664-65 (Colo. 1991) (suspending attorney for accepting an offer to purchase a percentage of his client's business without disclosing the potential for conflicts of interest in violation of Colo. D.R. 5-104(A)).

259 See supra Part III.A (discussing the practice of many Silicon Valley firms to require equity from clients before accepting representation).

260 See Suchman & Cahill, supra note 75, at 688 (noting that many unsophisticated founders of high-tech start-ups are former engineers or even worse, academics).

261 See ABCNY Op., supra note 104 ("Principal in startup companies typically entering into 'securities for fees' arrangements may be legally unsophisticated and may be relying on the attorney with respect to the transaction.").

262 See Gwyneth E. McAlpine, Comment, Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients' Stock?, 47 UCLA L. REV. 549, 583-84 (1999) (remarking that a client may fear turning down a request for investment by prospective attorney so that equity becomes a forced cost of doing business for a start-up).
like having a debt-ridden individual sign a waiver of any applicable usury laws before obtaining a loan from a loan shark.263

According to the ABA Opinion, the reasonableness of the fee will be determined at the time of the fee agreement according to the factors listed in Rule 1.5(a):

(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
(2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
(3) the fee customarily charged in the locality for similar legal services;
(4) the amount involved and the results obtained;
(5) the time limitations imposed by the client or by the circumstances;
(6) the nature and length of the professional relationship with the client;
(7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
(8) whether the fee is fixed or contingent.264

Although the ABA Opinion is clear that the reasonableness requirement applies to the value of the stock at the time that the agreement is made, the Opinion advises attorneys to provide an estimate of the cost of the legal services and receive an amount of stock equal to that cost.265

This requirement of the rules seems the most troublesome. Attorneys who accept equity in their clients do so because they anticipate that the stock will increase dramatically in value. The pre-IPO stock the attorney receives may have very little value, but after the company goes public, the stock may be very valuable. This dynamic might prove problematic to an attorney who has to prove that the value of the stock as a fee was reasonable.266 Few jurors would believe that a fee in the tens of millions for taking a company public was reasonable when the traditional hour-based fee would be in the hundreds of thousands.267 At the outset of the representation, the attorney is accepting the risk that the stock may never appreciate in value or have a secondary market. When viewed ex ante, the

266 Ronald C. Minkoff, Ethical Considerations for Attorneys Involved in Venture Capital Transactions, in PRACTICING LAW INSTITUTE, 1267 CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 917 (2001) (noting that determining whether a “stock-for-fee” is reasonable is difficult).
fee could always seem reasonable, having little value at all. 268 If the attorney were to require equity equal to the normal fee, say $250,000, that amount of equity may be a huge percentage of the worth of the company at the time that the legal representation is secured. 269 The ABA Opinion also recommends against taking large percentages. In addition, if the company goes public, that $250,000 worth of stock might become hundreds of millions.

However, the problems inherent in assessing the reasonableness of an equity-based fee are the same problems inherent in any type of contingency fee. The lawyer may collect nothing or collect a windfall. Contingency fees in personal injury litigation have been upheld even though the personal injury lawyer may collect a fee that seems unreasonable in hindsight. Because of the possibility of conflicts of interest, in New York, contingent fees in litigation are not recommended when the litigants could otherwise afford to pay an hourly fee. 270 Courts have concluded that the attorney is accepting a risk of no fee or a very small fee and that without contingent fees, meritorious plaintiffs may not be able to obtain representation. For the same reasons, windfall equity-based fees may also be seen as reasonable after taking into consideration the risk that the attorney assumed at the beginning of the representation. However, if the risk is small, then the fee may be seen as unreasonable. 271

In addition to the application of these rules at the outset of a representation, if the existence of the stock ownership creates a conflict of interest during the representation or adversely affects the attorney's professional judgment during the representation, then the attorney may have to withdraw from the representation under Rule 1.7(b). 272 If the conflict gives rise to a reasonable belief that the

268 But see ABCNY Op., supra note 104 (warning that under DR 2-106(A) not all client securities will be deemed reasonable fees, particularly if the risks are minimal and the amount of securities is excessive in relation to the services rendered).

269 See Howard, supra note 68 (musing whether it is “fair and reasonable” to accept $50,000 in stock options that have a good probability of becoming worth millions of dollars).

