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ACQUIRING AN OWNERSHIP INTEREST IN A CLIENT*

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Introduction and Scope

For many years, some lawyers have acquired an ownership interest in certain of their clients in connection with performing legal services, either by taking equity in lieu of cash fees or simply by investing money in return for equity.^{1, 2} An increasing number of start-up companies are in need of legal services, often with little or no money to do anything but develop their core product. In addition, there is a concomitantly increasing number of published reports of law firms making large amounts of money on their client-investment portfolios. The result is that, despite the ebb and flow of the equity markets, more lawyers and law firms are open to, or actively seeking, investment in their clients, either through direct equity ownership or by options or warrants to acquire equity. Indeed, at least one law firm representing exclusively start-up companies reportedly insists on being allowed to participate in the company's early-stage equity growth.³

Members of the bar and bar organizations have raised questions about the legal and ethical implications of a lawyer investing in a client. In 1986, the American Bar Association (ABA) Commission on Professionalism, in identifying potential problem areas in lawyer professionalism, voiced concern that while lawyers investing in clients, "may make the client's financing efforts easier, it creates a potential or actual conflict of interest, changing the lawyer-client relationship in a very fundamental way."⁴ More currently, and more bluntly, the ABA/BNA Lawyer's Manual on Professional Conduct identifies as the primary risk in this practice the conflict that the business relationship creates due to "the position of influence that lawyers have over their clients, and the possibility that lawyers could use their position to take advantage of their clients in business dealings."⁵

Those who insure lawyers against malpractice claims have joined in the concern. The Attorneys Liability Assurance Society (ALAS) in its Loss Prevention Manual cautions that, "[I]t is not an overstatement to say that lawyers' increasing involvement in client-related . . . activities [those arising out of some form of transaction with a client of the lawyer] is threatening to become an unmanageable crisis within the legal profession. * * * The fundamental problem with lawyers' client-related activities is the risk that the lawyer's independence, objectivity and judgment will be - or will be perceived to be - compromised."⁶

Nevertheless, the ABA Standing Committee on Ethics and Professional Responsibility, in Formal Opinion 00-418⁷, has concluded that the Model Rules of Professional Conduct do not prohibit a lawyer from acquiring an ownership interest in a client, either in lieu of a cash fee for providing legal services or as an investment opportunity in connection with such services, as long as the lawyer complies with applicable ethical rules. ABA Formal Opinion 00-418 is attached to this Opinion.

In Colorado, lawyers also must consider the implications of *In the Matter of Sather*, 3 P.3d 403 (Colo. 2000), regarding the circumstances under which a fee paid in advance may be considered earned and the reasonableness of that fee.

Syllabus

Subject to the limitations and additions comprising the balance of this Opinion, the Ethics Committee of the Colorado Bar Association (Committee) endorses ABA Formal Opinion 00-418 as the correct statement of the ethical considerations applicable to a lawyer or law firm acquiring an ownership interest in a client.

The Colorado Rules of Professional Conduct (Colo. RPC or Rules) do not prohibit a lawyer from acquiring an ownership interest in a client, either in lieu of a cash fee for providing legal services or other benefit to the client or by accepting an investment opportunity, as long as the lawyer complies with Colo. RPC 1.7(b) and (c) regarding representation that may be materially limited by the lawyer's own interests, Colo. RPC 1.8(a) governing business transactions with clients⁸ and, where the lawyer acquires the interest in lieu of cash fees, Colo. RPC 1.5(a) requiring that a fee for legal services be reasonable. The investing lawyer also must comply with other applicable rules discussed in this Opinion.

Discussion

Despite the potential conflicts that inevitably are present when a lawyer owns an equity interest in a client, such investments under some circumstances may have merit in promoting access to legal services. A lawyer's willingness to accept an equity interest in lieu of a cash fee may be the only way for a client with minimal uncommitted cash resources to obtain competent legal advice.

