

Taking Stock of Taking Stock

Poonam Puri

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TAKING STOCK OF TAKING STOCK

Poonam Puri†

Silicon Valley law firms were among the first to experiment with taking stock in their technology start-up clients. They were followed by law firms in other financial centers in the United States and Canada, as well as more conservative law firms in England and the rest of Europe. This Article critically analyzes the practice of lawyers taking equity in their clients as compensation for legal services. First, it explains that equity billing can provide significant private benefits to law firms and clients, and can also provide indirect public benefits. Second, it argues that equity billing can be usefully analogized to contingency fee arrangements. Third, it addresses ethical issues raised by equity billing. And fourth, it applies the economic theory of gatekeeping and explains that equity billing may impose externalities on third parties such as retail investors who rely on issuers' legal counsel to ensure compliance with securities laws. The Article concludes that a case cannot be made for prohibiting equity billing or capping the amount of equity that a lawyer can take in a client, and that the most appropriate form of regulation is heightened disclosure of equity billing arrangements, coupled with the preexisting regime of ethical rules and fiduciary principles.

INTRODUCTION	101
I. PRIVATE AND PUBLIC BENEFITS AND COSTS OF EQUITY BILLING	103
A. Private Benefits to Clients	103
1. <i>The Cash Crunch</i>	103
2. <i>Reputational Bonding</i>	104
3. <i>The Lawyer as Broker Between New-Economy and Old-Economy Clients</i>	106
4. <i>The Lawyer as Business Advisor—When Is a Law Firm Not a Law Firm?</i>	107
B. Private Benefits to Law Firms	109
1. <i>Entrepreneurial Risk-Taking</i>	110

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2.	<i>Reestablishment of Long-Term Client Relationships ...</i>	110
3.	<i>Retention of Associates and Partners</i>	111
C.	Private Costs to Law Firms	113
1.	<i>Financial Risks</i>	113
a.	<i>Liquidity Risk</i>	113
b.	<i>Investment Risk</i>	114
c.	<i>Risk of Nonpayment</i>	115
2.	<i>Reputational Risks</i>	115
3.	<i>Professional Risks</i>	115
4.	<i>Mitigating the Risks: Selectivity and Diversification ..</i>	116
D.	Public Benefits	117
II.	EXISTING MODELS OF BILLING	118
A.	Hourly Billing	118
1.	<i>Variations</i>	119
a.	<i>Capped Fees</i>	119
b.	<i>Discounts</i>	119
c.	<i>Premiums</i>	120
2.	<i>Critique</i>	120
B.	Flat Fees	121
C.	Contingency Fees	121
D.	Investor Financing	124
E.	Comparison with Equity Billing	124
III.	THE EFFECT OF LEGAL ETHICS AND FIDUCIARY DUTIES ON THE LAWYER-CLIENT RELATIONSHIP	127
A.	The Regulation of Legal Fees	128
1.	<i>Fees Must Be Reasonable</i>	128
2.	<i>Regulation of Contingency Fees</i>	130
3.	<i>Reasonableness Depends on Context</i>	131
a.	<i>Opinions on Equity Billing</i>	132
b.	<i>Application of Reasonableness to Equity Billing ..</i>	134
B.	Business Transactions Between Lawyers and Clients .	136
C.	Continuing Conflicts of Interest Between Lawyers and Clients	140
1.	<i>Conflicts Between the Best Interests of the Corporation and Those of Minority Shareholders</i>	141
2.	<i>Conflicts Between Shareholders and Creditors</i>	141
3.	<i>Conflicts Between Shareholders and Other Constituencies</i>	142
4.	<i>Conflicts Between Majority and Minority Shareholders in Closely Held Corporations</i>	142
5.	<i>Conflicts in Dealings with Venture Capitalists</i>	142
6.	<i>Conflicts with Serial Entrepreneurs</i>	143
7.	<i>Conflicts in Representation of Competitors</i>	143
8.	<i>Comparison of Equity Billing with Compensating Managers and Directors with Equity</i>	143

IV. LAWYERS AS GATEKEEPERS TO THE SECURITIES MARKET	144
A. Economic Theory of Gatekeeping	145
B. Gatekeepers in Securities Markets	147
1. <i>Aiding and Abetting Liability</i>	148
2. <i>Section 11: Liability for Misrepresentations in</i> <i>Registration Statements</i>	149
3. <i>Section 12: Liability for Selling Unregistered Securities</i> <i>Without an Exemption</i>	150
4. <i>Administrative Sanctions</i>	151
C. Does Equity Billing Undermine the Gatekeeping Role of Lawyers?	152
V. THE REGULATION OF EQUITY BILLING	154
A. Outright Prohibition	154
B. Capping the Amount of Equity	155
C. Heightened Disclosure.	156
CONCLUSION	157

INTRODUCTION

In 1999, Wilson Sonsini Goodrich & Rosati (“Wilson Sonsini”) took stock as a part of its compensation in thirty-three of the fifty-three companies that it represented in initial public offerings (IPOs).¹ Wilson Sonsini also took stock in companies in two other IPO transactions where it represented the underwriter on the deal.² Cooley Godward took stock in twenty of the twenty-three companies that it assisted in going public in 1999.³

Disclosure documents filed with the Securities and Exchange Commission (SEC) in 1999 also revealed that the firms that represented three of the top five IPOs for that year held stock in their clients.⁴ Of the over five hundred IPOs registered with the SEC, one-third of the law firms acting as issuer’s counsel held stock in the issuer at the time of the offering.⁵ In more than 40% of these IPOs, firms’ holdings were worth more than \$1 million each at the time of the offering.⁶ Wilson Sonsini made the highest gain of any of these firms

¹ Debra Baker, *Who Wants to Be a Millionaire?*, A.B.A. J., Feb. 2000, at 36, 37. Its holdings in twenty-four of those companies were valued in excess of \$1 million each at the close of the first day of trading. *Id.*

² *Id.*

³ *Id.*

⁴ *Id.* at 37–38.

⁵ *Id.* at 37.

⁶ *Id.* While the stock of VA Linux, a computer company, set a first-day gain record at 798% and earned Wilson Sonsini \$21.4 million, WebVan holdings netted a greater overall gain for the firm. *See id.* at 37–38.

through its two million shares of WebVan stock, which were worth more than \$51 million by the close of their first day on the market.⁷

Silicon Valley law firms were among the first to experiment in "equity billing," the practice of taking stock in high-tech clients as a component of a law firm's compensation for rendering legal services. Taking an equity stake in clients has become such a standard part of Silicon Valley legal culture that some firms will not even consider a new client unless an equity interest is a part of the deal.⁸ Law firms in other established financial centers in the United States, as well as several Canadian law firms, have accepted equity in their high-tech clients.⁹ Even the most conservative firms in London have accepted equity stakes in their clients, and the trend is spreading through Europe.¹⁰

Placing the issue of equity billing within the context of technology start-ups, this Article analyzes the issue of lawyers accepting equity in their clients as compensation for legal services. Part I concludes that equity billing provides significant private and public benefits. In analyzing those benefits, the Article places the incentives created by equity billing within the existing scholarship on what corporate lawyers actually do, what value they create, and what economic realities and competitive pressures their law firms face. Part II applies the economic theory of agency costs to the lawyer-client relationship to examine the incentives created for both parties by different billing arrangements and evaluates the practice of equity billing against the virtues and disadvantages of each. Part III examines the significant concerns associated with equity billing, including its effect on the lawyer-client relationship. This Part concludes that market forces, existing ethical rules, and common-law principles of contract and agency law are available to address these issues. Part IV explores the effect of equity billing on the role of the lawyer as guardian of the public interest, particularly in the context of the securities markets, where a securities lawyer is perceived as a special gatekeeper in the

⁷ *Id.* at 37.

⁸ See Dan McMillan, *Lawyers or Investors?*, BUS. J. PORTLAND, Feb. 18, 2000, at 2, available at <http://portland.bcentral.com/portland/stories/2000/02/21/focus1.html>.

⁹ See Cameron Stracher, *Beyond Billable Hours*, WALL ST. J., Feb. 12, 2001, at A26; see also Gail J. Cohen, *McMillan Binch Hatches New EGG to Attract High-Tech Clients*, LAW TIMES, Aug. 10, 1998, at 4 ("McMillan Binch has introduced a 'partnering' concept which lets entrepreneurs pay for services with shares of their company"); Margot Gibb-Clark, *Gowling Incubates High-Tech Practice*, GLOBE & MAIL (Toronto), May 8, 2000, at M1 (describing Gowling Lafleur Henderson's practice of taking equity or options as payment from high-tech start-ups).

¹⁰ *Cash? How Old Economy*, ECONOMIST, May 6, 2000, at 67, 68 (noting that one London firm, a pioneer in venture services, now holds seventy-five equity stakes in deals across Europe and Asia).

enforcement of securities laws.¹¹ This Part also questions whether the securities lawyer is truly a gatekeeper, even in the absence of equity billing, given the financial dependency of securities lawyers on their clients. Part V sets out three models for regulating equity billing: outright prohibition, a cap on the level of equity, and heightened disclosure coupled with letting market forces, existing ethical rules, and common law principles regulate.

The Article concludes that, given American lawyers' constant involvement in entrepreneurial activities that create serious conflicts of interest,¹² no special case can be made for prohibiting or capping equity billing while allowing the other activities to remain in place. Moreover, prohibiting or capping the level of equity that a lawyer can take in a client is also inconsistent with existing common-law principles governing transactions between fiduciaries and beneficiaries such as managers and corporations. The Article concludes that the most appropriate form of regulation is heightened disclosure of equity billing arrangements coupled with common-law principles, market forces, and existing ethical rules.

I

PRIVATE AND PUBLIC BENEFITS AND COSTS OF EQUITY BILLING

Equity billing can provide significant private and public benefits and costs. This Part analyzes these benefits and costs.

A. Private Benefits to Clients

Equity billing provides private benefits to cash-starved clients by providing them with a way to pay for, and thus to gain access to, premium legal representation otherwise beyond their financial reach. In addition, by associating themselves with prestigious law firms, cash-starved clients effectively rent their firms' reputation and benefit from their firms' business contacts and acumen. Analysis of these private benefits follows below.

1. *The Cash Crunch*

The clients who are most interested in paying for legal services by giving up equity in their companies are often cash-starved, and prefer to give out stock rather than pay for legal services because it conserves

¹¹ For the seminal article on gatekeeping theory, see Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986).

¹² These activities include, for example, routinely practicing in dual occupations simultaneously; engaging in business transactions with clients; serving on the boards of directors of client corporations; and creating, managing, and controlling vast tort and corporate class actions in which millions of dollars are invested.

cash.¹³ This practice is particularly important for start-ups, many of which have minimal or no revenue and high expenses. Generally speaking, start-up technology companies have little cash until their ideas translate into a product substantial enough to attract venture capital.¹⁴ In particular, these types of companies lack tangible, "bankable" assets with which to secure bank loans because they are primarily knowledge-based.¹⁵ The difficulty of funding start-ups through bank loans or other conventional financing arrangements becomes even clearer when one considers that 60% of start-up technology companies in an average venture capital portfolio will enter bankruptcy before investors can recoup their original stakes, while less than 10% will ever reach the most desirable liquidity event, an IPO.¹⁶ Because legal fees calculated on an hourly basis can be substantial, start-up technology companies use their stock as a substitute for cash to lure lawyers to provide them with legal services. Therefore, payment by equity helps to keep expenses low.

2. *Reputational Bonding*

The cash-crunch phenomenon does not fully explain why technology start-ups are willing to pay their lawyers in equity. Prestigious law firms, accounting firms, investment banks, and stock exchanges also act as reputational intermediaries for their clients.¹⁷ Reputa-

¹³ See Rebecca Mowbray, *Taking Stock in Your Client*, HOUSTON CHRON., Apr. 23, 2000, at 1D. As Mowbray notes, a founder of AutoInteractive.com and BigReferral.com commented, "I think it's a great idea. If we aren't successful, they don't get paid You get somebody to work harder on the front end. I know if I go to them, I'm going to be one of their top priorities." *Id.* A downside to distributing equity as compensation is that it dilutes existing shareholders' stakes. Shareholder dilution will be more significant if the company is a start-up rather than a publicly traded company because there are fewer shareholders in the former type of company.

¹⁴ See *id.*

¹⁵ See JEFFREY G. MACINTOSH, LEGAL AND INSTITUTIONAL BARRIERS TO FINANCING INNOVATIVE ENTERPRISE IN CANADA 57 (Gov't & Competitiveness Project, Queen's Univ., Discussion Paper No. 94-10, 1994).

¹⁶ See Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 LAW & SOC. INQUIRY 679, 685 (1996). Suchman & Cahill note that "even the most successful new companies often take several years to show a profit and substantially longer to offer positive returns on investment." *Id.*

¹⁷ See generally Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981) (introducing the notion of service-providing firms capitalizing on the value of a market-developed and valued reputation). The reputation-capital paradigm, first developed by Benjamin Klein and Keith Leffler, suggests that firms that sell high-quality products in a market where consumers are unable to distinguish between high- and low-quality producers will make the necessary investments to establish their reputation for quality, because consumers are willing to pay a premium for high-quality goods. The reputation for producing high-quality goods will result in an income stream. If a firm cheats and produces a lower quality good, the value of its reputation goes down and it loses income. A firm that produces high-quality goods will not cheat by producing lower quality goods so long as the benefit from cheating is less than the harm

tional intermediaries serve important functions in situations in which companies are unable to make credible or effective reputational capital commitments to third parties on their own. Companies that are newly established or new to the marketplace may be in this position. As a result, they might rent the reputations of prestigious intermediaries "who are repeat players in the marketplace," and upon whose reputations the market and third parties can rely.¹⁸ As compensation for lending reputational capital, intermediaries will receive higher billing rates or commissions. The ability to serve as a reputational bond for a client depends upon each intermediary's relative reputation.¹⁹ The more reputable the intermediary, the higher the rent it can charge for its bond.²⁰

A reputational intermediary may provide its reputational bond in the form of a legal opinion letter if it is a law firm, a comfort letter if it is an auditing firm, or a firm commitment underwriting if it is an investment bank.²¹ Professor Ronald Gilson notes, in relation to business lawyers acting as reputational intermediaries in an asset acquisition, that "[w]hen residual final-period problems prevent a seller from completely verifying the information it provides, a third party can offer *its* reputation as a bond that the seller's information is accurate."²²

Empirical evidence gathered in the auditing firm context supports the reputational capital theory, because it reveals that clients often switch to one of the large, international auditing firms just before going public.²³ In addition, a study by Firth and Smith found

to its overall reputation. See Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15, 22-23 (1995); *infra* notes 24-27 and accompanying text.

¹⁸ See Okamoto, *supra* note 17, at 23.

¹⁹ One source, *Vault.com*, provides prestige rankings according to which clients may gauge the relative reputations of law firms. According to the *Vault.com 2000 Associate Survey*, the ten most prestigious firms are: (1) Cravath, Swaine & Moore, (2) Wachtell, Lipton, Rosen & Katz, (3) Sullivan & Cromwell, (4) Davis Polk & Wardwell, (5) Skadden, Arps, Slate, Meagher & Flom, (6) Simpson Thacher & Bartlett, (7) Cleary, Gottlieb, Steen & Hamilton, (8) Shearman & Sterling, (9) Latham & Watkins, and (10) Wilson Sonsini Goodrich & Rosati. *Vault, America's 50 Most Prestigious Firms* (2000), at http://www.vault.com/nr/lawrankings.jsp?law2000=1&ch_id=242&top50=1.

²⁰ To some extent, prestige rankings of law firms correlate with profits per equity partner. Wachtell, Lipton, Rosen & Katz ranked first in 2000, with profits per partner averaging \$3,385,000; Cravath, Swaine & Moore ranked third with \$2,110,000; Sullivan & Cromwell ranked fourth with \$1,790,000; Simpson Thacher & Bartlett ranked fifth with \$1,655,000; Davis Polk & Wardwell ranked sixth with \$1,610,000; and Skadden, Arps, Slate, Meagher & Flom ranked seventh with \$1,600,000. See *Most Profits Per Partner*, AM. LAW., Nov. 2000, at 89. Wilson Sonsini failed to make the top ten.