270 N.Y. CODE PROF’L RESPONSIBILITY EC 2-20 (2001). This line of reasoning has never been persuasive to me. As a finance attorney, I was surprised to learn that in Texas, the usury rates for loans involving manufactured housing and used cars were higher than for other loans. The argument for the higher rate is that, without the incentive for lenders, low-income purchasers of these goods would not be able to obtain financing. My response was that the low-income purchasers of these goods are exactly the types of people who should be protected from gouging lenders. Conversely, New York has a logical usury law that has exceptions not for consumers of low-income housing but for corporate borrowers and borrowers of over $250,000. N.Y. GEN. OBLIG. LAW §§ 5-521(1), 5-501(6)(a) (2002).

271 See ABCNY Op., supra note 104; Kan. B.A. Ethics Advisory Comm., Op. 6 (1998) (“If such fees result in abnormally high hourly rates on a comparison basis and when there is little time or risk in the case, the fees are considered to be unreasonable.”).

272 MODEL RULES OF PROF’L CONDUCT R. 1.7(b) (1983); 2000 ABA Op., supra note 196 (stating that if a lawyer cannot maintain the “requisite professional independence” of an
representation would be adversely affected, this conflict is not waivable by the client. In an IPO setting, if the economic pressure of a large, contingent stock fee is significant enough to conceivably cause an attorney to commit malpractice, then the same pressure would cause that attorney not to withdraw from the representation and lose the fee entirely.

Finally, if the equity accepted by the attorney can be characterized as a fee or consideration for legal services, a written agreement between client and attorney should formalize the terms of that fee arrangement. Because this fee could be seen as contingent, Model Rule 1.5(c) may apply.

Attorneys who do accept equity in a start-up client with the expectation of sharing in a large increase in the stock price should realize that if anyone involved in the transaction has a disappointing outcome, then the fee may look unreasonable to the media, the public, or a jury. If litigation should ensue against the attorney, the attorney will have the burden of proving both that the client freely consented to the fee arrangement and that the fee was reasonable. Two types of litigation might be brought against an attorney in which a huge equity interest as a legal fee might make the attorney’s actions suspect: a malpractice action and a securities fraud action.

B. Legal Action by Client: Breach of Fiduciary Duty & Legal Malpractice

A client who believes that his attorney has not provided honest or competent legal representation may seek redress in a legal malpractice action or in a breach of fiduciary duty action. Recognition of the fiduciary duty between the attorney and the client originated in equity. Part of this duty is to act with undivided loyalty and to avoid conflicts of interest. Because of the fiduciary nature of the attorney for her client and ignore her economic interest as a shareholder, then she must withdraw.

275 MODEL RULES OF PROF'L CONDUCT R. 1.5(c) (2003).
276 See Burman, supra note 197, at 15 (“The courts, too, view lawyer-client business transactions with skepticism. That skepticism is rooted in the fiduciary nature of the lawyer-client relationship, where the lawyer must subordinate his or her interests to the client’s.”).
277 See id. at 16 (citing Comm. on Prof'l Ethics & Conduct v. Mershon, 316 N.W.2d 895, 899 (Iowa 1982) (“[The] safest and perhaps best course would [be] to refuse to participate personally in the transaction.”)).
278 See Meredith J. Duncan, Legal Malpractice by Any Other Name: Why a Breach of Fiduciary Duty Claim Does Not Smell as Sweet, 34 WAKE FOREST L. REV. 1137, 1148 (1999).
279 See id. at 1153; see also Lawrence E. Mitchell, The Death of Fiduciary Duty in Close Corporations, 138 U. PA. L. REV. 1675, 1686 (1990) (noting that the law approves of fiduciaries being disqualified from sharing ownership interests with the beneficiary to avoid the fiduciary's having to balance those competing interests).
relationship, if a client ever calls into question the equity in lieu of fee arrangement, the attorney will face a rebuttable presumption that he used undue influence over the client in securing that fee arrangement. This presumption may be made difficult to rebut if the attorney required the fee arrangement before agreeing to represent the client and the client was unsophisticated and in desperate need of both legal representation and capital. The presumption would also be more difficult to rebut if the attorney-client relationship was already in place at the time of the equity request by the attorney, and the relationship was characterized by the unsophisticated client relying on the attorney in both legal and business matters. If the presumption cannot be rebutted, then the transaction is voidable and the lawyer must disgorge all profits from the representation. Because courts view business transactions with clients with intense scrutiny, an attorney will want to avoid this type of litigation.