The Committee perceives no significant difference in the Rules' treatment of the acquisition by a lawyer of an ownership interest in the lawyer's client, whether the lawyer receives direct payment of fees through receipt of an ownership interest in the client entity or receives the opportunity to acquire such interest for cash, if that opportunity would not have been offered had the lawyer not also undertaken to perform legal services for the entity. Further, the same ethical issues must be addressed whether the ownership interest is acquired directly by the lawyer, the lawyer's firm, or (in taking advantage of an investment opportunity offered to the lawyer) an investment partnership controlled by the lawyer or by members of the lawyer's firm.⁹ *[omitted as no longer applicable]*

Conflicts of Interest

To comply with Colo. RPC 1.8(a), the transaction by which the lawyer acquires the interest and its terms must be fair and reasonable to the client and fully disclosed, and the terms of the transaction must be transmitted to the client in writing in a manner that the client can reasonably understand. The lawyer also must inform the client in writing that the advice of independent counsel is desirable¹⁰ and must give the client a reasonable opportunity to seek the advice of such independent counsel in the transaction. The client must consent to the transaction in writing.

[Rule 1.8(a)(2) requires that the client be "advised in writing of the desirability of seeking ... the advice of independent legal counsel on the transaction." Rule 1.8(a)(3) requires that "the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction." In addition, Comments [1] through [4] to Rule 1.8 discuss the application of the rule to business transactions between a lawyer and client and should be reviewed.

Reasonableness of Fees; Valuation

"Attorney fees are always subject to refund if they are excessive or unearned." *Sather*, 3 P.3d at 413. Compliance with Colo. RPC 1.5 requires that the fees paid by means of equity be of reasonable value in light of the legal services or other benefit to the client for which they are charged. The comment to that rule acknowledges that a lawyer may accept property, such as an equity interest, in payment of fees.¹² Although there is no clear guidance on the subject in Colorado case law, ABA Formal Opinion 00-418 and other authorities suggest that the circumstances to be considered in determining the value of the equity received and the reasonableness of that value as a fee for legal services or other benefit to the client are those circumstances reasonably ascertainable at the time of the transaction (the time at which a definitive agreement is made with the client regarding the lawyer's investment).^{13,14}

[Rule 1.5(b) states, "Except as provided in a written fee agreement, any material changes to the basis or rate of the fee or expenses are subject to the provisions of Rule 1.8(a)." A subsequent change in the value of equity that the lawyer receives as a fee will not trigger this requirement, provided the requirements of Rule 1.8(a) were satisfied at the date of the agreement under which the lawyer took equity as a fee. As stated in ABA Formal Opinion 00-418, that date is the point of valuation of the equity for purposes of assessing the reasonableness of the lawyer's fee.

The circumstances of each case should be judged under an objective standard of reasonableness. See Colo. RPC 1.5(a); *Feiger, Collison & Killmer v. Jones*, 926 P.2d 1244, 1252 (Colo. 1996) (client's sophistication a factor); *Beeson v. Indus. Claim Appeals Office*, 942 P.2d 1314, 1316 (Colo. App. 1997) (various factors should be employed to measure the reasonableness of the attorney fee, and the weight given to any factor depends on the circumstances of each case). A lawyer taking equity in lieu of fees would be well advised to obtain, if possible, an objective valuation of the equity interest at the time it is received to demonstrate that the fee is reasonable in light of the benefit conferred or services rendered or to be rendered to the client in return.

The Issue of Advance Fees

Receipt by a lawyer of an ownership interest in a client in lieu of cash fees is equivalent to receipt of advance fees, in whole or in part, if the services for which the ownership interest is given have not yet been performed or the client does not receive some benefit in return for the ownership interest at the time the interest is received. Under Colo. RPC 1.15B(a)(1) and the Colorado Supreme Court's holding in the *Sather* case, advance fees remain property of the client until earned.

In structuring an arrangement under which a lawyer receives an ownership interest in a client before performing the legal services for which the ownership interest is given, the lawyer must determine, with the client's consent, whether some portion or all of the equity interest has been earned at the time the engagement is entered into. The justification for such a decision and the manner in which it is memorialized should comply with the requirements in *Sather* for dealing with a cash payment that qualifies as an "earned retainer." If the equity interest is not intended as an earned retainer and does not meet the test under *Sather*, it remains the property of the client. In that case, if the equity interest takes the form of, for example, certificated securities, the lawyer must keep them in a safe deposit box or another appropriate location of safekeeping separate from the lawyer's own property (see Colo. RPC 1.15A(a) and Comments [4-6] to Colo. RPC 1.15A).¹⁵

If the investment in the client is not intended or does not qualify as an "earned retainer," as described in *Sather*, the lawyer must consider the additional complications that result from determining the time period over which,

and the legal services to be rendered for which, the equity investment is earned by the lawyer and the manner in which all or a portion of the equity investment will be returned to the client if the representation is terminated prior to completion of the representation, whether by the client or the attorney. There is a dearth of case law in this area, but the Committee believes that the writing called for under Colo. RPC 1.8(a) should describe how the equity interest will be earned, e.g., by valuing the ownership interest at the time it is granted and considering it earned in proportion to the hourly rate the lawyer charges or to specific legal services to be provided by the lawyer, and the conditions under which it could be returned to the client.