²¹ See Okamoto, *supra* note 17, at 23 n.21.

²² See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 289-90 (1984).

²³ Linda Elizabeth DeAngelo, *Auditor Size and Audit Quality*, 3 J. ACCT. & ECON. 183, 194 (1981).

that investment banks' underwriting fees were reduced when an issuer-client hired a large, international auditing firm in connection with a public financing.²⁴ They concluded that auditors serve an important bonding role and that the bonding value varies with the reputation of the auditing firm.²⁵ The results of the study also imply that one group of reputational intermediaries may rely on another group of intermediaries to signal client quality.

Testing the reputational capital theory in relation to investment banks, a number of studies have found that verifying issuer quality is the principal function of investment banks.²⁶ Studies conducted on the reputation of investment banks and the pricing of new issues of securities found that the cost of capital of an issuer decreases as the reputation of the underwriter increases.²⁷

Applying the theory of reputational capital in the context of elite law firms representing technology start-ups, it is clear that most start-ups will often have very little reputational capital and thus only a weak bond to offer to the marketplace. Generally speaking, prestigious law firms are very selective of the clients they are willing to accept; they generally avoid representing all but the most elite companies. With a reputable law firm on its side, a technology start-up can more easily attract capital and generate confidence in the enterprise. A prestigious law firm's willingness to lease its reputational bond to a start-up client (by taking equity) signals to the marketplace the firm's confidence in the client, its product, and the strength of the management team.²⁸

3. *The Lawyer as Broker Between New-Economy and Old-Economy Clients*

Law firms that take equity in their clients extend their professional relationship from being solely advisors to also being shareholders. As a result, they are more likely to act to increase the value of the client whose stock they hold. Law firms that take equity are also known to engage in a brokering function in which they introduce their equity-billed "new-economy" clients to their "old-economy" clients. This introduction may in turn lead to financing and strategic alliances, and thus an increase in the client's value and their stock

²⁴ See Michael Firth & Andrew Smith, *Selection of Auditor Firms by Companies in the New Issue Market*, 24 APPLIED ECON. 247, 252-53 (1992).

²⁵ See *id.* at 254.

²⁶ See James R. Booth & Richard L. Smith II, *Capital Raising, Underwriting and the Certification Hypothesis*, 15 J. FIN. ECON. 261, 263 (1986); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 619-20 (1984).

²⁷ See Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1059-62 (1990).

²⁸ See Suchman & Cahill, *supra* note 16, at 680-83.

holdings. The firms may also offer access to an extensive network of contacts, including financing sources such as angel investors, venture capitalists, and investment dealers, and professionals in related areas such as accountants and valuers.²⁹

A client could obtain a list of venture capitalists and other financing sources on its own, but because law firms are repeat players in the marketplace, they often have an informational advantage over their start-up clients in relation to the types of projects that are receiving financing, by whom, and on what terms. In this manner, law firms save their clients the expense of finding this information on their own.

Another benefit created by this brokering function relates to the value of introductions and recommendations. The fact that an elite law firm is willing to associate itself with a start-up speaks volumes. While an introduction to a financing source does not necessarily guarantee financing, a recommendation and call from a lawyer at an elite firm can increase the likelihood of a meeting between the potential investors and the start-up. This benefit relates back to the law firm's ability to act as a reputational intermediary for the client.³⁰

4. *The Lawyer as Business Advisor—When Is a Law Firm Not a Law Firm?*

A fourth factor at work is that lawyers who take equity in technology start-ups provide more than legal advice. This observation relates to the more general literature on what corporate lawyers actually do. Legal scholars, writing from different perspectives, including sociolegal and law-and-economics perspectives, have reached the same conclusion, namely that a corporate lawyer acts as both a legal and business advisor to her clients. Professor David Wilkins wrote:

Corporate lawyers have always provided a complex mix of business and legal advice to their clients. In the 1980s, however, elite law firms raised the business aspects of their practices to unprecedented heights. For example, many of the country's leading law firms moved into a variety of ancillary businesses in order to provide non-legal services to new and existing clients. At the same time, accountants, management consultants, investment bankers, and a host of other nonlawyer professionals stepped up their efforts to compete with lawyers for the right to advise multinational corporations about the best way to compete in the global marketplace. The dominant philosophy underlying all of these developments is that law firms

²⁹ See, e.g., *Torys, About Torys*, at <http://www.torys.com/about/index.html> (last visited Aug. 25, 2001).

³⁰ See discussion *supra* Part I.A.2.

and other professional service providers must take a multidisciplinary approach to survive.³¹

Professor Ronald Gilson, writing from a law-and-economics perspective on the value created by business lawyers, also noted that lawyers provide a host of services, which are not entirely legal in nature: "[T]he business lawyer is a transaction cost engineer, whose role is to design a transactional structure that allows the parties to act, with respect to their transaction, *as if* the perfect market assumptions on which capital asset pricing theory is built were accurate."³² Gilson noted, "*There is nothing traditionally 'legal' about the role I have described business lawyers as playing, nor are there any special requirements peculiar to lawyers necessary to play this role.*"³³ Similarly, Professor Charles Wolfram wrote:

[M]any lawyers acquire impressive knowledge and a sense of judgment in business matters through their practice, and many clients come to regard their lawyers as both trusted legal advisors and respected business colleagues.³⁴

Applying this theory of the corporate lawyer as both legal and business advisor, it is conceivable that a lawyer's efforts in non-legal or business matters are enhanced where the lawyer has a financial stake in the profitability of the company. Craig Johnson, a former Wilson Sonsini partner who formed Venture Law Group (VLG) in 1993, acknowledged that VLG provides more than legal services: "Think of us as a McKinsey or a Boston Consulting Group for startups, with the added value that we can actually do deals We see ourselves as somewhere between a traditional law firm and a venture-capital firm."³⁵

Lawyers who accept clients on an equity basis provide a combination of legal and business advice that is even more skewed toward business advice, especially in the early stages of the business lifecycle of the technology start-up. Often the founders have a sound idea but little business or legal experience. The start-up will seek to hire a law

³¹ David B. Wilkins, *Everyday Practice Is the Troubling Case: Confronting Context in Legal Ethics*, in *EVERYDAY PRACTICES AND TROUBLE CASES* 68, 88 (Austin Sarat et al. eds., 1998) (footnote and citations omitted). *See generally* MARC GALANTER & THOMAS PALAY, *TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM* (1991) (describing the evolution of the large law firm and attempting to account for the nature and growth of law firms); *LAWYERS' IDEALS/LAWYERS' PRACTICES: TRANSFORMATIONS IN THE AMERICAN LEGAL PROFESSION* (Robert L. Nelson et al. eds., 1992) (examining the meaning of professionalism in various areas of legal practice); ROBERT L. NELSON, *PARTNERS WITH POWER: THE SOCIAL TRANSFORMATION OF THE LARGE LAW FIRM* (1988) (explaining changes in law firms' ethics, practice, and growth over the last one hundred years).

³² Gilson, *supra* note 22, at 294.

³³ *Id.* at 295 (emphasis added).

³⁴ CHARLES WOLFRAM, *MODERN LEGAL ETHICS* § 8.11.1, at 479 (1986).

³⁵ D.M. Osborne, *When Is a Law Firm Not a Law Firm?*, INC., May 1, 1998, at 83, 84.

firm to provide it with legal services which may include incorporation, advice on capital structure, shareholder agreements, employment agreements, stock option plans, and intellectual property protection. The legal work, however, is often not the biggest part of the law firm's job. In a typical equity arrangement, a law firm will play an essential role in advising the client on business matters, promoting certain transactions over others, making the company as attractive as possible to potential investors, and introducing the client to venture capitalists.³⁶

Lawyers are among the first service providers that entrepreneurs contact to hone a strategy, establish ties with other key industry players, and prepare the start-up for introductions to investors.³⁷ VLG, for example, helps refine its clients' business plans and strategies; the lawyering does not come until later on in the relationship.³⁸ VLG's goal is to "treat [their] clients as business partners, to combine excellent legal skills with good business judgment and to play an active role in helping [their] clients succeed."³⁹

As the preceding quote suggests, law firms involved in equity billing are proactive participants rather than passive third-party service providers responding to client requests for assistance. At the Canadian law firm McMillan Binch, for example, the technology lawyers look for ways to improve their clients' companies and rather than waiting for their clients to request suggestions for improvements.⁴⁰ This active role is very different from the passive and restrained role that lawyers traditionally play.

B. Private Benefits to Law Firms

The previous section accounts for the interest in equity billing from a client's perspective.⁴¹ This section sets out and analyzes three reasons why law firms are willing to engage in equity billing.

³⁶ To attract capital from outside sources, a start-up company needs to develop a solid business plan. While lawyers are not venture capitalists and may not have a sophisticated sense of the client's product or market, they *are* well placed to advise on what ought to be in a plan and how it should be presented. When lawyers comment on a business plan, they are utilizing a skill that correlates closely with the preparation of a prospectus. See *supra* Part I.A.3.

³⁷ See Shawn Neidorf, *Silicon Valley Lawyers Embrace VC-Like Role*, VENTURE CAPITAL J., Oct. 1999, at 35.

³⁸ See Osborne, *supra* note 35, at 86-87.

³⁹ Venture Law Group, *About VLG*, at <http://www.vlg.com/more.html> (last visited Aug. 19, 2001).

⁴⁰ See Cohen, *supra* note 9.

⁴¹ Note that some of these benefits, such as the lawyer acting as a broker, could be provided by law firms even in the absence of equity billing. The point, however, is that equity billing provides better incentives than, for example, hourly billing for a law firm to engage in activities such as brokering. Equity billing better captures the value created by a lawyer for the client when the lawyer takes ten minutes to call a potential financing lead.

1. *Entrepreneurial Risk-Taking*

While Silicon Valley law firms have been engaging in equity billing practices with technology start-up clients for many years, law firms in other established financial centers such as New York, Toronto, and London have only recently begun to adopt the practice. The bull market for technology start-ups appears to have fueled interest in equity billing, and it remains to be seen how the terms of equity billing arrangements will change as the market for technology stock rises and falls.⁴²

Law firms are willing to accept stock in technology start-ups because they recognize the moneymaking potential in the arrangement. No sector of the stock market surged in 1999 like technology did, and Internet start-ups led the way.⁴³ Lawyers are recognizing that in this era of instant millionaires, their (considerable) hourly billing rates are no longer as impressive.⁴⁴

In addition, rejecting the opportunity to take stock in lieu of cash can prove psychologically devastating. The founding partner of Fenwick & West, a well-known Silicon Valley law firm, declined to take stock valued at \$50,000 of the then-start-up Apple Computer and lost an estimated \$12 million in terms of the value of that stock at the time of Apple's subsequent IPO.⁴⁵ From an economic perspective, the decision to decline the stock may have been rational because of the attendant financial risks.⁴⁶ Not every start-up will turn into the next Apple or Microsoft. Nevertheless, it can be hard to accept this kind of "loss" in hindsight, and thus many law firms have been willing to experiment with this new form of billing.⁴⁷

2. *Reestablishment of Long-Term Client Relationships*

Law firms may also view equity billing as an opportunity to forge longer-term relationships with clients. The lawyer-client relationship

⁴² While not addressed in this Article, a direction for future research in this area would be to empirically analyze the relationship between the terms of equity billing arrangements and market demand for technology stock.

⁴³ See Baker, *supra* note 1, at 37.

⁴⁴ Mowbray, *supra* note 13.

⁴⁵ John C. Coffee, Jr., *The New Compensation*, N.Y. L.J., Mar. 16, 2000, at 5.

⁴⁶ See discussion *infra* Part I.C.1.

⁴⁷ See, e.g., Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. Rev. 630, 659-60 (1999) (noting that, due to the cognitive tendency known as the "hindsight bias," when "individuals are confronted with unambiguous evidence of a past outcome, they often construct a hypothesis from which they claim that they could have and would have predicted (and perhaps did predict) that outcome"); Jeffrey J. Rachlinski, *Huristics and Biases in the Courts: Ignorance or Adaptation?*, 79 OR. L. REV. 61, 66 (2000) ("People overestimate the predictability of past events: a phenomenon known as the hindsight bias.").

has changed dramatically in recent decades.⁴⁸ In the past, clients had tremendous loyalty to law firms and their lawyers, but clients are no longer as loyal as they once were.⁴⁹ They regularly shop around for law firms, invite law firms to submit bids on particular transactions in “beauty contests,” and often use multiple law firms for their legal work.⁵⁰ Equity billing has the promise of reestablishing long-term relationships between lawyers and clients.⁵¹ Law firms hope that after their initial representation, clients will use them for subsequent corporate work and transactions because it may be costly to change law firms.⁵² Clients may also feel a sense of loyalty because the law firm did them a “favor” by agreeing to represent them on an equity basis rather than by using a traditional billing method.

3. *Retention of Associates and Partners*

Some law firms view equity billing as a way to improve associate and partner satisfaction and, in particular, to deal with the high turnover rate of associates.⁵³ For example, through its recruiting materials portraying lawyers spending time with their families in the outdoors, VLG markets a supposed virtue of equity billing: shorter working hours and a more balanced life. The potential for dramatic returns irrespective of the number of hours spent on the transaction relays a message of freedom and opportunity.⁵⁴

⁴⁸ See generally Rachel S. Arnow Richman, *A Cause Worth Quitting for? The Conflict Between Professional Ethics and Individual Rights in Discriminatory Treatment of Corporate Counsel*, 75 IND. L.J. 963 (2000) (noting the increased reliance on in-house counsel and concomitant selection of specific, specialized firms hired for particular needs); Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869 (1990) (exploring clients' motivations for maintaining long-term relationships with lawyers).

⁴⁹ See Arnow Richman, *supra* note 48, at 989. While at one point, corporate clients found it efficient to develop a long-term relationship with one firm, it is now common for those clients to select counsel on a deal-by-deal basis, matching the discrete needs of the transaction with the specialties of the firm. *Id.* Another commentator observed that the trend in law firm retention is increasingly moving “away from bilateral monopolies toward a competitive market in which alternative suppliers are plentiful and may be hired either on a spot contract or an employment basis.” Robert Eli Rosen, *The Inside Counsel Movement, Professional Judgment and Organizational Representation*, 64 IND. L.J. 479, 489 (1989). Price-shopping and “beauty contests” are becoming standard practice. *Id.* at 484.

⁵⁰ See Rosen, *supra* note 49, at 484.

⁵¹ William Zucker, a partner at Gadsby & Hannah, says that working for start-ups with little capital involves “recognizing that some of the reward will be down the road. There’s no guarantee.” Beth Healy, *Lawyers as Shareholders*, BOSTON GLOBE, Feb. 15, 2000, at A1.

⁵² For example, law firms gain client-specific information that enhance the efficiency of subsequent transactions.

⁵³ For example, Cravath, Swaine & Moore lost 37% of its associates and Dewey Ballantine lost 41% of its associates in 1999. Stracher, *supra* note 9.

⁵⁴ See *id.* Stracher observes:

[F]irms like Brobeck and Wilson Sonsini [are] the destination of choice for young lawyers and law school graduates. In 1999, Brobeck grew by 45%, leading the nation’s 250 largest law firms in non-merger growth, according to the National Law Journal. Cooley Godward, another West Coast leader,

A significant amount of anecdotal evidence exists on the dissatisfaction of associates and partners.⁵⁵ The concerns that they most often express are a lack of involvement in business decisions, under-compensation, and long hours. Lawyers often lament that they just “paper” the transaction while the business people are involved in the decisionmaking and do the really interesting work. What is heard even more often is that lawyers work just as hard or even harder than their investment banker counterparts, but earn significantly less.⁵⁶

The argument that equity billing will address these concerns, however, is in large part ill-conceived. Working with technology start-ups certainly allows lawyers to do more business-related work.⁵⁷ They are able to get involved at what some would consider the most exciting stage of a company’s life cycle. While partners’ compensation may increase by taking equity in clients, the potential for greater compensation does not come without greater risk of loss as well.⁵⁸ However, associates’ compensation will not increase unless partners agree to share (directly or indirectly) any increase in the value of their equity holdings with associates.⁵⁹ In terms of hours and billing, equity billing does not necessarily reduce the pressure on associates to bill. It is unlikely that associates at Wilson Sonsini or VLG, or in the technology groups at leading firms have any less pressure to bill than other firms or other departments in the same firm. Furthermore, equity billing certainly does not relieve associates from maintaining a docket to record the hours they spend on a client’s file because taking equity in the client is usually combined with some form of hourly billing.

saw the number of students signing up for on-campus interviews increase by 36% in 1999, and 11% last fall. Meanwhile, New York firm Cravath, Swaine & Moore lost 37% of its associates in 1999. Dewey Ballantine lost a whopping 133 of its associates, or 41% of the total.