A disappointed client whose business venture has gone south may also seek to recover from the attorney in the form of a malpractice lawsuit. If a client is pressured into bankruptcy because of shareholder lawsuits, then the client or the bankruptcy trustee may turn to the attorney and allege that the client’s legal problems are a result of relying on the improper advice of counsel, who had a large economic stake in now questionable transactions. This type of lawsuit would be grounded in negligence, and a plaintiff would have to establish the basic elements of duty, breach of duty, causation, and harm. An attorney who realized tens of millions of dollars in the months following an IPO will not look very sympathetic to a jury when compared to a defunct company and shareholders who collectively lost millions (or billions) of dollars in the year or two following the IPO. Although the plaintiff will have a difficult hurdle in proving that the attorney breached his professional duty of care and that this breach was the cause of the client’s downward spiral, defending the lawsuit will be costly both in terms of dollars and reputation for the law firm involved.

280 See McAlpine, supra note 262, at 560 (“To rebut the presumption of undue influence, the lawyer must show that he acted in good faith, that the transaction was fair to the client, that there was full disclosure of the lawyer’s interest, and that there was no overreaching or fraud by the lawyer.”).

281 See Duncan, supra note 278, at 1161.

282 See Howard, supra note 68 (reporting that one malpractice lawyer had received a number of complaints regarding attorney-investors).

283 See Duncan, supra note 278, at 1141.

284 See Howard, supra note 68 (stating a multi-millionaire attorney would find it difficult and expensive to defend himself in front of a blue-collar jury even if the lawsuit only involved the appearance of impropriety).
C. Legal Action by Shareholders: Securities Fraud Violations

The largest unknown risk that a law firm faces when investing in its clients is whether the law firm will be named and eventually held liable in a securities fraud lawsuit.\textsuperscript{285} The bursting of the technology bubble has created a new wave of securities lawsuits.\textsuperscript{286} Shareholders lost huge sums after buying stocks at inflated prices and then watching those prices plummet and, in some cases, the issuers declare bankruptcy.\textsuperscript{287} The size of the losses has driven many shareholders to file securities fraud cases, many in the Southern District of New York.\textsuperscript{288} These lawsuits may also spawn ancillary litigation against attorneys.\textsuperscript{289} In addition, the recent accounting scandals and daily restatements of earnings by large corporations have spawned new lawsuits, many with accounting firms as defendants.\textsuperscript{290} The outcomes of these lawsuits will predict how attorneys will be treated in similar lawsuits.\textsuperscript{291}

Prior to the mid-1990s, secondary parties such as accountants and attorneys could be named in shareholder lawsuits for violations of Section 10(b) of the Securities Exchange Act of 1934\textsuperscript{292} and Rule 10b-5 promulgated thereunder\textsuperscript{293} as

\textsuperscript{285} See Blackwood, supra note 69 (quoting the chairman of the California State Bar committee on professional responsibility as saying that being a defendant in a securities lawsuit was one possible unknown in taking equity in a client).


\textsuperscript{288} See Swanson & Roberts, supra note 286, at 109 (attributing the growth in securities fraud cases to a group of IPO allocation cases filed in the Southern District of New York “which involve virtually every initial public offering made in the past several years”).

\textsuperscript{289} See Howard, supra note 68 (“Someplace down the road there are going to be failures, and other investors are going to say, ‘You, the law firm, did not adequately convey to us what we should have known because you were a party to this.’ ”) (quoting Bob Brockhaus, director of the Jefferson Smurfit Center for Entrepreneurial Studies at St. Louis University).

\textsuperscript{290} See Swanson & Roberts, supra note 286, at 109–10 (noting that recently plaintiffs have increasingly returned to naming accountants in fraud cases and that about 89% of all post-PSLRA securities class actions involve accusations of accounting fraud or insider trading).

\textsuperscript{291} See id. at 110 (questioning whether the PSLRA will fulfill its promise of limiting exposure to secondary parties such as accountants and attorneys).