Related Non-Ethical Issues

Apart from the ethical implications of investing in a client, a lawyer contemplating such an investment should give serious consideration to other significant implications of such action. The burden of proof is on the lawyer to show that the terms of both a business transaction and a compensation agreement with a client were fair and reasonable and that the client was fully informed.¹⁶

Issues deserving of scrutiny include potential civil liability claims based in securities law (e.g., shareholder derivative suits), compliance with applicable securities laws (e.g., insider trading rules), the circumstances in which a lawyer should disclose her or his equity interest in a client to others involved in a transaction with the client, the fiduciary duties the lawyer may owe to the client, the lawyer's duty of loyalty under the law of agency,¹⁷ the extent of and relevant exclusions from the lawyer's or firm's professional liability insurance, and the need for clear, thorough firm policies regarding investing in clients. These implications are beyond the scope of this Opinion, but are of substantial importance to a lawyer dealing with the question of whether or how to invest in a client.¹⁸

Notes

1. Debra Baker, *Who Wants to be a Millionaire?*, ABA Journal, February 2000, at 36.
2. For purposes of this opinion, "equity" and "an ownership interest" are used synonymously and include the right to receive future equity, e.g., options or warrants. For ease of reference, the Committee refers to this practice as "investing in clients."
3. Richard B. Schmitt, *Little Law Firm Scores Big by Taking Stake in Clients*, Wall Street Journal, at B1 (Mar. 22, 2000).
4. ABA Comm'n on Professionalism, *In the Spirit of Public Service: A Blueprint for the Rekindling of Lawyer Professionalism* (1986).
5. Lawyer's Manual on Professional Conduct, 51:502 (ABA/BNA) (Lawyer's Manual).
6. *1999 Loss Prevention Manual*, Tab III.A at 3 (ALAS).
7. Lawyer's Manual, at 1101:207.
8. ABA Formal Op. 00-418, Section A, *Compliance with Rules 1.8(a) and 1.5(a) When Acquiring Ownership in a Client* ("In our opinion, a lawyer who acquires stock in her client corporation in lieu of or in addition to a cash fee for her services enters into a business transaction with a client such that the requirements of Model Rule 1.8(a) must be satisfied.") (citing, *inter alia*, Restatement (Third) of the Law Governing Lawyers (Restatement or Rest.), §126, cmt. a, and G.C. Hazard and W.W. Hodes, *The Law of Lawyering*, §1.8:202, *et*

seq. (2d ed. 1998), and noting that Rule 1.8(a) does not apply to open market purchases or in other circumstances not involving direct client intervention).

9. [Omitted as no longer applicable.]

10. In reading ABA Formal Opinion 00-418, Colorado lawyers should note that Colo. RPC 1.8(a)(2) requires that the client be informed that the use of independent counsel "*may be advisable.*" This differs from the Model Rules of Professional Conduct, cited in the ABA Opinion, that require only "*a reasonable opportunity to seek the advice of independent counsel,*" and also differs from the recommendation under §126 of the Restatement that the client consent "*after being encouraged*" to seek independent legal advice.

11. Even with this disclosure, the lawyer should proceed cautiously in exercising her or his right to vote the equity interest in a manner that could be adverse to the best interest of the client or the wishes of client's governing body (e.g., board of directors). Such action could lead to allegations of a violation of Rule 1.7(b) regarding the representation itself.

12. Colo. RPC 1.5, Comment, *Terms of Payment*, states: "A lawyer may accept property in payment for services, such as an ownership interest in an enterprise, providing this does not involve acquisition of a proprietary interest in the cause of action or subject matter of the litigation contrary to Rule 1.8(j). However, a fee paid in property instead of money may be subject to special scrutiny because it involves questions concerning both the value of the services and the lawyer's special knowledge of the value of the property."