Id.

⁵⁵ For example, a popular website called *Greedy Associates*, at <http://www.greedyassociates.com>, provides a public forum for discontented associates to gripe about law firm culture, politics, and salaries. Two other websites that post surveys from “insiders” revealing uncensored opinions of law firm life are *Infirmation*, at <http://www.infirmation.com>, and *Vault*, at <http://www.vault.com>.

⁵⁶ See sources cited *supra* note 55.

⁵⁷ See discussion *supra* Part I.A.3.

⁵⁸ See discussion *infra* Part I.C.

⁵⁹ When Silicon Valley firms, led by Gunderson Dettmer Stough Villeneuve Franklin & Hachigian’s 45% hike in entry-level associate salaries, set the pace for salary raises, large firms nationwide were quick to follow in an effort to preclude associate departure. NALP Reference, *The Salary Wars and Their Aftermath*, at <http://www.nalp.org/refdesk/salwars.htm> (last visited Aug. 25, 2001).

C. Private Costs to Law Firms

While the potential upside may be significant, law firms that accept equity as compensation face significant commensurate risks.⁶⁰

1. *Financial Risks*

Start-ups have a high rate of failure. According to one industry report, only one in every ten start-ups ever reaches profitability.⁶¹ Markets for new technology, in particular, are difficult to predict.⁶² The success of start-up technology companies is often dependent on the protection of their technology by patent or copyright. Technology companies are also under tremendous pressure to engage in research and development to improve their technology, as their products typically have a life cycle of only two to three years.⁶³ The very nature of representing technology start-ups requires lawyers to maintain progressive views on their role and on the degree of risk they are willing to assume. If the client fails, not only does the law firm fail to make a profit, but it will have provided free legal work. The various types of financial risk are analyzed below.

a. *Liquidity Risk*

A component of the law firm's risk relates to the liquidity of the client's equity position. The law firm will not profit from taking equity until the client exercises an exit strategy, such as merging with another company or engaging in an IPO.⁶⁴

As a result, law firms that engage in equity billing must assess the probability of a company's liquidity event. This requires that a law firm analyze the potential client's business prospects, something that they do not need to do in relation to other potential new clients, aside from a most routine assessment of the client's creditworthiness. Because of this liquidity risk, law firms must hold a well-diversified portfolio of clients' equity, in order to ensure that their clients' liquidity

⁶⁰ For a thorough analysis of the relationship between risk and return, see WILLIAM A. KLEIN & JOHN C. COFFEE JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* (7th ed. 2000).

⁶¹ See Andrew B. Katz & William F. Savarino, *Representing a Technology Start-Up*, N.Y. L.J., Nov. 9, 1998, at T2.

⁶² See Suchman & Cahill, *supra* note 16, at 688-90.

⁶³ See John M. Cunningham, *What Is a High Tech Lawyer? An Essay in Self-Definition*, *COMPUTER LAW*, Mar. 1993, at 23, 23.

⁶⁴ Such transactions are subject to any lock-up agreements imposed by regulations or voluntarily entered into by shareholders. See LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 498 (3d ed. 2001).

events occur periodically and that the firm therefore has the sufficient cash to pay current expenses.⁶⁵

b. *Investment Risk*

Partners draw profits from their firms on a periodic basis, but generally do not reinvest them in the firm in the form of retained earnings. However, law firms that accept equity in clients often hold their stock even after the occurrence of a liquidity event out of a belief in the long-term growth potential of the company. The value of stock in some law firms' portfolios is so high that portfolio management has become a principal business, and legal practice a relatively less important or secondary activity, at these firms.⁶⁶ For example, VLG's equity portfolio was estimated to be worth more than \$100 million.⁶⁷

If a law firm decides to hold its technology start-up clients' stock, it faces the same risks as any other investor. The volatility of the NASDAQ Stock Market, particularly among the shares of technology start-up companies, is illustrative of one such risk.⁶⁸ Associated with these investment risks are the costs of maintaining the investment portfolio, as well as costs of compliance with insider trading laws.⁶⁹ Law firms too deeply involved with equity billing may also be caught under the definition of "Investment Company" and would need to comply with the relevant regulations.⁷⁰

⁶⁵ This financial risk analysis also suggests that most law firms would be averse to accepting 100% equity in lieu of cash for all their clients and would prefer instead cash hourly billing combined with a lesser amount of equity.

⁶⁶ See Coffee, *supra* note 45, at 1; see also Davan Maharaj, *More Firms Are Willing to Work for Stock Options*, L.A. TIMES, Jan. 24, 2000, at C1 (discussing other firms with high value portfolios).

⁶⁷ As Craig Johnson, one of VLG's founders, noted: "We see ourselves as somewhere between a traditional law firm and a venture-capital firm." Osborne, *supra* note 35, at 84.

⁶⁸ See Guy Dixon, *Turbulent Tech Market Takes Toll on Brokers*, GLOBE & MAIL (Toronto), May 24, 2000, at B1. The NASDAQ market has been described as "violent" as it recently fell 25% in one week in April 2000 and rebounded nearly 19% in a four-day period in May and June. Such instability only promises "more high jinks down the road." Terzah Ewing & E.S. Browning, *Nice Rally, but Street Still Cautious on Tech*, GLOBE & MAIL (Toronto), June 5, 2000, at B7.

⁶⁹ Although considerable costs may be associated with insider trading compliance, existing scholarship suggests that most law firms already have compliance mechanisms in place. See Harvey L. Pitt et al., A.B.A., *Law Firm Policies Regarding Insider Trading and Confidentiality*, 47 BUS. LAW. 235 (1991); Alan M. Weinberger, *Preventing Insider Trading Violations: A Survey of Corporate Compliance Programs*, 18 SEC. REG. L.J. 180 (1990). The prevailing theory is that because large firms frequently deal with material nonpublic information, they are driven by a sense of ethical responsibility and liability concerns to formulate specific policies and procedures to avoid the misuse of confidential client information and protect reputational interests by avoiding scandal. See *id.*

⁷⁰ See Coffee, *supra* note 45. As an Investment Company, the law firm would have to register with the SEC and comply with aggressive regulations. See *id.*

c. *Risk of Nonpayment*

Law firms that work with technology start-up clients, which tend to be financially insecure, also face the risk that their hourly fees may not be paid. While this risk is present even with well-established and financially secure “blue-chip” clients, it is more pronounced with start-ups. Perhaps this risk justifies or at least helps to explain why many law firms take an equity interest in their technology start-up clients, but nonetheless continue to charge their standard hourly rates. The equity taken not only represents a premium charged by the law firm for reputational bonding and networking services, but also represents compensation for the risks associated with taking on a financially insecure client that might not be in a position to keep up with the firm’s billings. While a retainer will mitigate some of the risk of nonpayment, the start-up client may not be in a position to pay it.⁷¹

2. *Reputational Risks*

As noted above, law firms act as reputational intermediaries for their clients.⁷² Some may argue that working with start-ups and serving as their reputational intermediaries could result in “making an introduction that will ultimately backfire on [them].”⁷³ Because of the new “partner” role for law firms that accompanies equity billing, the argument is that law firms that are affiliated too closely with companies could be placing their own reputations on the line. However, it would appear that law firms could minimize this reputational risk by engaging in greater scrutiny of the client’s business plan and management team.

3. *Professional Risks*

By accepting equity, lawyers subject themselves to professional scrutiny about the reasonableness of their fees and whether there is a conflict of interest between them and their clients. While it is suggested in Part III below that equity billing can be reconciled with the rule that fees be reasonable and with conflict-of-interest concerns, the

⁷¹ A financially shrewd or risk-averse arrangement from the law firm’s perspective would be to take a one percent or so equity interest, charge their standard hourly rates, and ask for a retainer that covers their variable costs. The understanding would be that the law firm will not ask for payment of the bill until the client receives venture capital financing, at a minimum. As a rule of thumb, a law firm’s costs are usually one third of billings. As a result, the firm should ask for a \$10,000 retainer to cover up to \$30,000 worth of legal work. The \$10,000 retainer will cover the costs of the time that associates and partners spend on the client’s legal matters. On the downside, if the firm does not get paid the other \$20,000, it has not lost anything out of its pocket. On the upside, if the client is successful, the law firm will receive the remaining \$20,000 plus a premium reflected in the increase in the value of the equity it holds.

⁷² See discussion *supra* Part I.A.2.

⁷³ Suchman & Cahill, *supra* note 16, at 699.

novelty of equity billing means that lawyers who engage in this practice might nonetheless be subject to increased scrutiny.⁷⁴

4. *Mitigating the Risks: Selectivity and Diversification*

Law firms that engage in equity billing will attempt to minimize the risks noted above, and will negotiate to be appropriately compensated for bearing them. There are two methods through which law firms will attempt to reduce the risks they face: First, they can exercise heightened selectivity in the clients to whom they offer equity billing arrangements. Second, they can diversify their client base.

The client selection process varies from firm to firm. Some will only take equity in clients whose management has several exit strategy options,⁷⁵ while others base their decision on the client's financial expectations and on an assessment of management's competence and sophistication.⁷⁶ Many Silicon Valley law firms screen prospective technology start-up clients not only for their technological prowess but also to determine whether a client is "serious, focused, cooperative, businesslike, and so on."⁷⁷ VLG adds a twist to their selection criteria: they take equity in the clients that they deem to be most exciting and cutting-edge.⁷⁸ Linklaters & Alliance, a London-based firm, follows a more conservative approach: 75% of their decision is based on the quality and experience of the management team and 25% on the business proposition.⁷⁹

Additionally, a firm will often have its own technology due diligence team to verify the potential of the business' technical aspects.⁸⁰ For example, Wilson Sonsini encourages its lawyers to take into account: (1) the financial ability of the client to pay for its services; (2) whether agreeing to represent the client will create conflicts with other clients; and (3) whether the client's business proposal is reasonable.⁸¹

Diversification is the other method that law firms employ to mitigate risk. In this respect, equity billing arrangements are analogous to contingent fee arrangements, which are described as being "likened

⁷⁴ See discussion *infra* Part III.

⁷⁵ These options may include going public, selling to a larger entity, or merging with a similar business. See Cindy Krischer Goodman, *The Stock-for-Service Swap*, MIAAMI HERALD, May 7, 2000, at 1E.

⁷⁶ See Suchman & Cahill, *supra* note 16, at 698.

⁷⁷ See *id.* at 698 n.58 (internal quotation marks omitted).

⁷⁸ See Osborne, *supra* note 35, at 86.

⁷⁹ Linda Tsang, *E is for E-Commerce and Ethics*, INDEPENDENT (London), May 2, 2000, at 10.

⁸⁰ See *id.*

⁸¹ See MARK SUCHMAN, ON THE ROLE OF LAW FIRMS IN THE STRUCTURATION OF SILICON VALLEY 28 (1993) (Disputes Processing Research Program, Inst. for Legal Studies, Working Paper DPRP 11-7, 1994).

to a lottery ticket, the more tickets you have, the better the chance of holding a winning ticket.”⁸² Law firms that hold a large and well-diversified portfolio of clients’ equity can expect to return an overall profit.

D. Public Benefits

From a public policy perspective, equity billing arrangements, similar to contingency fees, create a financing device that allows broader access to important legal and nonlegal services. Equity billing encourages elite corporate law firms to advise clients that they would not normally represent. However, unlike contingency fees, which are often frowned upon because the lawyer is viewed as profiting from a client’s misfortune, taking an equity share in a start-up does not appear to carry as much of a negative stigma amongst the elite corporate law firms. Perhaps this is because lawyers are not seen as profiting from their client’s misfortune, but rather as partnering with their client to build a fortune. Furthermore, the typical start-up client is more sophisticated than the typical contingency fee client and may have access to other advisors to assist in assessing the lawyer’s equity fee arrangement, addressing some of the concerns surrounding the lawyer-client relationship.⁸³

Not only do lawyers provide important legal advice that helps to create certainty with respect to their clients’ relationships (shareholder relationships, employer-employee relationships, tax planning, and so forth), but they also provide their start-up clients with important nonlegal services, such as access to networks and reputational bonding services.⁸⁴ An argument could be made that law firms which have agreed to bill clients on an equity basis should be credited for facilitating the success and development of the high-tech industry and hence for such public goods as the creation of employment.

⁸² Ronald D. Rotunda, *Moving from Billable Hours to Fixed Fees: Task-Based Fees and Legal Ethics*, 47 U. KAN. L. REV. 819, 819–20 (1998).

⁸³ See discussion *infra* Part III.A–B.

⁸⁴ See discussion *supra* Part I.A. Karl Okamoto observes in relation to concerns about reputational intermediaries:

[T]he privilege of a group to accept some also empowers them to exclude others. This raises the specter of exclusion based on inappropriate categories such as race, gender or socio-economic background. Indeed the elite law firms of the United States must be, as a group, some of the most nondiverse institutions that can nevertheless wield the power that they do. It would be surprising if such monolithic organizations managed nevertheless to extend their reputational services to all members of society in a way unaffected by irrational criteria such as socially constructed stereotypes or biases. Therefore a decline in their value as reputational bonds might be a positive social development. It might signal an opening in the markets in which law firms and other intermediaries previously functioned as necessary, but sometimes exclusionary, gatekeepers.

Okamoto, *supra* note 17, at 44 (footnote omitted).

II

EXISTING MODELS OF BILLING

When applied to the lawyer-client context, agency theory provides a useful way to examine the incentives created for both parties by different billing arrangements.⁸⁵ Since clients have difficulty in monitoring the price and quality of legal services, lawyers have the opportunity to engage in self-interested behavior.⁸⁶ Market forces, as well as legal and ethical rules, attempt to reduce the divergence of interests between lawyers and clients.⁸⁷

In order to make a properly informed judgment on the practice of equity billing, it is necessary to evaluate it against the relative merits of existing billing arrangements. As a general conclusion, each of the billing arrangements that law firms currently use involves agent-principal conflicts and is susceptible to abuse.

A. Hourly Billing

Lawyer compensation has traditionally focused on the concept of hourly billing, which is considered to be objective. Most legal work at major law firms is billed on an hourly basis. Law firms calculate legal fees by multiplying the number of hours a lawyer spends on a file by her hourly rate, which is based on seniority and experience.⁸⁸ Law-

⁸⁵ See generally ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) (identifying the key organizational problem of the modern corporation as the separation of ownership and control); Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 *ECONOMETRICA* 7 (1983) (discussing an alternative approach to the principal-agent problem); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *J. FIN. ECON.* 306 (1976) (analyzing the effect of outside equity on agency costs by comparing the behavior of a manager who owns 100% of the firm to her behavior when outsiders own the firm).

⁸⁶ See Gillian K. Hadfield, *The Price of Law: How the Market for Lawyers Distorts the Justice System*, 98 *MICH. L. REV.* 953 (2000) (arguing that lawyers have incentives to behave in accordance with the standard economic model of self-interest by padding bills and disregarding the impact of particular arguments or strategies on the cost of law).