\textsuperscript{293} 17 C.F.R. § 240.10b-5 (2000).
aiders and abettors. To prove liability, shareholders only had to prove that secondary participants acted knowledgeably or recklessly in connection with a primary violation and that the secondary participant provided substantial assistance to the primary violator. In 1994, the Supreme Court held in *Central Bank of Denver v. First Interstate Bank of Denver* that Congress did not intend for shareholders to have a private right of action against aiders and abettors under Section 10(b). Accordingly, plaintiffs then had to allege and prove the elements for a primary violation of Section 10(b) against defendants such as accountants and attorneys who were involved in a sale of securities. These elements are harder to plead and to prove: (1) misrepresentation; (2) duty; (3) scienter; (4) materiality; (5) reliance; and (6) injury. These changes were codified in 1995 with the passage of the Private Securities Litigation Reform Act, which also increased the pleading standard for violations of 10b-5. After 1995, secondary parties such as securities attorneys could be granted motions to dismiss lawsuits when the plaintiff did not meet the heightened pleading standard for alleging that the attorney had the requisite "scienter" or intent to defraud. However, the Circuit Courts of Appeals have disagreed on how stringent the PSLRA's pleading standard is.

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295 See id. at 712 (articulating the test as having three prongs: (1) a primary participant must have committed a securities law violation; (2) the aider and abettor must have been generally aware of improper activity; and (3) the aider and abettor must have knowingly and substantially assisted the violation).


297 See Patterson, supra note 120, at 648 ("As a consequence of the *Central Bank* decision, anyone sued in a private action under Section 10(b) must be sued as a primary, and not a secondary, violator.").

298 Rothman v. Gregor, 220 F.3d 81, 89 (2d Cir. 2000).


300 15 U.S.C. § 78u-4(b)(2) (2000) ("[T]he complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.").


302 See Swanson & Roberts, supra note 286, at 114–15 (chronicling the split in the circuit courts, with the Ninth Circuit on one end of the pleading spectrum, the Second and Third Circuits on the other end, and the Fifth, Sixth, Tenth, and Eleventh Circuits holding the middle ground).
Because the most difficult element of a 10b-5 action, scienter, is very difficult to prove in the case of a secondary party, most securities attorneys are less at risk of being named in a securities lawsuit and certainly less at risk of being found liable in such a lawsuit after Central Bank and the enactment of the PSLRA. However, at least in some federal circuits, an attorney may lose this comfort by virtue of owning equity in an issuer client. In the Second Circuit, which includes the Southern District of New York, where many shareholder suits, particularly IPO lawsuits, are filed, including in the pleading the fact that the attorney defendant owned issuer stock may be sufficient for a 10b-5 lawsuit to survive a motion to dismiss. Although that fact alone is not sufficient to prove a violation, it does prove that the attorney defendant had motive and opportunity to commit securities fraud, which will satisfy the Second Circuit’s requirement that the plaintiffs plead facts that give a “strong inference” of the required state of mind. However, although the Third Circuit has followed the Second Circuit, the Ninth Circuit, which includes the Northern District of California, has construed the PSLRA as requiring that the plaintiffs plead sufficient facts that “constitute strong circumstantial evidence” of intent and as requiring more than facts alleging motive and opportunity to survive a motion to dismiss. The Fifth Circuit has maintained a middle ground, but will in all likelihood have the opportunity to speak on this issue in Newby v. Enron Corp., in which two law firms have been named as defendants.

303 This theoretical decline in risk has mostly proved to be valid. Although securities fraud cases have been filed against both VA Linux and Webvan, two of Wilson Sonsini’s largest client-investments, Wilson Sonsini was not named as a defendant in either lawsuit. Cf. id. at 120 (noting that after Central Bank abolished aiding and abetting liability and the PSLRA adopted proportionate liability, accountants have had reduced liability in securities fraud cases).

304 See Patterson, supra note 120, at 660 (“In the Second and Third Circuits . . . an investment in the client by the attorney will probably be enough to pass this test.”); see also In re Scholastic Corp. Sec. Litig., 252 F.3d 63, 74 (2d Cir. 2001) (holding that facts surrounding the sale of stock by the company president during time of misstatements were sufficient to plead motive and opportunity to commit securities fraud under 10b-5).