13. ABA Formal Op. 00-418 n.9.

14. Rest., §126, cmt. e ("The requirement that the transaction be fair from the perspective of an objective observer derives from the general fiduciary requirement of fair dealing with a client. [Citation omitted]. Unintended overreaching is a possibility in transactions involving lawyers and their clients. Accordingly, a lawyer must overcome a presumption that overreaching has occurred by demonstrating the fairness of the transaction. Fairness is determined based on the facts that reasonably could be known at the time of the transaction, not as the facts later develop. The relative ability of the lawyer and client to foresee how the facts might develop, however, is relevant in determining fairness. An appropriate test is whether a disinterested lawyer would have advised the client not to enter the transaction with some other party.").

15. The lawyer also must deal with questions regarding the extent to which, if at all, the lawyer may exercise the rights of ownership of the equity interest, e.g., voting rights, the right to receive dividends or liquidation distributions, and the right as an equity owner to corporate information.

16. See *Howard v. Hester*, 338 P.2d 106, 109 (Colo. 1959) ("Lawyers and real estate men stand in a confidential relation to their clients and principals, and extreme care must be exercised by them to see that their transactions bear the searching light of fair and above-board dealing.") *Bryant v. Hand*, 404 P.2d 521, 523 (Colo. 1965) ("Where after the relationship has been established, an attorney and client enter into an agreement in reference to the attorney's compensation, *** the burden is on him to prove that the agreement was fairly and openly made, was supported by adequate consideration, and that he gave the client full knowledge of the facts and of his legal rights, when he entered into the agreement, and that the services to be performed were reasonably worth the amount stated in the agreement.; ***.") (quoting *Rupp v. Cool*, 362 P.2d 396 (Colo. 1961) (quoting 7 C.J.S., Attorney and Client §204a(2)) (internal quotation marks omitted). See also *Cupeiro v. Baron*, 555 So.2d 370 (Fla. App 3 Dist. 1989) (burden of proof clear and convincing evidence); *Cleery v. Cleery*, 692 N.E.2d 955 (Mass. 1998); accord *The Florida Bar v. Simonds*, 376 So.2d 853 (Fla. 1979); *Bauermeister v. Mc Reynolds*, 575 N.W.2d 354 (Neb. 1998)).

17. The duties of loyalty in general prohibit the lawyer from harming the client. Rest., §16, cmt. e.

18. For additional guidance in identifying and dealing with some of these areas of concern, see the report of the ABA's Litigation Task Force on the Independent Lawyer, *Lawyers Doing Business With Their Clients: Identifying and Avoiding Legal and Ethical Dangers* (ABA 2001).

[In Rule 1.0, Terminology, Rule 1.0(e) states that "[i]nformed consent" denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." Comments [6] and [7] provide a detailed commentary on "informed consent", including a comment that relevant factors in determining whether the information and explanation communicated to the client are reasonably adequate include the experience of the client in legal matters generally and in making decisions of the type involved and whether or not the client has the benefit of independent counsel in determining whether to consent.

[Rule 1.0(e) defines both a "writing" and a "signed" writing.]

In determining the effect of such an investment on the lawyer's representation of the client in which the lawyer invests, the lawyer must comply with Colo. RPC 1.7(b) and (c) governing situations in which the representation of a client may be materially limited by the lawyer's own interests.

[Rule 1.7(b)(4) requires informed consent, confirmed in writing. Although the Rule no longer states that the client's consent could not be validly obtained where a disinterested lawyer would conclude that the client should not consent under the circumstances, the lawyer should consider carefully whether she or he "reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client" as required by Rule 1.7(b)(1), and that the interests of the clients will be adequately protected, Rule 1.7, cmt. [15]. One standard of reasonableness that a lawyer may use in this analysis is whether a disinterested lawyer would advise against consent under the circumstances.

[Lawyers should review Comments [18] and [19] (Informed Consent), [20] (Consent Confirmed in Writing), [21] (Revoking Consent), and [22] (Consent to Future Conflict). In addition, Comments [34] and [35] address Organizational Clients, with Comment [35] addressing in a more detailed manner the position and obligations of a lawyer who serves on the organization's board of directors or equivalent governing body.]

The lawyer also must comply with Colo. RPC 2.1 requiring that a lawyer exercise independent professional judgment and render candid advice in representing a client. If such an investment is made, the lawyer should give careful attention to Colo. RPC 1.13 regarding representation of an organization as the client. In addition, the lawyer must consider potential circumstances that might result in the lawyer using information relating to representation of a client to the disadvantage of the client in violation of Colo. RPC 1.8(b).