⁸⁷ For scholarship applying agency theory to gain insights on the divergence of lawyer and client interests in various contexts, see John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 *U. CHI. L. REV.* 877 (1987) [hereinafter Coffee, *Entrepreneurial Litigation*]; John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, *LAW & CONTEMP. PROBS.*, Summer 1985, at 5 (suggesting that plaintiffs' attorneys should be viewed as risk-taking entrepreneurs outside of their clients' control); Jonathan R. Macey & Geoffrey P. Miller, *An Economic Analysis of Conflict of Interest Regulation*, 82 *IOWA L. REV.* 965 (1997); and Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 *U. CHI. L. REV.* 1 (1991) [hereinafter Macey & Miller, *Plaintiffs' Attorney's Role*].

⁸⁸ WOLFRAM, *supra* note 34, § 9.2.2, at 504 & n.58 (noting that in the not-too-distant past, a typical legal bill contained no information other than the words "for legal services rendered," and that today, the almost universal practice of lawyers is to justify bills with elaborate details of hours worked); John A. Beach, *The Rise and Fall of the Billable Hour*, 59

yers prefer hourly billing because of the uncertainty and unpredictability of professional effort that may be inherent in legal work, and because they fear scaring away a client by quoting a large flat fee. Unlike contingency fees or equity billing, where the lawyer must make a business decision as to whether to accept the client, the lawyer in an hourly billing arrangement focuses exclusively on the provision of legal work. Consequently, outside of the risk of nonpayment by the client (which can be minimized by the use of upfront retainers) the hourly billing system involves minimal risk to the lawyer.⁸⁹

1. *Variations*

Of course, straight hourly billing does not constitute the only way in which lawyers can structure the compensation that they receive for rendering legal services. Within the general framework of hourly billing, many firms employ more complex billing arrangements, such as capped fees, discounts, and premiums, and a different rationale underlies each method. A brief discussion of the mechanics of each variation follows, as does a critique of current practices.

a. *Capped Fees*

Capped fees represent a variation on the traditional hourly billing arrangement. Capped fees are becoming popular among clients as law firms compete with one another in "beauty contests" for new work. Under this method, law firms bill clients based on time spent by each lawyer on the matter multiplied by his hourly rate to an agreed maximum total fee. Lawyers cannot bill the client for anything beyond the capped fee without client approval.⁹⁰

To set the capped fee, the firm estimates the total hours that each lawyer will require to complete the task. The law firm bears the risk of under-compensation if the estimate is too low, particularly where it cannot anticipate all of the complex issues that might arise.⁹¹

b. *Discounts*

Another variation on the traditional hourly billing arrangement involves the law firm offering a percentage discount on fees billed at the standard hourly rates of each lawyer who works on the client's matter. This type of arrangement serves to reward clients for bringing

ALB. L. REV. 941, 944-47 (1996); Herbert M. Kritzer et al., *Understanding the Costs of Litigation: The Case of the Hourly Fee Lawyer*, 1985 AM. B. FOUND. RES. J. 559.

⁸⁹ See WOLFRAM, *supra* note 34, § 9.2.2.

⁹⁰ See Comm. on Lawyer Bus. Ethics, Am. Bar. Ass'n, *Business and Ethics Implications of Alternative Billing Practices: Report on Alternative Billing Arrangements*, 54 BUS. LAW. 175, 182-84 (1998).

⁹¹ See *id.* at 183.

business to the firm.⁹² In general, law firms only agree to discount hourly rates for established clients who are significant to the law firm in terms of aggregate billings. The economic rationale for providing discounts is that the marginal decrease in revenue resulting from the discount is less than the marginal increase in revenue from the additional business, such that the law firm is better off overall.

c. *Premiums*

Some law firms, especially during strong economic times, charge their clients a premium above and beyond the amount billed based on standard hourly rates. The firm justifies charging a premium by claiming that it is providing more value to the client than what is reflected by hourly billing. Premiums are often charged in connection with mergers and acquisition transactions where such value is being created from the perspective of clients that they are willing to pay the extra fee.⁹³

2. *Critique*

Despite the benefits of hourly billing, lawyers and clients are increasingly critical of the practice. Some lawyers argue that it does not reward them for the value of their work, but solely for the time it takes to complete it.⁹⁴ Others resent having to account for every six minutes of their working lives and regard docketing as an inefficient use of their time.⁹⁵

From an agency perspective, two issues stand out with respect to hourly billing arrangements. First, how does the law firm decide how many hours to spend on a matter? Second, how can a client effectively monitor her lawyer's real or claimed effort?⁹⁶ For example, a lawyer can draft a ten-page joint venture agreement but can also draft a more complex and sophisticated fifty-page joint venture agreement. So long as the law firm has partners and associates who have "time" to work, there is an incentive to spend more time on individual matters and hence create complex and lengthy agreements.

⁹² See *id.*

⁹³ For example, in the Time Warner/AOL merger, Time Warner agreed to allow its law firm, Cravath, Swaine & Moore, charge a premium of \$35 million if the merger was successfully completed. See Krysten Crawford & Karen Hall, *High Rollers*, AM. LAW., Feb. 2000, at 19.

⁹⁴ See Robert S. Banks, *Time-Keeping Isn't the Answer*, AM. LAW., Apr. 1992, at 39; Beach, *supra* note 88, at 943; Charles H. Carman, *Your Role in Restructuring the Legal Industry*, CORP. LEGAL TIMES, Mar. 1992, at 4 ("Hourly billing is the root of suspicion, poor service and bad customer relations.").

⁹⁵ See, e.g., sources cited *supra* note 94.

⁹⁶ See Daniel L. Rubinfeld & Suzanne Scotchmer, *Contingent Fees for Attorneys: An Economic Analysis*, 24 RAND J. ECON. 343 (1993).

Clients are frequently in no position to scrutinize the amount of effort and time that has been, or should have been, put into a matter. This makes hourly rate billing especially risky because it has the potential to encourage lawyers, especially those who must reach target billable hours, to take excessive or inefficient amounts of time to complete tasks.⁹⁷

The law firm's desire to maintain its reputation for responsiveness to clients' needs should act as a countervailing force to the incentive to spend excessive amounts of time on a matter. Thus, a fifty-page agreement should only be drafted where such level of detail would be valuable to the client. In addition, ethical rules barring unreasonable fees should also act to discourage excessive billing.⁹⁸

B. Flat Fees

Although less popular among law firms than the billable hour, some law firms use flat fees for such legal work as residential real estate transactions, the incorporation of businesses, and simple family law cases. For more complex files, flat fee billing arrangements require lawyers and clients to have a clear understanding of the scope of the work covered.

Clients benefit from flat fee arrangements because they can easily predict their legal expenses.⁹⁹ Another virtue is that the flat fees encourage efficiency on the part of lawyers, because similar to capped fees, they will not earn more than the negotiated amount. However, unlike capped fees, lawyers cannot earn less than the negotiated amount. As a result, this arrangement may provide a disincentive to lawyers to be thorough in the scope of the tasks they perform.¹⁰⁰ This fee arrangement works well for lawyers in a position to accurately estimate the amount of time required to handle a particular file.¹⁰¹ However, clients have an incentive not to disclose information until after the fee is set.

C. Contingency Fees

Contingency fee arrangements provide a direct link between the fees earned by lawyers and the results obtained for clients. In the litigation context, a typical contingency fee arrangement gives the lawyer

⁹⁷ See Macey & Miller, *Plaintiffs' Attorney's Role*, *supra* note 87, at 17–18.

⁹⁸ See discussion *infra* Part III.A.1.

⁹⁹ See Charles S. McCowan, Jr. & Esteban Herrera, Jr., *Alternative Fee Arrangements: TIME for Consideration*, 43 LA. B.J. 466, 468 (1996).

¹⁰⁰ See Comm. on Lawyer Bus. Ethics, *supra* note 90, at 182, 186.

¹⁰¹ See George B. Shepherd & Morgan Cloud, *Time and Money: Discovery Leads to Hourly Billing*, 1999 U. ILL. L. REV. 91, 98.

a percentage of the plaintiff's award if the lawsuit succeeds, in exchange for bearing the risk of no compensation if the lawsuit fails.¹⁰²

Contingency fees are justified primarily because they enhance access to the civil litigation system. They enable individuals who would not otherwise be able to afford the cost of hiring a lawyer to do so. Contingency fees are attractive to clients who are risk averse or face free-rider problems as in the class action context. While the contingency fee arrangement poses no financial risk for clients, the price they pay for shifting the risk of loss to lawyers is often a significant portion of recovery. A common contingency fee is one-third of the proceeds of litigation.¹⁰³

Contingency fees are controversial.¹⁰⁴ Though historically prohibited by common law and statutes, contingency fees are now permitted in the United States and in most jurisdictions in Canada.¹⁰⁵ Contingency fee arrangements are used primarily by plaintiffs' personal-injury lawyers and are criticized as being ambulance-chasing schemes that benefit lawyers rather than clients. Many legal commentators regard contingency fee arrangements as promoting lower professional standards and meritless litigation.¹⁰⁶

At their core, contingency fee arrangements enable law firms to finance the provision of legal services. The firms continue to pay their associates, support staff, and overhead, but will only collect their fees when they win or settle a case.

Law firms entering into contingency fee arrangements must engage in business decisions as to whether to accept any particular case on such a basis. Among other factors, firms must assess the merits of the lawsuit, the magnitude of likely recovery, the likelihood of winning at trial, the likelihood of settlement, and the time frames for such events. The firms must also analyze whether the particular case fits well within their portfolio of existing and prospective contingency fee cases. Law firms that accept cases on a contingency fee basis obviously bear greater risk than those that use hourly billing arrangements.

¹⁰² See generally LESTER BRICKMAN ET AL., *RETHINKING CONTINGENCY FEES* (1994) (discussing the present fee system and presenting an alternative); Kevin M. Clermont & John D. Currihan, *Improving on the Contingent Fee*, 63 CORNELL L. REV. 529 (1978) (same); James D. Dana, Jr. & Kathryn E. Spier, *Expertise and Contingent Fees: The Role of Asymmetric Information in Attorney Compensation*, 9 J.L. ECON. & ORG. 349 (1993) (applying economic analysis); Rubinfeld & Scotchmer, *supra* note 96 (same).

¹⁰³ See Herbert M. Kritzer, *The Wages of Risk: The Returns of Contingency Fee Legal Practice*, 47 DEPAUL L. REV. 267, 285 (1998).

¹⁰⁴ See BRICKMAN ET AL., *supra* note 102; Kritzer, *supra* note 103.

¹⁰⁵ See GEOFFREY C. HAZARD, JR. ET AL., *THE LAW AND ETHICS OF LAWYERING* 510-11 (3d ed. 1999).

¹⁰⁶ See Marc Galanter, *Anyone Can Fall Down a Manhole: The Contingency Fee and Its Discontents*, 47 DEPAUL L. REV. 457, 457-68 (1998); Kritzer, *supra* note 103, at 267-69.

Law firms that bear the additional risk associated with contingency fees can reap significant rewards. Although there is some risk of ultimately rendering services for free, evidence suggests that contingency fees as a whole produce profits greater than those generated by hourly billing arrangements, particularly for those firms that develop expertise and processes for handling many similar cases.¹⁰⁷ To be profitable, law firms that accept contingency fee arrangements must ensure that they hold a well-diversified portfolio of cases that will ripen at appropriate times to cover their expenses.¹⁰⁸

Contingency fees create different incentives for lawyers and clients as to when to settle, how much to settle for and how much effort to expend on a matter.¹⁰⁹ Illustratively, in relation to incentives to settle, if the contingency fee arrangement cannot be renegotiated, and new information is brought to surface suggesting a significantly reduced likelihood that a damages award will be forthcoming at trial, the plaintiff may wish to continue the litigation nonetheless because he does not bear the risk of loss. On the other hand, the lawyer, who has to bear the additional costs associated with continuing the litigation, may wish to settle instead. This divergence of incentives has been a source of much criticism, particularly in class actions where the class has little or no control over the lawyers who run the litigation.¹¹⁰ Their incentives to settle and expend effort may diverge significantly from those of the class. For example, lawyers for the class may wish to settle early in the process before they expend a significant amount of effort, even though more effort and a later settlement would result in a greater recovery for the class.

Contingency fees are regulated in an attempt to address the agency problems discussed above. Because a lawyer takes a vested financial interest in the outcome of a case involving contingency fees, the potential for a conflict of interest arises. The American Bar Association (ABA) requires that contingency fee arrangements be in writing with the method of calculation of the fee set forth to ensure that the client is informed of how the fee will be determined.¹¹¹ In the context of class actions where additional agency problems arise, fur-

¹⁰⁷ See Kritzer, *supra* note 103, at 285–90.

¹⁰⁸ The evidence available as of 1989 is summarized in Lester Brickman, *Contingent Fees Without Contingencies, Hamlet Without the Prince of Denmark?*, 37 UCLA L. REV. 29, 105–11, 132–34 (1989), concluding that the contingent fee results in higher transaction costs in high-stakes cases and larger-than-average returns on lawyer time in smaller cases.

¹⁰⁹ See WOLFRAM, *supra* note 34, § 9.4; Thomas D. Morgan, *The Evolving Concept of Professional Responsibility*, 90 HARV. L. REV. 702, 732 (1977); Rubinfeld & Scotchmer, *supra* note 96, at 346.

¹¹⁰ See Coffee, *Entrepreneurial Litigation*, *supra* note 87, at 897–98; Macey & Miller, *Plaintiffs' Attorney's Role*, *supra* note 87, at 7 (describing agent-principal problems created by contingent fees in class actions).

¹¹¹ MODEL RULES OF PROF'L CONDUCT R. 1.5(c) (2000).

ther regulatory safeguards have been implemented.¹¹² Courts must approve settlement of class actions to ensure fairness to the class.¹¹³ Courts must also review lawyers' fees to ensure that they are not receiving an unreasonable amount of compensation at the expense of the class.¹¹⁴ Critics of contingency fee arrangements doubt whether judicial involvement results in satisfactory settlements or levels of lawyer compensation.

D. Investor Financing

A relatively new method of financing legal fees is through the use of investors who finance a legal matter in return for a share of any successful recovery.¹¹⁵ Investor financing resembles contingency fee arrangements but does not limit the class of investors exclusively to lawyers. In terms of bearing risk, the client is in the same risk position as she would be in a contingency fee arrangement. The lawyer is presumably in the same risk position as she would be in an hourly billing arrangement. The investor bears the risk that the litigation may not succeed in exchange for a stake in the upside. Investor financing may impose additional agency costs because of the possibility of encouraging frivolous litigation, discouraging settlement, and stripping the client of effective control.¹¹⁶

E. Comparison with Equity Billing

Law firms that engage in equity billing structure their compensation packages in one of three ways. First, law firms may simply accept equity in lieu of cash as total compensation for legal services. Second, law firms may accept equity coupled with discounted hourly rates. Third, law firms may charge their standard hourly rates and accept equity as a form of premium.

Which type of equity billing arrangement is optimal from a law firm's perspective? It is unlikely that a law firm could survive entirely on equity billing for all of its clients because it is difficult to predict with a high degree of accuracy the value and timing of a particular client's liquidity event. If a law firm is billing a high proportion of its clients exclusively on an hourly basis, then the firm can afford to take the risk associated with accepting the occasional client entirely on an equity basis. Generally speaking, if a law firm is considering taking

¹¹² See Macey & Miller, *Plaintiffs' Attorney's Role*, *supra* note 87, at 27-96.

¹¹³ See *id.* at 44-48.

¹¹⁴ See Coffee, *Entrepreneurial Litigation*, *supra* note 87, at 898; Macey & Miller, *Plaintiffs' Attorney's Role*, *supra* note 87, at 11.

¹¹⁵ See Poonam Puri, *Financing of Litigation by Third-Party Investors: A Share of Justice?*, 36 OSGOODE HALL L.J. 515 (1998).

¹¹⁶ *Id.* at 531-44.

equity in a significant portion of its clients, a hybrid approach of equity, along with standard or discounted hourly rates, is a better strategy from a risk minimization standpoint. In fact, most elite law firms in the United States and Canada prefer to take on new technology start-up clients by agreeing to a relatively small (one percent or so) equity stake in the client coupled with their standard hourly rates.¹¹⁷

Which type of equity billing arrangement is optimal from a client's perspective? All else being equal, a client would prefer to be billed on an equity basis rather than be charged standard hourly rates if it needed to preserve its cash. In addition, the more equity a firm is willing to accept, the stronger the signal that is sent to the marketplace of the firm's confidence in the business venture and management team.