305 See In re Scholastic, 252 F.3d at 74 (holding that facts detailing company president’s motive and opportunity to profit from the fraud as sufficient to withstand a motion to dismiss).

306 See Swanson & Roberts, supra note 286, at 114 (stating that the Third Circuit has lined up with the Second Circuit and citing In re Adavanta Securities Litigation, 180 F.3d 525 (3d Cir. 1999)).

307 See Patterson, supra note 120, at 659 (citing In re Silicon Graphics Inc. Securities Litigation, 183 F.3d 970 (9th Cir. 1999)).

308 See Swanson & Roberts, supra note 286, at 115 (describing the Fifth Circuit as having an interim approach and citing Nathenson v. Zonagen Inc., 267 F.3d 400 (5th Cir. 2001)).


310 See infra Part VI.A (discussing the treatment of accounting firms and law firms in the wake of the Enron bankruptcy).
In securities fraud cases in which the attorney does not own securities in the issuer, scienter has been almost impossible to prove. Most securities attorneys with a stable of clients do not have a motive to participate in fraud in connection with a securities offering. When an attorney is seen as independent from the client, with independent economic incentives, then a judge is unlikely to infer that an attorney would have the requisite intent to permit recovery in a lawsuit. However, if the attorney stood to gain enormous sums of money in the securities offering, then the attorney now automatically has motive, which may be used to infer scienter.312 As someone granted stock or stock options earlier for free or at cheap prices, the attorney’s incentives are aligned with the issuer and the early investors, not with the prospective shareholders.313 An attorney in this situation will benefit from a higher selling price, making the attorney’s interest inconsistent with the buyers in the securities offering.

Even if the facts would not support a judgment against an attorney, having to defend a securities lawsuit can be very costly. If the plaintiff’s cause of action against the attorney survives a motion to dismiss, then expensive discovery will commence and the settlement value of the case increases.314 Although the PSLRA abolished joint and several liability under 10b-5,315 law firms may find themselves paying out large sums to settle these cases to minimize the overall economic drain.

In an extreme case, an attorney with a large equity stake who is very involved in many aspects of a client’s business may be named in a shareholder suit as a controlling person under Section 15 of the Securities Act of 1933 or Section 20 of the Securities Exchange Act of 1934. Although courts have been disinclined to consider attorneys as controlling persons, evidence of a large equity percentage and a relationship in which an unsophisticated client relied on the attorney’s advice in nonlegal matters may aid a plaintiff in overcoming that bias.
In addition, new legislation introduced in both the House and the Senate seeks to expand the liability of secondary violators such as accountants and lawyers by repealing the PSLRA and reversing Central Bank. Lobbyists that fought against the PSLRA are now using the accounting scandals to energize Congress to change the provisions that may insulate the accounting firms and law firms from liability. Specifically, these bills seek to reinstate aider and abettor liability, joint and several liability, and lower pleading standards. Although this legislation may not become law, it certainly reflects a nationwide desire to hold accountants and attorneys liable for some of the nation’s financial ills.

VII. A CAUTIONARY FEE TALE

One argument that law firms make to support taking client equity is that when the practice gained momentum, creating investment opportunities was necessary to compete in an environment where junior associates could easily go to work for start-up clients and receive lucrative stock option packages. Attorneys are also quick to point out that other professionals, such as investment bankers, routinely take equity in clients, and often the entire investment bank’s fee will be contingent on the closing of the transaction. Attorneys have also referred to the growing trend in multidisciplinary practice among accounting firms as a reason to revamp and become more of a “one-stop shopping” center for clients. However, after recent events have called accounting firms’ “one-stop

stock, may be liable as a controlling person along with other directors. See id. at 662. In the late 1990s, many Silicon Valley attorneys were taking both stock and board positions in their clients. See Osborne, supra note 138, at 73 (reporting that in 1996, three VLG partners were board members of start-up clients).


318 See Carrie Johnson, Fight Renewed over Limits on Investor Suits, WASH. POST, May 10, 2002, at E1 (quoting Sally Greenberg, senior counsel at Consumers Union, which was opposed to the 1995 bill, as saying “Our nightmare has come true” with regard to the numerous financial scandals and corporate earnings restatements); John Shipman, Fund Group Head Urges Congress to Act on Accounting Reform, WALL ST. J., July 9, 2002, http://online.wsj.com/article/0,,BT_CO_20020709_005122,00.html?mod=INDUSTRY (subscription required) (describing the mutual fund industry’s lobbying arm, Investment Company Institute, as urging Congress to pass reform legislation).