The potential conflicts of interest between a lawyer who is both counsel to and an equity owner in a client are myriad. As one example, a lawyer advising the board of directors of an acquisition target may find a direct conflict between her or his desire to maximize the present value of the client company's stock (and the lawyer's investment) as represented by the would-be acquirer's offer and the board's desire to maximize longer term value by remaining independent. This is a classic example of a situation in which the "business judgment rule" may apply to protect directors acting in accordance with the rule from liability to the company's owners, even though their actions do not result in immediately maximized value to those owners. In another example, a lawyer advising the board of directors of a company on disclosure issues in connection with a public offering of securities may be influenced by her or his desire to maximize the return on the lawyer's investment in the company. In each case, the question remains whether the board is receiving objective advice from counsel. That is, is the lawyer's own interest in her or his equity investment so in

conflict with the interests of the client as to make it unreasonable to believe that "the representation will not be adversely affected" (Colo. RPC 1.7(b)(1)) or that the lawyer can "exercise independent professional judgment and render candid advice" (Colo. RPC 2.1)?

There are no bright-line guides to answering these questions, and the examples above (and, in the Committee's opinion, examples contained in ABA Formal Opinion 00-418) are not meant to establish such bright lines. Each set of facts must be analyzed on its own merit. Among the many things a lawyer must take into consideration in attempting to answer these questions are the amount of the lawyer's investment relative to his or her net worth and the amount of the investment relative to the capitalization of the client. How much financial pressure is on the lawyer with respect to the investment? How much control or influence can the lawyer exert by virtue of his or her equity interest relative to the total outstanding (or voting) equity?

A separate concern in this analysis is whether or not the investing lawyer is free to vote that equity interest in the lawyer's own self-interest under any or all circumstances, even if, under the particular circumstances at the time of the vote, the lawyer's vote may defeat the purposes of the client. Here again, there are no bright-line guides to addressing this concern. However, the lawyer must constantly reanalyze the changing circumstances in the course of the representation for potential conflicts of interest that may adversely affect the representation (Colo. RPC 1.7(b)(1)), or impair his or her ability to exercise independent professional judgment and render candid advice (Colo. RPC 2.1).

The Committee believes that it is strongly advisable that the lawyer include in the disclosure made to the client prior to consummation of the investment transaction the following:

- that there are potential conflicts of interest that may arise resulting from the lawyer's investment and/or actions as an equity owner;
- that such conflicts may under certain circumstances require the lawyer to withdraw from the representation if those conflicts rise to the level that continued representation would violate the Rules (Colo. RPC 1.16(a)); and
- that as an equity owner, the lawyer may in the future vote her or his equity interest as she or he sees fit in the lawyer's own self-interest, regardless of the wishes of the management of the client.¹¹

The rules regarding conflicts of interest apply equally to all clients, regardless of their level of sophistication. It is the lawyer's duty to recognize the conflict of interest and comply with the rule.

"No matter what the sophistication level of a client, it is never the client's duty to recognize the conflicts of interest nor is it the client's duty to seek out such information. No matter what the education level or the sophistication of a client, it is always the attorney's duty to fully disclose the existence or potential for conflict of interest, to avoid such conflicts, and to obtain, if necessary, a full waiver of such conflict." *In the Matter of Breen*, 830 P.2d 462 (Ariz. 1992).

* On January 1, 2008, substantial amendments to the Colorado Rules of Professional Conduct became effective. The text of Colo. RPC 1.7, Conflict of Interest: Current Clients, was significantly modified. However, the ABA Ethics 2000 Commission reported that it intended no substantive changes in the rule, and that the changes were intended for clarification purposes only. The Committee agrees that the changes to Rule 1.7 are not substantive and do not alter the conflict analysis. Rather, the changes to Rule 1.7 merely alter the procedure through which informed consent must be obtained. Accordingly, the changes to Rule 1.7 do not alter the analysis or conclusions contained in this Formal Opinion. The Subcommittee recommends appending this legend to the following Formal Opinions: 45 (Representation of client by part-time judge), 46 (Municipal attorney, representation of defendants), 58 (Water rights, representation of multiple clients), 97 (Ethics considerations where an attorney or the attorney's partner serves on the board of a public entity), 98 (Ethical Responsibilities of Lawyers who Engage in other Business), 109 (Acquiring an ownership interest in a client), 115 (Collaborative Law).