How does equity billing compare to other types of billing arrangements with respect to risk and return? Given the greater risks involved in equity billing, one would expect the returns to be greater than those that can be earned by hourly billing. In several respects, equity billing can be analogized to contingency fees. First, equity billing allows clients who may not have the funds to pay for legal services to obtain them. Equity billing is to corporate transactional work and start-up clients what contingency fees are to litigation and access to the courts. Second, because law firms bear a greater risk of nonpayment than with hourly billing, their potential returns are greater as well. Third, lawyers must engage in a cost-benefit analysis to determine whether to accept the representation. In the context of contingency fees, lawyers must evaluate the prospects of their clients' legal claims (likelihood and size of outcome), something which they are well equipped to do.¹¹⁸ In the context of equity billing, lawyers must evaluate their clients' business ideas in order to determine the likelihood of liquidity events.

Although at first glance, one might question lawyers' abilities to make such assessments of their clients' long-term prospects, a compelling case can be made that lawyers in fact possess the analytical tools to make these types of judgments. For example, if the value of the business depends upon the strength of the legal protection for a key asset (as would be the case with an invention that needs to be or has already been patented), then a lawyer would be well equipped to determine the likelihood of patentability and thus the value of the business. Similarly, a lawyer is in a good position to assess the vulnerability

¹¹⁷ However, Shearman & Sterling has adopted a policy of accepting equity in lieu of cash up to 50% of its fees to an upper limit; similarly, LeBoeuf, Lamb, Greene & MacRae prefers to receive at least 70% of its fees in cash but is willing to accept equity in a client up to a value of \$50,000. Stracher, *supra* note 9.

¹¹⁸ See discussion *supra* Part II.C.

of a "blocking" patent of a non-client. Even in situations in which the analysis does not turn solely on the application of legal principles, lawyers are generally well-positioned to make business judgments. As many commentators have noted, lawyers do not engage exclusively in providing legal advice to clients.¹¹⁹ Business skills and business valuation are learned on the job; over time, lawyers develop a capacity to judge businesses. The recent rise of law firm partners, associates, and newly minted law graduates entering investment banking and management consulting suggests that individuals trained as lawyers may indeed have valuable business skills.

From an agency perspective, what incentives are created by equity billing? Just as contingency fee arrangements narrow the gap between the interests of lawyers and plaintiffs,¹²⁰ equity billing aligns the interests of lawyers and shareholders. Equity billing creates incentives for lawyers to provide services that reach beyond the traditional scope of law practice and advice. It encourages lawyers to expend effort to make the business more valuable by making it grow in order to reach a liquidity event.

As with contingency fees, which, according to some commentators create incentives for lawyers to encourage frivolous or non-meritorious litigation,¹²¹ it can be argued that equity billing creates incentives for lawyers to encourage clients to develop nonessential or nonviable business ideas and technology. The notion is that a lawyer would be willing to assist a technology start-up only on the basis that it may make the lawyer wealthier. However, as described in Part I, lawyers who accept equity are selective in the clients that they are willing to represent, so that a potential client who has a technology which, in the lawyer's judgment, is not viable will not be represented.

While the economics of contingency fees and equity billing are similar, the politics are quite different. We have witnessed years of battle in most jurisdictions to allow for or authorize contingency fees, but equity billing arrangements have been endorsed and approved in a relatively short period of time by lawyers' regulatory bodies. The reason for the differing treatment may be because contingency fees and equity billing deal with two different hemispheres of lawyers and clients. Contingency fees deal with relatively less powerful individual clients and small firm practitioners compared to equity billing which deals with relatively more powerful business clients and large firm lawyers. In addition, contingency fees create more direct and visible ex-

¹¹⁹ See discussion *supra* Part II.A.2.

¹²⁰ See discussion *supra* Part II.C.

¹²¹ *But see* Herbert M. Kritzer, *Contingency Fee Lawyers as Gatekeeper in the Civil Justice System*, JUDICATURE, July-Aug. 1997, at 22, 22-29 (concluding that contingency fee lawyers do screen and turn down cases, thus acting as gatekeepers to the civil justice system).

ternalities than equity billing. Contingency fees increase the levels of litigation in a society and therefore add direct costs to the civil justice system. Equity billing appears to be a purely private transaction with no effect on third parties. The externalities that may arise from equity billing are much more subtle and imposed on groups of people (such as public shareholders or other investors), each of whom are impacted in a small way, rather than a monolithic institution such as the administration of justice.

III

THE EFFECT OF LEGAL ETHICS AND FIDUCIARY DUTIES ON THE LAWYER-CLIENT RELATIONSHIP

One set of concerns surrounding equity billing relates to the effect of equity billing on the lawyer-client relationship. ETHICSearch of the American Bar Association Center for Professional Responsibility reports that it has received numerous inquiries on the propriety of lawyers accepting equity interests in clients in lieu of monetary compensation.¹²² The number of lawyers searching for an opinion on the topic suggests that there is much uncertainty about the ethical issues surrounding this type of arrangement, and that there is a clear need for clarification.¹²³ Based on an analysis of the relevant rules of professional responsibility and their interpretation in other contexts, equity billing as a general matter can be reconciled with the ethical duty of lawyers to charge their clients reasonable fees. Concerns surrounding conflicts of interest between law firms and their clients can be addressed by compliance on the part of firms with existing ethical safeguards on lawyers transacting business with their clients.¹²⁴ Other conflicts that result from equity billing can be addressed by more general ethical rules on conflicts of interest requiring law firms to provide full disclosure and to obtain informed consent from their clients. While lawyers who engage in equity billing may expose themselves to discipline by their self-regulatory bodies, the reality is that professional discipline in the context of fee arrangements is very rare, particularly where competent business clients are involved.¹²⁵ Nonetheless, a client may attempt to invalidate an equity billing arrangement on the basis that her lawyer violated fiduciary duties. However, as a general matter, equity billing can function within the fiduciary duties that lawyers owe to clients.

¹²² See Peter H. Geraghty, *Ask ETHICSearch*, PROF. LAW., Summer 2000, at 21.

¹²³ See *id.*

¹²⁴ See *id.*

¹²⁵ Ted Schneyer, *Professional Discipline for Law Firms?*, 77 CORNELL L. REV. 1, 6-7 (1991).

A. The Regulation of Legal Fees

ABA Model Rule 1.5, its enumerated factors, case law in the area, and a number of opinions rendered on the issue of equity billing provide useful guidance for determining whether equity billing can sit comfortably with the rule that lawyers' fees be reasonable.

1. *Fees Must Be Reasonable*

Unlike the provision of most other goods or services, there are upper limits to the price that lawyers can charge for rendering legal services.¹²⁶ This regulation of prices suggests that consumers have difficulty in monitoring the quality and assessing the price of legal services. The Third Restatement of the Law Governing Lawyers ("Restatement") succinctly states:

Courts are concerned to protect clients, particularly those who are unsophisticated in matters of lawyers' compensation, when a lawyer has overreached. Information about fees for legal services is often difficult for prospective clients to obtain. Many clients do not bargain effectively because of their need and inexperience. The services required are often unclear beforehand and difficult to monitor as a lawyer provides them. Lawyers usually encourage their clients to trust them. Lawyers, therefore, owe their clients greater duties than are owed under the general law of contracts.¹²⁷

Therefore, regulation of legal fees reflects a public policy of promoting access to the justice system.¹²⁸ The ABA has adopted a "reasonable[ness]" standard to ensure that legal fees are not excessively high.¹²⁹ Rule 1.5(a) of the ABA's Model Rules reads that "[a] lawyer's fee shall be reasonable."¹³⁰ Courts will apply Rule 1.5 when a lawyer sues her client for unpaid legal fees or when a client sues his lawyer to

¹²⁶ For general background discussion, see MICHAEL J. TREBILCOCK, *THE LIMITS OF FREEDOM OF CONTRACT* (1993). The upper limit for the price of most other goods and services is judged using a standard of unconscionability.

¹²⁷ See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 34 cmt. b (2000).

¹²⁸ See *id.*

¹²⁹ *Id.* § 34.

¹³⁰ MODEL RULES OF PROF'L CONDUCT R. 1.5(a) (2000); see also MODEL CODE OF PROF'L RESPONSIBILITY DR 2-106(B) (1969) ("A fee is clearly excessive when, after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee."). Along similar lines, the Law Society of Upper Canada (LSUC) Rule 2.08 of the Rules of Professional Conduct states that a lawyer shall not "charge or accept . . . a fee . . . unless it is fair and reasonable and has been disclosed in a timely fashion." LSUC RULES OF PROF'L CONDUCT R. 2.08(1) (2001) (LSUC is the self-regulatory body for lawyers in the province of Ontario), at http://www.lsuc.on.ca/services/RulesProfCondpage_en.jsp (last visited Oct. 3, 2001). The commentary following Rule 2.08 lists factors very similar to those that follow ABA Model Rule 1.5. The rule also warns that fees are subject to an assessment under the Solicitors Act, which involves a substantive review of a lawyer's fees by the LSUC if a complaint is filed by his client. See *id.* cmt.

recover fees already paid.¹³¹ Rule 1.5 also applies when a disciplinary authority attempts to discipline a lawyer for charging unreasonably high fees.¹³² Courts are empowered to inquire about the reasonableness of legal fees as part of their inherent authority to regulate the practice of law.¹³³

ABA Rule 1.5 sets out a non-exhaustive list of factors for courts or disciplinary bodies to consider when determining the reasonableness of a fee.¹³⁴ These factors include: the time, labor, and skills required; fees customarily charged for similar legal services; the amount at stake; the results obtained; the nature and length of the professional relationship; the experience, reputation, and ability of the lawyers involved; the time limitations imposed by the client; and finally, whether the fee is fixed or contingent.¹³⁵

The Restatement notes that the rules on reasonable fees address three questions.¹³⁶ First, courts must assess whether the client made a free and informed choice when entering into the fee arrangement.¹³⁷ The client's level of sophistication constitutes one relevant fact.¹³⁸ Fees to which sophisticated clients have agreed are most often found to be reasonable.¹³⁹ Another consideration is whether the lawyer offered and explained alternative forms of billing to the client.¹⁴⁰ A fee paid in the form of real or personal property will attract special scrutiny because it raises questions concerning the valuation of both the property and the services rendered, along with the lawyer's special knowledge, if any, of the value of the property.¹⁴¹ In negotiating and collecting fees, lawyers must meet duties of good faith and fair dealing

¹³¹ See, e.g., *Pfeifer v. Sentry Ins.*, 745 F. Supp. 1434, 1443 (E.D. Wis. 1990) (explaining that courts have the inherent power to refuse to enforce a legal services contract on the basis of excessive or unreasonable fees); *Drury v. Fawer*, 590 So. 2d 808, 811 (La. Ct. App. 1991) (finding that that trial court has discretion to determine the value of legal services rendered); *Beatty v. NP Corp.*, 581 N.E.2d 1311, 1315 (Mass. App. Ct. 1991) (stating that legal fee contracts are reviewed in light of lawyers' fiduciary duties to their clients).

¹³² See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 34 cmt. a (2000).

¹³³ See cases cited *supra* note 131.

¹³⁴ MODEL RULES OF PROF'L CONDUCT R. 1.5(a) (2000).

¹³⁵ *Id.*

¹³⁶ See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 34 cmt. c (2000).

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ See, e.g., *Brobeck, Phleger & Harrison v. Telex Corp.*, 602 F.2d 866, 875 (9th Cir. 1979) (enforcing a contract to pay high contingency fees on an important case against a large corporation with inside legal counsel); *Citizens Bank v. C. & H. Constr. & Paving Co.*, 600 P.2d 1212, 1218 (N.M. Ct. App. 1979) (enforcing a large contingency fee arrangement).

¹⁴⁰ See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 34 cmt. c (2000).

¹⁴¹ See *id.*

to their clients because courts view lawyers as having substantially greater bargaining power than their clients.¹⁴²

Second, courts should consider whether the fee arrangement is similar to what would be entered into by other lawyers in similar circumstances.¹⁴³ The fairness of the fees at issue can be judged by comparing the hourly rates in question with the hourly rates of lawyers with comparable skills, reputation, and experience. In the context of contingency fee arrangements, courts often make comparisons between the percentage in question and the percentage charged by other law firms for similar matters.¹⁴⁴

Third, courts inquire into whether any events have taken place subsequent to determining the fee that would make the fee unreasonable. Reasonableness is normally assessed *ex ante*, at the time the contract was entered into and with the information the parties had at that time.¹⁴⁵ Under limited circumstances, however, subsequent events may have a bearing on the reasonableness of the terms of an already negotiated agreement.¹⁴⁶ For example, a fee may be unreasonable after the fact if a lawyer has provided poor service, even if the fee would have been viewed as reasonable for better quality service.¹⁴⁷

2. Regulation of Contingency Fees

Given the similarities between contingency fees and equity billing, a brief account of the regulation and reasonableness of contingency fees is necessary.¹⁴⁸ Contingency fees are expressly permitted under ABA Model Rule 1.5(c).¹⁴⁹ Given the greater potential for conflicts of interest between lawyers and clients, the rules of professional conduct regulate contingency fees to a greater extent than other fee arrangements.¹⁵⁰ ABA Model Rule 1.5 prohibits contingency fees where the public interest is significantly undermined or the potential for conflict of interest is deemed too great.¹⁵¹ For example, contin-

¹⁴² *Morse v. Espeland*, 696 P.2d 428, 430-31 (Mont. 1985) (noting the inequality that exists between the attorney and client when bargaining over fees).

¹⁴³ See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 34 cmt. c (2000).

¹⁴⁴ See *id.*

¹⁴⁵ See *id.*

¹⁴⁶ See *id.*

¹⁴⁷ See *id.* § 34.

¹⁴⁸ See discussion *supra* Part II.C.

¹⁴⁹ MODEL RULES OF PROF'L CONDUCT R. 1.5(c) (2000).

¹⁵⁰ See *id.* R. 1.5 cmt. 3.

¹⁵¹ See *id.* R. 1.5(d)(1)-(2).

gency fees are prohibited in relation to the representation of defendants in criminal cases,¹⁵² as well as in divorce and custody cases.¹⁵³

In situations in which contingency fees are permitted, they must be in a written document that states the method by which the fee is to be calculated.¹⁵⁴ The rules of professional conduct recognize that the amount earned will exceed that produced by an hourly billing arrangement, but note that the lawyer bears greater risk under the former arrangement.¹⁵⁵ Applying these principles, courts tend to find contingency fees unreasonable in the following three circumstances: when there is a high likelihood of recovery and thus a very low risk of nonpayment;¹⁵⁶ when a client has not been offered alternative billing arrangements;¹⁵⁷ and when the percentage rate or the base to which it is applied is excessive.¹⁵⁸

3. Reasonableness Depends on Context

What constitutes a reasonable fee will vary with the circumstances of each case and requires a fact-specific inquiry. A legal fee of \$4 million, constituting thirty-three percent of the plaintiff's recovery in a derivative action, was found not to be unreasonable.¹⁵⁹ Similarly, a

¹⁵² *Id.* R. 1.5(d)(2). The Reporters of the Restatement believe that the prohibition of criminal contingent fees should be relaxed. See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 35 cmt. f (2000). For criticism on the use of contingency fees in criminal cases, see WOLFRAM, *supra* note 34, § 9.4.3.

¹⁵³ MODEL RULES OF PROF'L CONDUCT R. 1.5(d)(1) (2000). The traditional rationale proffered for this rationale is that contingent fees in this context create incentives for lawyers to discourage reconciliation and encourage adversarial proceedings. It has been noted that the prohibition has a disproportional impact on women who are less propertied or have less income so as to be able to pay a flat fee on a cash hourly basis. See HAZARD ET AL., *supra* note 105, at 518–19. However, one could undermine the public interest in preserving marriages by arguing that contingent fees are unnecessary in this context because courts will readily assign reasonable legal fees from the propertied spouse to the non-propertied spouse's attorney. See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 35 cmt. g (2000). This prohibition has been criticized. See *id.*

¹⁵⁴ MODEL RULES OF PROF'L CONDUCT R. 1.5(c) (2000).