319 See S. 1933, 107th Cong. §§ 2–5.

320 See Orenstein, supra note 100 (citing attorneys at VLG as arguing that client equity is a necessary associate retention tool); Howard, supra note 68 (citing attorneys as bemoaning the defection of associates with “flat base salaries” to the “dot-com world”).

321 Gilson, supra note 173, at 299.

shopping” practices into question, the accounting profession provides us not with a pattern to emulate, but with a cautionary tale.

A. What About Those Nice Public Accountants?

Public accounting firms have always prided themselves on being independent from their many clients. Because of their independence, accountants have served the same reputational intermediary function as corporate counsel in transactions such as public offerings and mergers and acquisitions. These “Big Five” firms, down from “Big Eight” and “Big Six” due to mergers, serve many clients each and therefore are presumed to safeguard their reputations over any single client. Accountants issue comfort letters and vouch for the veracity of audited financial statements of their clients. To protect the sanctity of the public audit, accounting firms have always prohibited accountants from owning stock in clients.

In the 1990s, the large public accounting firms began to experiment with expanding into both business consulting and the provision of legal services. The reasons for doing so parallel the reasons why law firms sought to transform themselves into venture capitalist law firms: accounting firms could not remain profitable simply by leveraging junior auditors and increasing workload. In the United States, ethical rules were problematic for lawyers who wanted to work for multidisciplinary firms, so the trend of integrating legal services into accounting firms stalled somewhat in that arena. However, the business

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323 See Kostant, supra note 4, at 60 (comparing the legal profession’s misplaced concern with client confidentiality with accountants’ disclosure duties, which reflect accountants’ obligations to the investing public, not to the employment relationship).
324 See Gilson, supra note 173, at 290.
325 See id. at 291 (comparing the auditor’s comfort letter with the legal opinion).
326 See Miller, supra note 107, at 446 (stating that accountants cannot hold equity in auditing clients under the rules of both the American Institute of Certified Public Accountants and the SEC). Another safeguard of the independence of accountants has been the requirement that issuers disclose the firing or withdrawal of independent auditors on Form 8-K. See 17 C.F.R. § 229.304 (giving instructions to issuers on disclosing the resignation of independent accountants and whether any disagreement between the accountants and the issuer preceded the resignation). The new SEC rules implementing the Sarbanes-Oxley Act of 2002 propose to create an analogous “noisy withdrawal” for attorneys. See infra, Part VI.C. n.233.
327 Garth & Silver, supra note 322, at 921.
328 See id. at 903 (noting that laws of other countries permit attorneys to practice in multidisciplinary firms).
329 See id. (stating that until U.S. ethical rules are changed, a Big Five firm would have to try to compete in the legal services market through an offshore entity, with little chance of success).
consulting activities of accounting firms exploded. Although some firms formed separate business entities to conduct these activities, other firms provided both consulting advice and auditing services under the same umbrella.

Recent cases have highlighted the inherent conflicts of interest in accounting firms providing both auditing services and consulting services. However, public attention became more focused on the conflict when Arthur Andersen's auditing services to Enron Corp. began to be suspect. Because Andersen earned more from consulting services provided to Enron than from its auditing services, its motivations to conduct an eagle-eye audit were instantly suspect in light of Enron's "earnings management" accounting practices. Andersen subsequently lost in a criminal trial for obstruction of justice and then was told by the SEC that it had lost its ability to provide public audits. Legislation was quickly introduced in Congress to prohibit any accounting firm from auditing a client that is also a business consulting client. The independence that the accounting profession so fiercely guarded was destroyed in a matter of months once hidden conflicts surfaced arising from the double role that accounting firms were trying to perform.

The legal profession is in danger of having the spotlight turn on it with the same intensity. The relationships that attorneys are cultivating in which the attorney is the business consultant, venture capitalist, and legal advisor may also

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330 See Deogun & MacDonald, supra note 76 (reporting that KPMG International advised on 524 mergers and acquisitions in 1999, making it the leader that year, with PriceWaterhouseCoopers the sixth firm in terms of numbers of mergers and acquisitions and Ernst & Young the sixteenth).