¹⁵⁵ See, e.g., *McKenzie Constr., Inc. v. Maynard*, 823 F.2d 43, 48 (3d Cir. 1987) (explaining that large contingency fee agreements are justified by the risk of non-recovery).

¹⁵⁶ See, e.g., *Redevelopment Comm'n v. Hyder*, 201 S.E.2d 236, 239 (N.C. Ct. App. 1973) (holding that contingency fees are inappropriate where there is little to no risk of nonpayment).

¹⁵⁷ See, e.g., *Comm. on Legal Ethics v. Tatterson*, 352 S.E.2d 107, 113 (W. Va. 1986) (stating that lawyers should fully explain the need for a particular fee arrangement to their clients). A comment on ABA Model Rule 1.5 states: "When there is doubt whether a contingent fee is consistent with the client's base interest, the lawyer should offer the client alternative bases for the fee and explain their implications." MODEL RULES OF PROF'L CONDUCT R. 1.5 cmt. 3 (2000).

¹⁵⁸ See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 35 cmt. d (2000).

¹⁵⁹ See *Principe v. Ukropina (In re Pac. Enters. Sec. Litig.)*, 47 F.3d 373, 379 (9th Cir. 1995).

fee of \$14.2 million arising from a \$42 million settlement of a class action securities litigation was found not to be unreasonable.¹⁶⁰

On the other hand, many court decisions have found fees to be unreasonable. Lawyers who charge clients for getting up to speed in an area may find that their fees are deemed unreasonable.¹⁶¹ Lawyers who charge a high fee despite the lack of complexity of the work involved may also find their fees to be unreasonable. In *Kentucky Bar Association v. Newberg*, legal fees of forty-five percent of the recovery of reparation benefits from an insurer were found to be excessive when there was little prospect that the insurer would contest the claim.¹⁶² Also, collecting a contingency fee for monies recovered (but not through settlement or litigation) may constitute an excessive fee, as in the case of *In re Gerard*, where legal fees of over \$150,000 were collected for redeeming bank certificates through a simple administrative process.¹⁶³

Although legal fees are not necessarily unreasonable even when they exceed the client's recovery,¹⁶⁴ legal fees that leave the client with no recovery will be viewed as being excessive.¹⁶⁵ Lack of proportionality between the legal services performed and the result obtained may also result in a finding of unreasonableness.¹⁶⁶ For example, the Connecticut Bar Association's Committee on Professional Ethics ruled that a legal fee of two percent of the sale price of the client's asset could be unreasonable if it was not proportionate to the value of the services rendered.¹⁶⁷

a. *Opinions on Equity Billing*

A 1998 Utah State Bar Opinion cites ABA Model Rule 1.5 and states that the following additional factors should be considered in relation to equity billing:

- 1) The liquidity of the client's stock; in particular, whether the client's stock trades publicly at the time of the fee arrangement and if

¹⁶⁰ See *In re Crazy Eddie Sec. Litig.*, 824 F. Supp. 320, 326 (E.D.N.Y. 1993).

¹⁶¹ See *Norman v. Hous. Auth.*, 836 F.2d 1292, 1306 (11th Cir. 1988).

¹⁶² 839 S.W.2d 280, 281 (Ky. 1992).

¹⁶³ 548 N.E.2d 1051, 1057 (Ill. 1989).

¹⁶⁴ See, e.g., *W. Media, Inc. v. Merrick*, 757 P.2d 1308, 1311 (Mont. 1988) (finding that a \$5,000 fee was not excessive, regardless of whether it exceeded the amount of recovery).

¹⁶⁵ See, e.g., *Fla. Bar v. Hollander*, 594 So. 2d 307, 307-08 (Fla. 1992) (holding that retaining the entire amount of a settlement obtained on behalf of a client warrants forfeiture of excessive fees); *McCrary v. McCrary*, 764 P.2d 522, 525-26 (Okla. 1988) (holding that a fee arrangement awarding the client's home to a lawyer for successful representation in a single-asset divorce proceeding was an improper contingency arrangement).

¹⁶⁶ See Comm. on Prof'l Ethics, Conn. Bar Ass'n, Informal Op. 88-5 (1988), *abstracted in* 4 ABA/BNA LAWYERS' MANUAL ON PROFESSIONAL CONDUCT 106 (1988) [hereinafter *LAWYERS' MANUAL*].

¹⁶⁷ *Id.*

it does not, the risk that the client's stock will not be publicly traded in the future;

- 2) The present and anticipated value of the client's stock including the risk that a proposed patent or trademark may not be granted or that necessary government approvals may not be received;
- 3) Whether the stock to be given to the law firm is subject to restrictions; and
- 4) The amount of the stock to be received by the law firm and whether it will be able to exercise voting control over the client.¹⁶⁸

A formal opinion issued by the ABA Committee on Ethics and Professional Responsibility in July 2000 ("ABA Opinion on Equity Billing") confirms that lawyers are not prohibited from acquiring an ownership interest in a client so long as they comply with Model Rule 1.5,¹⁶⁹ but cites Professors Hazard and Hodes who caution that, "[o]ne danger [to the lawyer who accepts stock as a fee is that the business will] so prosper that the fee will later appear unreasonably large for the work performed."¹⁷⁰

The ABA Opinion on Equity Billing notes that determining reasonableness involves making a difficult assessment of the market value of the stock at the time the transaction is entered into.¹⁷¹ It recognizes that the value of the stock may not be readily ascertainable, and in such cases, "the percentage of stock agreed upon should reflect the value, as perceived by the client and the lawyer at the time of the transaction, that the legal services will contribute to the potential success of the enterprise."¹⁷²

A formal opinion issued by the Association of the Bar of the City of New York's Committee on Professional and Judicial Ethics in 2000 also expressly permits lawyers in some circumstances to accept shares or other securities, including options, as compensation for the rendering of legal services, but states that the fee realized by such an arrangement may not be excessive.¹⁷³ Interestingly, the opinion cau-

¹⁶⁸ See Ethics Advisory Opinion Comm., Utah State Bar, Op. 98-13 (1998), *abstracted in* [1996-2000] *LAWYERS' MANUAL*, *supra* note 166, at 1101:8507, *available at* <http://www.utahbar.org/opinions/html/98-13.html>.

¹⁶⁹ ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 00-418 (2000), *reprinted in* [1996-2000] *LAWYERS' MANUAL*, *supra* note 166, at 1101:207 [hereinafter ABA Opinion on Equity Billing].

¹⁷⁰ 1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, *THE LAW OF LAWYERING* § 1.8:202 (2d ed. Supp. 1998).

¹⁷¹ ABA Opinion on Equity Billing, *supra* note 169, at 1101:209.

¹⁷² See *id.* at 1101:210. The opinion states in a footnote that "[t]he committee is aware that sometimes the lawyer will ask the corporation to issue her a percentage of the shares initially issued to the founders as a condition to the lawyer agreeing to become counsel to the new enterprise. We take no position on the ethical propriety of the practice." *Id.* at 1101:210 n.16.

¹⁷³ Comm. on Prof'l & Judicial Ethics, Ass'n of the Bar of the City of N.Y., Formal Op. 2000-3 (2000), *abstracted in* [1996-2000] *LAWYERS' MANUAL*, *supra* note 166, at 1101:6405

tions that if a lawyer is discharged or withdraws from her representation of an equity-billed client, she would not be entitled to receive more than the value of the work performed to the date of termination of the representation.¹⁷⁴ The ABA Opinion on Equity Billing is more flexible and favorable to lawyers, and states that they may keep the equity “[i]f the client’s understanding is that the lawyer keeps the stock interest regardless of the amount of legal services performed by the lawyer” and that understanding is clearly memorialized in the retainer agreement.¹⁷⁵ Otherwise, a court may treat any stock they received as an advance fee and require all or part of it to be returned if the work originally contemplated has not been performed.¹⁷⁶

b. *Application of Reasonableness to Equity Billing*

As noted above, the value of Wilson Sonsini’s stock in its client WebVan increased by \$51 million on the stock’s first day of trading on public markets.¹⁷⁷ Wilson Sonsini had taken as compensation two million shares in WebVan in addition to its hourly fees.¹⁷⁸ Some would argue that this fee was not reasonable. However, as noted above, the reasonableness of a fee depends on many factors.

A number of issues are relevant to the analysis of whether equity billing can be reconciled with reasonable-fee requirements. First, one must determine whether the technology start-up’s decision to enter into the equity arrangement was free and informed. Under this criterion, one would determine whether the client had been offered a number of billing alternatives, of which equity was one option. If so, this would imply that the client’s decision was voluntary. However, as illustrated by Wilson Sonsini, many top law firms that represent start-ups, as a matter of course, request equity in addition to charging their

[hereinafter NYC Bar Formal Opinion], available at <http://www.abcny.org/eth2000.htm#20003>.

¹⁷⁴ *Id.* (citing Comm. on Prof’l & Judicial Ethics, Ass’n of the Bar of the City of N.Y., Formal Op. 1988-7 (1988)); NEW YORK CODE OF PROF’L RESPONSIBILITY DR 2-106, DR 5-101, DR 5-104, DR 5-105, EC 2-20, EC 2-24, EC 5-3, EC 5-13 (1999).

¹⁷⁵ See ABA Opinion on Equity Billing, *supra* note 169, at 1101:211.

¹⁷⁶ See, e.g., *Ryan v. Butera, Beausang, Cohen & Brennan, P.C.*, 193 F.3d 210, 218 (3d Cir. 1999) (noting that a lawyer’s ethics may be questioned for failure to return the “unearned” portion of the fee); see also *In re Cooperman*, 633 N.E.2d 1069, 1072 (N.Y. 1994) (noting that “the use of a special nonrefundable retainer fee agreement clashes with public policy”).

¹⁷⁷ See *supra* text accompanying note 7.

¹⁷⁸ See *id.* While Wilson Sonsini’s equity in WebVan may have appreciated by \$51 million on its first day of trading, it was likely prohibited from realizing these gains because of lock-up requirements. In fact, if Wilson Sonsini continued to hold the stock on July 9, 2001, the date on which WebVan announced that it would file for bankruptcy, the value of its two million shares would have been worth just \$120,000. WebVan closed at \$0.06 per share on Friday, July 6, 2001. See *Webvan Shuts Down*, at <http://cnfn.cnn.com/2001/07/09/technology/webvan/index.htm>. WebVan’s initial public offering took place in November 1999 at a price of \$15.00 per share. *Id.*

standard hourly rates. This practice can be justified on the basis that the equity represents a financing charge for deferring collection of the client's account until its liquidity event. Furthermore, even when the start-up client does not wish to give any equity to the law firm and is willing to pay on a regular basis, the firm may argue that its willingness to associate with the start-up provides the start-up with indirect benefits (such as a positive signal to the marketplace) and that the firm should be compensated accordingly.

The level of sophistication of the start-up's management team and outside advisors is also relevant in determining whether it made a fully informed decision in offering equity. One cannot generalize whether technology start-ups as a class are sophisticated or unsophisticated. As a starting point, the age, education, and business experience of the start-up's management team would have to be assessed. A technology start-up can involve a group of twenty-somethings or it can be comprised of serial entrepreneurs or other individuals who have left traditional old-economy jobs in banking, consulting, or law.¹⁷⁹

A comparison of the equity arrangement in question with the equity arrangements of other law firms of comparable skill and reputation is another factor to consider. This analysis, however, should be used with extreme caution and should not be viewed as determinative. As has been noted in the tort context, an entire industry may fall below the reasonable standard of care.¹⁸⁰ In a market which is not fully competitive, the prices that other law firms charge for similar services may only reflect what the market will bear and not what would be considered reasonable. With this caveat aside, if most law firms are charging their standard hourly rates in addition to one percent of the client's equity, then a law firm that is charging standard hourly rates along with a more significant equity stake, for example, five percent of the client's equity, may have its fees scrutinized as being unreasonable.¹⁸¹

It is also possible that subsequent events can make an equity billing arrangement unreasonable. Generally speaking, the reasonableness of an arrangement should be evaluated as of the time at which it

¹⁷⁹ Serial entrepreneurs can be defined as individuals who have brought many ideas to fruition and are working on their latest venture. Because of the recent technology meltdown, a number of the managers who left old-economy jobs for start-ups are returning to their previous existences. This phenomena has been coined "b2b" for "back to banking" and "b2c" for "back to consulting."

¹⁸⁰ See *Helling v. Carey*, 519 P.2d 981, 983 (Wash. 1974), *superseded by statute as stated in* 579 P.2d 374, 376 (Wash. Ct. App. 1978); see also *The T.J. Hooper*, 60 F.2d 737, 740 (2d Cir. 1932) (Hand, J.) (noting that "a whole calling may have unduly lagged in the adoption of new and available devices").

¹⁸¹ There may be legitimate reasons for a higher fee, if, for example, the law firm in question has such a prestigious reputation that the value of reputational bonding provided by it is unusually valuable.

is entered.¹⁸² Even if a one percent equity interest ends up having a value of \$1 million on the first day of public trading, as a general matter, reasonableness should still be assessed at the time the parties made the arrangement. However, if a law firm takes equity and charges standard hourly rates as a premium for the introduction to venture capitalists, for example, then what if the start-up client, subsequent to entering into the equity arrangement with the law firm, arranges venture capital financing independent of the firm's assistance? Could the equity fee be considered unreasonable under these circumstances because the contingency upon which the firm was supposed to receive the equity fee did not occur? If the equity is compensation not for the introduction to financing sources, but for the additional risk that the firm bears by dealing with a client that is of lower financial quality than that with which it normally deals, then, even if one percent turns out to be \$1 million, it is harder to make the argument that the equity interest was unreasonable. Similarly, if the equity is compensation for the firm's reputational bonding services, then the value provided by it is much more indirect. In other words, even if the firm's contacts did not provide the client with financing, its association with the start-up was of great assistance in the securing of financing. Given that reasonableness will depend upon the purpose for which equity was issued to the law firm, it is in the interests of both firms and their clients to specify in a written contract the exact bases for its issuance and under what circumstances, if any, it must be returned.¹⁸³

B. Business Transactions Between Lawyers and Clients

The acquisition of a client's stock by a lawyer in lieu of cash is considered a business transaction between a lawyer and her client that is governed by fiduciary obligations and various rules adopted by bar associations.¹⁸⁴ Lawyers are held to high standards by courts when they review business transactions with clients. In *In re Lowther*, the Missouri supreme court stated that becoming personally involved with the affairs of clients "is an area wrought with pitfalls and traps and the Court is without choice other than to hold the attorney to the highest of standards under such circumstance."¹⁸⁵

¹⁸² See NYC Bar Formal Opinion, *supra* note 173.

¹⁸³ Law firms would likely insist on listing all of the above-noted factors in a written fee arrangement, given that they are so open-textured.

¹⁸⁴ See Geraghty, *supra* note 122, at 21; see also ABA Opinion on Equity Billing, *supra* note 169.

¹⁸⁵ 611 S.W.2d 1, 2 (Mo. 1981) (per curiam). Some cases, such as *In re Neville*, 708 P.2d 1297 (Ariz. 1985), come close to suggesting that any substantial transaction between a lawyer and her client may be voidable at the client's option. HAZARD ET AL., *supra* note 105, at 565.

ABA Model Rule 1.8 permits business transactions between lawyers and clients provided that: (1) the transaction and its terms are fair and reasonable to the client; (2) the transaction has been fully disclosed in writing; (3) the client has been given a reasonable opportunity to seek independent legal advice; and (4) the client consents to transaction in writing.¹⁸⁶ Courts have sanctioned lawyers for not complying with the requirements of ABA Model Rule 1.8 in a variety of business dealings with clients.¹⁸⁷

The current commentary following ABA Model Rule 1.8 makes no reference to equity billing. The Ethics 2000 Commission of the ABA has proposed amendments to Rule 1.8 to acknowledge and regulate the growing trend toward equity billing.¹⁸⁸ The proposed commentary section on Rule 1.8 would clarify that accepting equity in lieu of cash is a business transaction which must meet written disclosure, consent, and fairness requirements.¹⁸⁹ The Ethics 2000 Commission has proposed to amend Rule 1.8 to require that a lawyer not only give his client the opportunity to seek independent legal advice, but also must advise the client in writing to do so.¹⁹⁰ Also, the client's consent must be "informed" and relate not only to the transaction but also to "the lawyer's role in the transaction."¹⁹¹

¹⁸⁶ MODEL RULES OF PROF'L CONDUCT R. 1.8 (2000). LSUC's rule on conflicts of interest, although more generally framed than ABA Model Rule 1.8, is applicable to equity billing transactions. LSUC Rule 2.04(3) provides: "A lawyer shall not act or continue to act in a matter when there is or is likely to be a conflicting interest unless, after disclosure adequate to make an informed decision, the client or prospective client consents." See LSUC RULES OF PROF'L CONDUCT R. 2.04(3) (2001), available at http://www.lsuc.on.ca/services/RulesProfCondpage_en.jsp (last visited Oct. 3, 2001). A conflict of interest is defined as an interest "that would be likely to affect adversely a lawyer's judgment on behalf of, or loyalty to, a client or prospective client." *Id.* R. 2.04(1)(a). The commentary following Rule 2.04(1) states that a conflict of interest would exist if a lawyer, a family member, or a law partner had a personal financial interest in a client's affairs. See *id.* cmt. Lawyers who call LSUC's Practice Advisory Service are informed that equity billing is not contrary per se to the Rules of Professional Conduct, but are advised to follow several safeguards to avoid a conflict of interest. Telephone Interview with Professional Advisory Services of LSUC (May 24, 2000). It recommends that the billing agreement be in writing and that it expressly state that legal services are being exchanged for shares. *Id.* The service also suggests that a negotiated value be assigned to the shares in the agreement so that at the time they are accepted in lieu of cash, there is no dispute as to their worth. *Id.* In addition, lawyers are advised to inform their clients to seek independent legal advice on the merits of the billing arrangements. *Id.*

¹⁸⁷ See, e.g., *In re Cordova-Gonzalez*, 996 F.2d 1334 (1st Cir. 1993) (disbarring a lawyer for borrowing money from a client without disclosing ownership of property pledged as collateral and bankruptcy court's jurisdiction over collateral); *Fla. Bar v. Loebel*, 526 So. 2d 65 (Fla. 1988) (disbarring attorney for use of client funds to satisfy personal obligations and failure to reimburse client); HAZARD ET AL., *supra* note 105, at 562-65.

¹⁸⁸ See MODEL RULES OF PROF'L CONDUCT R. 1.8 (Discussion Draft 2000), available at http://www.abanet.org/cpr/e2k-report_home.html.

¹⁸⁹ See *id.* cmt.

¹⁹⁰ See *id.* R. 1.8.

¹⁹¹ *Id.*

The ABA Opinion on Equity Billing notes that a transaction should not be viewed automatically as being "fair and reasonable to the client" under Rule 1.8(a) even if a fee is found to be "reasonable" under Rule 1.5(a).¹⁹² The Opinion provides that to grant full disclosure consistent with Rule 1.8(a), a lawyer must explain the potential effects of the equity billing arrangement on the client-lawyer relationship including the potential for conflicts between the lawyer's self-interest and his client's best interests.¹⁹³ The opinion also states that a lawyer must advise his client in writing to seek the advice of independent legal counsel and must give his client a reasonable opportunity to do so.¹⁹⁴

A billing agreement may be unenforceable by a law firm if it has not strictly complied with the procedural requirements discussed above. In *Passante v. McWilliam*,¹⁹⁵ Passante, a lawyer, arranged for a \$100,000 loan that was essential to the survival of his client, the Upper Deck Company.¹⁹⁶ Upper Deck's board of directors agreed to compensate Passante by giving him three percent of the company's equity.¹⁹⁷ The company became successful and Passante's shares became worth \$33 million, but the board refused to honor the agreement.¹⁹⁸ The trial judge set aside a jury verdict of \$33 million and the dismissal was upheld on appeal on the grounds that Passante did not advise his client of the need for independent legal advice.¹⁹⁹ The court reasoned that the board might have negotiated a flat finder's fee for Passante had he advised them to obtain independent legal advice.²⁰⁰

Passante highlights that even though an equity billing arrangement may be fair and reasonable in substance to a client, courts are willing to impose penalties on law firms that do not comply with procedural requirements in order to create the proper incentives for compliance by other law firms.²⁰¹

On the issue of independent legal advice, it is significant to note that the ethical rules do not require the client to obtain independent

¹⁹² ABA Opinion on Equity Billing, *supra* note 169, at 1101:209.

¹⁹³ *Id.* at 1101:210.

¹⁹⁴ See MODEL RULES OF PROF'L CONDUCT R. 1.8 (1983); see also 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 (1999) (analyzing this ethical issue).

¹⁹⁵ 62 Cal. Rptr. 2d 298 (Cl. App. 1997).

¹⁹⁶ See *id.* For an analysis of the case, see HAZARD ET AL., *supra* note 105, at 562-63.

¹⁹⁷ *Passante*, 62 Cal. Rptr. 2d at 298-99.

¹⁹⁸ *Id.* at 299.

¹⁹⁹ *Id.* at 302.

²⁰⁰ See *id.*

²⁰¹ See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989).

legal advice, only that his lawyer advise him to do so.²⁰² The reality is that many technology start-up clients are financially constrained from obtaining independent legal advice. If the client does go to another law firm, it will also have to give that law firm equity, creating a never-ending domino effect due to which the client does not actually end up receiving what the ethical rules would consider to be independent legal advice.

There is also the problem of hindsight bias. Even though ethical rules require that the fairness and reasonableness of the transaction between the lawyer and client be assessed *ex ante*—at the time the parties entered into the arrangement and with the information they had at the time—judges will often take into account the actual large payout to the lawyer without taking into account the extremely low probability of its occurrence.²⁰³

Ethical and fiduciary rules for business transactions with clients are not inconsistent with the statutory provisions and common-law principles governing self-dealing transactions between other types of fiduciaries and the individuals or entities to whom they owe duties. For example, similar rules currently exist in the context of directors who engage in self-dealing transactions with corporations on whose boards they sit.²⁰⁴ While the strict Anglo-American common-law rule prohibited directors from entering into such transactions (even if the transactions were fair to the corporation), the current general rule recognizes the potential gains that may arise from such contracts. As such, the current rule allows business transactions to be consummated between directors and corporations if the director makes full disclosure of his interest in the transaction, and either a majority of disinter-

²⁰² See MODEL RULES OF PROF'L CONDUCT R. 1.8(a) (2000).

²⁰³ Similar problems have arisen when judges have reviewed the large contingency fees lawyers have received from the settlement of tobacco litigation. See, e.g., *State v. Am. Tobacco Co.*, 772 So. 2d 417 (Ala. 2000).

²⁰⁴ Justice Cardozo pronounced the classic formulation of the obligations of corporate fiduciaries in *Meinhard v. Salmon*:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

164 N.E. 545, 546 (N.Y. 1928) (Cardozo, C.J.) (citation omitted). For an example of a more permissive rule, see N.Y. BUS. CORP. LAW § 713(a) (McKinney 1986), which states that "[n]o contract or other transaction between a corporation and one or more of its directors . . . shall be either void or voidable" solely on the basis of a conflict of interest.

ested directors or shareholders approve the transaction, or the terms of the transaction are fair and reasonable to the corporation.²⁰⁵

C. Continuing Conflicts of Interest Between Lawyers and Clients

The general rule on conflicts of interest, set out in ABA Model Rule 1.7(b), states that a lawyer "shall not represent a client if the representation of that client may be materially limited by . . . the lawyer's own interests, unless: (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation."²⁰⁶

In general, equity billing can be seen as aligning the interests of law firms and their clients. The ABA Opinion on Equity Billing provides that "[a] lawyer's representation of a corporation in which she owns stock creates no inherent conflict of interest under Rule 1.7" because "management's role primarily is to enhance the business's value for the stockholders. . . . [and t]he lawyer's legal services in assisting management usually will be consistent with the lawyer's stock ownership."²⁰⁷ The benefits that arise from the convergence of lawyers' and clients' interests have already been discussed in detail in Part I.²⁰⁸

However, circumstances may arise where equity billing could lead to a conflict between a client's best interests and his lawyer's self-interest. In other words, equity billing could impair a lawyer's ability to exercise independent professional judgment. As one lawyer stated: "A lawyer holding stock in a client company . . . could be tempted to discourage the company from taking a necessary step because it might hurt the stock's prospects."²⁰⁹ Yet another said: "[a]s a lawyer you might be thinking to give cautious advice. As an entrepreneur you might be more of a risk taker."²¹⁰ Sullivan & Cromwell, second only to Wilson Sonsini in the number of IPOs that it handled in 1999, ref-

²⁰⁵ See AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 5.02 (1994). Most states have statutory provisions governing self-dealing transactions between directors and corporations. Some states have slightly different requirements for self-interested contracts to pass scrutiny. See, e.g., N.Y. BUS. CORP. LAW § 713 (requiring disclosure of any financial interest and approval by a disinterested board or shareholders).

²⁰⁶ MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (2000). LSUC Rule 2.04(3) contains a similar provision. See *supra* note 186.

²⁰⁷ ABA Opinion on Equity Billing, *supra* note 169, at 1101:212.

²⁰⁸ Two practitioners even go as far as suggesting that if a lawyer is unwilling to invest his own money in the start-up, then the investment of time, which is money to a lawyer, should itself be questioned. See Katz & Savarino, *supra* note 61.

²⁰⁹ Sean Somerville, *Lawyers Stocking Up on Payday*, SUN (Baltimore), Nov. 7, 1999, at 1D.

²¹⁰ See Goodman, *supra* note 75.

uses to hold stock in clients, and cites potential conflicts as the rationale for the policy.²¹¹ Several possible conflicts are highlighted below.

1. *Conflicts Between the Best Interests of the Corporation and Those of Minority Shareholders*

The doctrines of corporate law require that directors and officers act in the best interests of the corporation.²¹² This means not only acting in the best interests of a majority of shareholders but the corporation as a whole. Thus, when a lawyer advises the directors and officers of a corporation, she must give advice that is in the best interests of the corporation as a whole. An argument can be made that by holding a minority interest in a corporation, a lawyer's judgment may be compromised in favor of the interests of the minority shareholders to the detriment of majority shareholders or the corporation as a whole.

2. *Conflicts Between Shareholders and Creditors*

The judiciary has also developed the principle that directors owe fiduciary duties to a corporation's creditors when the business nears insolvency, and has recognized that directors may engage in opportunistic behavior at such times to the detriment of creditors.²¹³ In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*,²¹⁴ Chancellor Allen wrote that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."²¹⁵ In an often-quoted footnote to the judgment, he continued, "[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior."²¹⁶ Conceivably, a law firm holding a minority equity interest in a client that is near insolvency may face a conflict between its self-interest as a shareholder and its duty to advance the superior legal interests of creditors.

²¹¹ See Osborne, *supra* note 35, at 83.

²¹² See *Dodge v. Ford Motor Co.*, 170 N.W. 668, 681-82 (Mich. 1919); see also AM. LAW INST., *supra* note 205, § 2.01 (a) ("[A] corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.") (citation omitted); N.Y. BUS. CORP. LAW § 102(4) (McKinney 1986) (defining "corporation" as a "corporation for profit").

²¹³ See, e.g., *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982) ("[W]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors."); *Clarkson Co. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981) (noting the policy of preserving the assets of insolvent corporations for their creditors).

²¹⁴ Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. 1991).

²¹⁵ *Id.* at *34.

²¹⁶ *Id.* at *36 n.55.

3. *Conflicts Between Shareholders and Other Constituencies*

Corporate constituency statutes enacted in many states allow (and in some cases require) directors to consider the interests of constituencies other than shareholders when making decisions.²¹⁷ Although the State of Delaware has not enacted such a statute, judicial decisions rendered by the Delaware courts allow boards to consider the interests of non-shareholder stakeholders so long as the non-shareholder interests are not inconsistent with the interests of shareholders.²¹⁸ Thus, directors may have a reasonable regard for the interests of employees, consumers, suppliers, and the local community, for example. One could argue that in situations in which a lawyer is also a shareholder, she will not be able to consider the interests of other stakeholders properly if it is detrimental to her own position as a shareholder.

4. *Conflicts Between Majority and Minority Shareholders in Closely Held Corporations*

A law firm that has an equity interest in a client when negotiating a shareholders' agreement may also find itself in a conflict-of-interest situation. It is not uncommon for minority shareholders in private corporations to negotiate exit options for themselves with the majority shareholder. A law firm that holds a five-percent equity interest in a client that wants to negotiate an exit option by requiring the majority shareholder to buy its stake may find itself in a conflict between its self-interests and advising the majority shareholder on its best interests.

5. *Conflicts in Dealings with Venture Capitalists*

Other conflicts may also arise in the context of start-ups that obtain financing from venture capitalists. Lawyers holding equity in their clients may, as a general matter, negotiate less rigorously and

²¹⁷ See KLEIN & COFFEE, *supra* note 60, at 195 (explaining that a number of states have enacted statutes that allow consideration of non-shareholder interests). For a discussion of to whom the fiduciary duties of corporate managers run, see E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932). Cf. A.A. Berle, Jr., Note, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932). Since the early 1980s, several states have enacted shareholder statutes that allow or require directors to consider the interests of non-shareholder stakeholders in making decisions. See generally Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992) (examining the debate about the proper interpretation of corporate constituency statutes); John C. Alexander et al., Note, *Nonshareholder Constituency Statutes and Shareholder Wealth: A Note*, 21 J. BANKING & FIN. 417 (1997). For a lucid criticism of stakeholder statutes, see Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991).

²¹⁸ See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986) ("A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders.").

give marginally more favorable terms to venture capitalists to ensure that the client obtains financing. Alternatively, law firms may be tempted to withhold adverse financial information from venture capitalists on the basis that the revelation may terminate the deal.²¹⁹

6. *Conflicts with Serial Entrepreneurs*

A law firm representing a technology start-up founded by serial entrepreneurs (individuals who in the past have developed technology-related ideas, brought them to a liquidity event, cashed out, and have now started a new project) may find itself in a conflict when it negotiates with venture capitalists over the terms of the entrepreneurs' continued association with the start-up. It is often in a company's best interest to maintain a longer rather than shorter association with its founders. The firm and entrepreneurs, however, may find it in their self-interests to negotiate a more limited association so that the entrepreneurs can be free to work on their next venture, in which the firm expects involvement and therefore an equity interest.

7. *Conflicts in Representation of Competitors*

Lawyers who engage in equity billing may be constrained in representing competitors of equity-billed clients.²²⁰ Under circumstances such as those described above, compliance with ABA Model Rule 1.7(b) requires a lawyer to self-evaluate her ability to subordinate her self-interest in favor of her client's best interests.²²¹ Even after this self-assessment, a lawyer must obtain her client's informed consent.

8. *Comparison of Equity Billing with Compensating Managers and Directors with Equity*

Notably the potential conflicts indicated above are not dissimilar from the conflicts that can arise when corporations compensate managers and directors through stock. A significant component of the compensation of managers of North American corporations includes stock grants and stock options in addition to a cash base salary.²²² Similarly, outside directors of many corporations in the United States are also compensated through stock grants and stock options of the

²¹⁹ See ABA Opinion on Equity Billing, *supra* note 169, at 1101:212.

²²⁰ See, e.g., *Cash? How Old Economy*, *supra* note 10, at 68. Stewart Alsop, a general partner at New Enterprise Associates, sees no conflict-of-interest problem with lawyers investing in start-ups, but does warn against representing a company and its competitor. See Neidorf, *supra* note 37, at 37.

²²¹ ABA Opinion on Equity Billing, *supra* note 169, at 1101:213.