331 Although KPMG consulted through the same entity, PriceWaterhouseCoopers held a subsidiary that was a registered broker-dealer. In an effort to separate auditing and consulting activities, this subsidiary is to be acquired by IBM Corp. for $3.5 million. See William M. Bulkeley & Kemba Dunham, IBM Speeds Move to Consulting with $3.5 Billion Acquisition, WALL ST. J., July 31, 2002, at A1.

332 KPMG, L.L.P. v. SEC, 289 F.3d 109, 126 (D.C. Cir. 2002) (upholding SEC cease and desist order because the consulting arm of KPMG was accepting success fees that threatened the independence of its auditing services).

333 ENRON REPORT, supra note 11, at 10 (concluding that Arthur Andersen did not provide objective and critical professional advice to Enron).

334 Coffee, Berle & Flom Testimony, supra note 12 (testifying that in 2000, Enron paid $25 million in audit fees to Arthur Andersen, but $27 million in nonaudit fees).


336 This double role also served to destroy accounting firms' leverage when trying to convince issuers to make disclosures: the noisy exit. An issuer could threaten to fire an annoying auditor from the lucrative consulting payroll, a move that would not require an SEC disclosure.
seem questionable under the same scrutiny. The legal profession has already felt the bursting of the economic bubble in declining revenue, forcing the once overloaded Silicon Valley firms to slim down their ranks. Layoffs and belt-tightening may not be the only negative results that the legal profession will suffer during the economic downturn. If one large case surfaces in which the "one-stop-shopping" law firm may have disregarded its professional duty in the face of a conflict of interest, then the entire legal profession may suffer in the same way that the accounting profession has suffered.

B. The View from the Crucible

For the accounting industry, the witch hunt has already begun. With each restatement of earnings that is announced by a public corporation, a new shareholder lawsuit is filed, often naming the accountants as defendants in addition to the issuer. Much as the nation saw with the savings and loan crisis of the 1980s, the third party professionals will be under attack as the primary participants go bankrupt and lose economic value as defendants.

The legal profession will be watching closely to see what happens to the lawyers in these cases. So far, few law firms have been named. However, attention is being focused on whether the law firms named in the Enron cases will be held liable under the new pleading standards of the PSLRA. Should that happen, then a new wave of cases will sweep the nation. Moreover, if a wave of cases happens to unearth windfall profits made by attorneys with lucrative stock options, then the media glare will turn from the accounting profession to the legal profession.

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337 See Garth & Silver, supra note 322, at 907–08 (remarking that Vinson & Elkins' actions in the Enron scandal paralleled those of Arthur Andersen's and constituted lending its reputation to Enron in return for the promise of continued legal work).

338 See, e.g., Lashinsky, supra note 73, at 134 (chronicling the slowdown of work at Cooley, Godward, which laid off about 100 attorneys in 2002).

339 See Swanson & Roberts, supra note 286, at 109–10 (reporting a continued increase of post-PSLRA filings alleging accounting irregularities or accounting fraud).

340 See Howard, supra note 68 (noting that attorneys fear a replay of the savings and loan debacle in which investors looked to attorneys as stakeholders); Claybrook Testimony, supra note 287 (testifying that the savings and loan scandal could not have occurred without the assistance of the lawyers and the accountants).

341 See Claybrook Testimony, supra note 287 (noting that Vinson & Elkins and Kirkland & Ellis have each cited the Central Bank decision in their Motions to Dismiss).
VIII. SO, WHADDAYA GONNA DO ABOUT IT?

A. Disclosure

One proposal to attempt to counteract the public’s misplaced trust in an attorney or law firm that invests in a client is to require disclosure of this fact in the legal opinion issued in connection with a securities offering. Although certain attorney-investors will be required to make disclosures if they own a large percentage of the equities of the client or fall into certain categories of persons, most investors will not be aware of those SEC filings. In addition, many attorney-investors will not be required to file anything with the SEC. However, if the law firm legal opinion contained a disclosure of equity investment, then the investing public could make its own informed decision as to whether the law firm could adequately perform its reputational intermediary function and gatekeeping function.

B. ABA Guidelines

Another proposal, albeit a much more far-reaching one, would be for the ABA to promulgate rules that limit that investment to a certain percentage. If the taking of an equity interest creates a conflict of interest, then the smaller the equity interest, the smaller the conflict. The percentage of equity that an attorney holds will not necessarily reflect the absolute dollar amount of the interest, but it can serve as a rough benchmark. In addition, the smaller the percentage of equity that an attorney holds, the smaller the influence that the attorney should have over the business decisions made by management.

To eliminate any equity-induced conflict, of course, the ABA could also promulgate an ethical rule that would prohibit the practice of taking equity in a client altogether. This action is highly unlikely and may also overly restrict attorney-client relations. The ABA could prohibit individual members of a law firm to hold investments, however, and allow only the law firm to make client


343 See ABCNY Op., supra note 104 (listing as a factor that should be considered in determining whether an equity interest is an excessive fee “the percentage amount of the interest, and what, if any, degree of control it provides the lawyer over the business”) (quoting Utah Bar Assoc. Op. 98-13 (1998)).

344 See Patterson, supra note 120, at 668–69 (suggesting that attorneys limit liability and avoid the appearance of aiding and abetting securities fraud by minimizing the actual amount of the investment because that way an attorney will be seen as having little to gain from the fraud).

345 See id. at 668 (noting that the percentage amount of equity that an attorney holds will determine whether the attorney can be seen as a “controlling person” under securities laws).
investments. The risk of an individual attorney having a conflict with the issuer's long-term goals would then be reduced as no individual attorney would have a large stake in the outcome of the issue. Any unethical behavior due to a conflict of interest would necessarily take place on the individual level; the individual attorney may not have a long-term interest in maintaining the independent reputation of the law firm and therefore may be motivated to cheat to realize short-term gain. Relieving that individual attorney from that conflict would take away the motivation to behave unethically or to violate any securities laws.

IX. CONCLUSION

The legal profession is in danger. Continually attacked in popular culture as greedy, unethical, and amoral, lawyers already suffer from a public relations problem. However, a new source of discontentment with the legal profession is brewing. Watching their retirement accounts dwindle while the business industry is rocked with reports of corporate malfeasance and creative accounting, Americans are beginning to suspect everyone who participated in selling overpriced securities to the public. Shareholder lawsuits are papering the courthouses, often naming accounting firms as participants in the securities fraud. The accounting industry is suffering, as one of the oldest auditing firms, which historically was famous for its independence, becomes "a symbol of corroded ethics."

Attorneys are nervously commenting on the happenings, trying to remain mere observers to a car crash when in fact many attorneys can be described as being in the front passenger seat just moments before the collision. If media scrutiny turns from the accounting profession to the legal profession, it may expose the profession's vulnerable Achilles' heel: the fact that in many of these deals that are imploding, the issuer's attorney accepted substantial amounts of equity as a part of the representation. In employment law seminars, attorneys always counsel business clients that off-color jokes always seem innocuous and funny to everyone until they are repeated in front of a jury. Equity deals may also seem innocuous and mutually beneficial until described in front of the same jury.

See id. at 666-67 (suggesting that individual attorneys not hold private investments in their clients).

See Claybrook Testimony, supra note 287 (arguing that lawyers and accountants drive corporate fraud and should be held accountable).

See id. ("The financial horror show that the American public has watched unfold across the corporate landscape over the past few months is nothing less than a corporate crime wave of epic proportions.").

Ianthe Jeanne Dugan, Auditing Old-Timers Recall When Prestige Was the Bottom Line, WALL ST. J., July 15, 2002, at A1 (quoting Al Bows, one of the oldest living Big Five auditors, as saying "[Arthur Andersen] would be disgusted with what these guys did to his company.").
The conflicts that equity fees create, and the potential liability for those conflicts, warn against engaging in this practice. Although the ABA Model Rules do not prohibit the practice, changes should be made to ethical rules either to forbid the practice or to restrict the amount of equity involved to an insignificant amount, reducing the conflicts that arise in these situations to the usual conflicts inherent in any fee arrangement. Practitioners should also police themselves and forego what seems like a lucrative opportunity but what could be a ticking time bomb.