²²² See Gary Strauss, *Corporate Directors Reaping More Stock*, *Cash*, USA TODAY, June 8, 1999, at B1.

companies on whose boards they sit.²²³ The National Association of Corporate Directors' Blue Ribbon Commission Report on Director Compensation recommended, as one of its best practices, "paying directors exclusively in cash and equity, with equity comprising a significant portion of overall director pay."²²⁴

The benefit of such arrangements is that stock-based compensation aligns the interests of managers and directors with those of shareholders.²²⁵ However, managers and outside directors who hold minority equity positions may find themselves in conflict-of-interest situations similar to those faced by law firms. While these conflicts may exist, the relevant issue is how much conflict should be accepted, or at least tolerated, in light of the benefits of managers, directors, and law firms holding stock in the companies they work for or represent.²²⁶

IV

LAWYERS AS GATEKEEPERS TO THE SECURITIES MARKET

The purpose of securities regulation is to protect investors and ensure the efficient functioning of capital markets.²²⁷ In this context, the securities lawyer specifically is perceived to play a special "gatekeeping" role in the enforcement of securities laws. For example, the SEC itself has repeatedly noted that "the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders."²²⁸ One SEC Commissioner even stated on the record that "in securities matters (other than those where advocacy is clearly proper) the attorney will have to function in a manner more akin to that of the auditor than to that of an advocate."²²⁹ The courts have agreed: "In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than

²²³ See Gary Strauss, *Forget Brass Rings—Execs Grab for Gold*, USA TODAY, June 15, 2001, at B1.

²²⁴ Dan R. Dalton & Catherine M. Daily, *Directors and Shareholders as Equity Partners? Handle with Care!*, COMPENSATION & BENEFITS REV., Jan. 1, 1999, at 73, 75. In 1990, only 6% of companies included stock as part of the compensation for directors whereas, in 1997, 84% of companies granted stock-based compensation to their directors. *Id.*

²²⁵ See KEVIN J. MURPHY, EXECUTIVE COMPENSATION 54 (Soc. Sci. Research Network, Working Paper, 1998), available at <http://papers.ssrn.com/sol3/delivery.cfm/99051113.pdf?abstractid=163914>.

²²⁶ For an analysis of auditor independence, see Lawrence J. Fox, *Dan's World: A Free Enterprise Dream; An Ethics Nightmare*, 55 BUS. LAW. 1533 (2000).

²²⁷ DAVID JOHNSTON & KATHLEEN DOYLE ROCKWELL, CANADIAN SECURITIES REGULATION 2 (2d ed. 1998); LOSS & SELIGMAN, *supra* note 64; ALAN B. PALMITER, SECURITIES REGULATION: EXAMPLES & EXPLANATIONS (1998); LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES REGULATION 3 (4th ed. 1999).

²²⁸ LOSS & SELIGMAN, *supra* note 64, at 1199.

²²⁹ *Id.* at 1200; see also PALMITER, *supra* note 227, at 371 ("Securities lawyers act as the conscience of the securities industry, structuring and channeling client desires to fit regulatory prescriptions. . . . But, just as the superego carries guilt, the lawyer's role as conscience carries responsibility.").

the chisel or the crowbar.”²³⁰ Given this pervasive perception, one must ask whether accepting equity in a client impairs a lawyer’s ability to act as a gatekeeper to the securities market. Examination of the economic theory of gatekeeping, as well as the relation between securities regulation and its enforcement mechanisms, permits a meaningful analysis of this issue.

A. Economic Theory of Gatekeeping

There are many ways to detect, monitor, and punish wrongdoing. Using the typical enforcement strategy of first-party liability, the initiator of the wrongdoing is punished, resulting in deterrence and/or internalization of the costs of the misconduct.²³¹ When this strategy is ineffective because, for example, wrongdoers are not sufficiently capitalized to pay the large fines imposed on them and thus do not internalize their wrongdoing, third-party liability may supplement it.²³²

Third-party liability is criminal or tort liability which is imposed on a party who, although not an initiator of wrongdoing, is nevertheless able either to deter it or force the internalization of its costs.²³³ Third-party liability can come in the form of strict or duty-based liability. Strict third-party liability regimes include employers’ vicarious liability for employees’ tortious or criminal misconduct under the doctrine of respondeat superior.²³⁴ Duty-based third-party liability regimes include criminal liability for aiding and abetting wrongdoing and liability for negligently failing to detect misconduct.²³⁵

A gatekeeping regime is an *ex ante* indirect enforcement method. “Gatekeeping liability” is defined as a regime that imposes a duty on a private third party to monitor for misconduct and to with-

²³⁰ United States v. Benjamin, 328 F.2d 854, 863 (2d Cir. 1964) (Friendly, J.).

²³¹ See Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984); Kraakman, *supra* note 11.

²³² See Kraakman, *supra* note 231; Kraakman, *supra* note 11.

²³³ See Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523 (1984); Kraakman, *supra* note 11.

²³⁴ See generally Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994) (analyzing corporate criminal liability rules); C.Y. Cyrus Chu & Yingyi Qian, *Vicarious Liability Under a Negligence Rule*, 15 INT’L REV. L. & ECON. 305 (1994) (arguing for a lower level of vicarious liability); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984) (developing economic principles to analyze vicarious liability); Note, *An Efficiency Analysis of Vicarious Liability Under the Law of Agency*, 91 YALE L.J. 168 (1981) (analyzing vicarious liability).

²³⁵ See Kraakman, *supra* note 11. Whistleblowing is another liability strategy that could be imposed on third parties. See generally Robert Howse & Ronald J. Daniels, *Rewarding Whistleblowers: The Costs and Benefits of an Incentive-Based Compliance Strategy*, in CORPORATE DECISION-MAKING IN CANADA 525 (Ronald J. Daniels & Randall Morck eds., 1995); William E. Kovacic, *Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting*, 29 LOY. L.A. L. REV. 1799 (1996).

hold support once misconduct is detected.²³⁶ The wrongdoer cannot misbehave without the gatekeeper's involvement.²³⁷

Many conditions must exist for an effective gatekeeping regime. First, the wrongdoer needs to be screened through a gate.²³⁸ Some entry point must exist through which he *must* pass in order to commit the misconduct. If the wrongdoer can find another route whereby the gatekeeper is avoided, then this regime will be ineffective. Second, the gatekeeper must be the only individual who is able to open the latch on the gate. The wrongdoer must not be able to open it on his own. Third, the gatekeeper must have some influence over the wrongdoer.²³⁹ If successive gatekeepers can be hired and fired at the will of the wrongdoer until a gatekeeper is found who does not detect or is willing to ignore the misconduct, the gatekeeping regime will be ineffective. For example, securities laws attempt to prevent opinion shopping by registrants for this purpose. When an auditor resigns or is dismissed, securities laws require that the registrant disclose whether, in the last two years, the auditor and the registrant had any disagreements about the registrant's financial affairs and whether the auditor's report contained adverse or qualified opinions.²⁴⁰ Fourth, and perhaps most important, gatekeepers must be outsiders who value their reputations and professional duties more than any potential gain they may derive from the wrongdoer's misconduct.²⁴¹

Outsider status is so crucial because only then can a combination of economic and non-economic incentives prevent gatekeepers from involving themselves in misconduct.²⁴² Because the wrongdoer is only one of the gatekeeper's many clients, the benefit gained by assisting the wrongdoer will generally be outweighed by the threat of liability and harm to the gatekeeper's reputation, because either would result in a loss of income from other clients.²⁴³ This factor is the most important for an effective gatekeeping regime:

Despite their disparate roles, moreover, it is easy to see why outside directors, accountants, lawyers, and underwriters are likely targets for a gatekeeper liability strategy. . . . [M]ost important, each is an *outsider* with a career and assets beyond the firm. At the very least, these potential gatekeepers face incentives that differ sys-

²³⁶ Kraakman, *supra* note 231, at 889.

²³⁷ *See id.* at 891.

²³⁸ *See id.*

²³⁹ *See id.* at 890.

²⁴⁰ *See id.* at 892 n.105.

²⁴¹ *See id.* at 892-93. For more on the role of reputation, rather than liability, in creating a gatekeeping regime, see Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925 (1999).

²⁴² *See* Kraakman, *supra* note 231, at 891.

²⁴³ *See id.*

tematically from those of inside managers; in the usual case, they are likely to have less to gain and more to lose from firm delicts than inside managers. Indeed, gatekeeper liability can jeopardize not only the personal interests of individual lawyers and accountants, but also the larger interests and reputations of their respective firms or even of their entire professions.

. . . Outsiders will be more reluctant than managers to risk personal liability on the firm's behalf. Thus, if these gatekeepers can detect offenses, it will be difficult—or at least very costly—to entice them into a conspiracy.²⁴⁴

Alternatively, assisting the wrongdoer may simply be wrong according to the gatekeeper's moral, ethical, or professional code. In this context, it is not surprising that the roles that lawyers play in a wide variety of contexts have attracted much attention from scholars interested in the economic theory of gatekeeping.²⁴⁵ Professor Gilson has noted that litigators act as gatekeepers for clients who may wish to pursue frivolous litigation.²⁴⁶ As another example, Professors Jackson and Wilkins, writing separately about the savings and loan crisis, have noted that lawyers acted as gatekeepers for clients who wanted to thwart government investigation.²⁴⁷ As yet another example, Professor Kraakman has noted that corporate and securities lawyers act as gatekeepers when clients attempt to engage in illegal transactions that require a legal opinion letter as a condition of closing.²⁴⁸ The sheer diversity of literature on the subject reflects the breadth of opportunities that lawyers have to monitor and deter misconduct on the part of others.

B. Gatekeepers in Securities Markets

Outside directors, accountants, and lawyers act as gatekeepers to the securities market.²⁴⁹ Each kind of gatekeeper has its own "key":

²⁴⁴ *Id.* (footnote omitted). Item 304 of Form 8-K attempts to deter "opinion shopping." See LOSS & SELIGMAN, *supra* note 64, at 143–44.

²⁴⁵ For gatekeeping in the context of multidisciplinary firms, see Peter C. Kostant, *Breeding Better Watchdogs: Multidisciplinary Partnerships in Corporate Legal Practice*, 84 MINN. L. REV. 1213 (2000). For the role of lawyers as gatekeepers in the context of contingency fees for criminal cases, see Pamela S. Karlan, *Contingent Fees and Criminal Cases*, 93 COLUM. L. REV. 595 (1993); and David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 801 (1992).

²⁴⁶ See Gilson, *supra* note 48.

²⁴⁷ See Howell E. Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions*, 66 S. CAL. L. REV. 1019 (1993); David B. Wilkins, *Making Context Count: Regulating Lawyers after Kaye, Scholer*, 66 S. CAL. L. REV. 1145 (1993).

²⁴⁸ See Kraakman, *supra* note 11, at 58.

²⁴⁹ With respect to first-party liability, securities laws can impose significant criminal and civil liability on issuers of securities. Section 17(a) of the Securities Act of 1933, the main anti-fraud provision, prohibits the use of "any device, scheme, or artifice to defraud" in connection with the offer or sale of securities. 15 U.S.C. § 77q (1994). Issuers of securities are subject to criminal and civil liability for fraud under Rule 10b-5, civil liability in the

outside directors must sign off on securities transactions,²⁵⁰ accountants must certify financial statements,²⁵¹ and lawyers are called upon to provide legal opinions.²⁵² Many securities transactions require a lawyer's legal opinion that the transaction does not violate securities laws.²⁵³ A brief account of secondary liability imposed on lawyers as third-party gatekeepers in the securities market is set out below.

1. *Aiding and Abetting Liability*

Lawyers and other gatekeepers who advise "securities swindlers" in relation to a securities offering may be subject to criminal and civil aiding-and-abetting liability under Rule 10b-5.²⁵⁴ In *SEC v. National Student Marketing Corp.*,²⁵⁵ the SEC took the position that the lawyers in question should be subject to liability for failing to stop a merger from proceeding even though the accountants had advised them that the proxy documents contained misleading financial information.²⁵⁶ In the face of the false financial information, the lawyers for each party to the transaction gave favorable legal opinions that the registrant had not violated any federal or state laws to the knowledge of counsel.²⁵⁷ The court held that the lawyers were liable for aiding and abetting the fraud of the registrant.²⁵⁸

case of fraudulent registration statements under section 11, civil liability for noncompliance with registration requirements under section 12(a)(1), and civil liability for a misstatement or omission in connection with the offer or sale of securities in section 12(a)(2). See SODERQUIST & GABALDON, *supra* note 227, at 270, 283, 300-03.

²⁵⁰ See SODERQUIST & GABALDON, *supra* note 227, at 102.

²⁵¹ *Id.*

²⁵² *Id.*

²⁵³ See PALMITER, *supra* note 227, at 371.

²⁵⁴ See 17 C.F.R. § 240.10b-5 (2001). The rule states, in pertinent part:

It shall be unlawful . . .

(a) [t]o employ any device, scheme, or artifice to defraud,

(b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or

(c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

²⁵⁵ 457 F. Supp. 682 (D.D.C. 1978).

²⁵⁶ *Id.* at 712-14.

²⁵⁷ See Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221, 236 n.61 (1995). The SEC took the position that, in addition to not participating in the misconduct and trying to dissuade the client from committing the wrong, lawyers must inform the SEC of the client's intention to violate securities laws. See *id.* at 233. The SEC's position is starkly different from lawyers' responsibilities under professional ethical rules. The ABA Model Rules permit (rather than require) a lawyer to disclose client confidences only when the lawyer believes imminent death or substantial bodily harm is likely. *Id.* at 227 n.20.

²⁵⁸ See *Nat'l Student Mktg. Corp.*, 457 F. Supp. at 715.

In *Central Bank v. First Interstate Bank*,²⁵⁹ however, the U.S. Supreme Court rejected aiding-and-abetting liability for secondary participants in private 10b-5 actions.²⁶⁰ In a 5-4 decision, the Court held that Rule 10b-5 defendants must engage in actual fraudulent behavior, as opposed to simply providing secondary assistance.²⁶¹ The result of the decision is that Rule 10b-5 only reaches primary violators who make false or misleading statements that induce investors to trade to their detriment.²⁶²

Because *Central Bank* eliminates Rule 10b-5 liability for lawyers and other gatekeepers on the basis that they are secondary participants, some subsequent lower court decisions have recharacterized accountants, lawyers, and underwriters as primary violators for their role in drafting, editing, and reviewing disclosure documents that contain misrepresentations, so as to subject them to Rule 10b-5 liability.²⁶³

In addition, the Private Securities Litigation Reform Act of 1995 ("Reform Act")²⁶⁴ expressly authorizes the SEC to seek injunctive relief or monetary damages from those who aid or abet a Rule 10b-5 violator by knowingly giving "substantial assistance."²⁶⁵ Although the Reform Act does not define substantial assistance, older case law suggests that substantial assistance is established if investors relied on a securities professional's reputation when investing, and that professional remained silent in the face of the client's perpetration of fraud.²⁶⁶

2. *Section 11: Liability for Misrepresentations in Registration Statements*

Section 11 of the Securities Act²⁶⁷ creates a civil remedy for purchasers of a registered offering if they can prove a material misrepresentation or omission in the registration statement.²⁶⁸ Section 11 defendants, who are jointly and severally liable, include traditional primary wrongdoers such as issuers, chief executives, and financial and accounting officers.²⁶⁹ Significantly, section 11 also imposes lia-

²⁵⁹ 511 U.S. 164 (1994).

²⁶⁰ *Id.* at 177.

²⁶¹ *Id.*

²⁶² *See id.* at 191.

²⁶³ *See, e.g.,* *Dannenberg v. PaineWebber Inc. (In re Software Toolwork, Inc. Sec. Litig.)*, 50 F.3d 615, 629-30 (9th Cir. 1994) (holding that a reasonable factfinder could find that underwriters know or should have known of fraud in quarterly statements, and that accountant's letters to SEC made false statements).

²⁶⁴ Pub. L. 104-67, § 104, 109 Stat. 737, 757 (1995).

²⁶⁵ *See* 15 U.S.C. § 78t (1994 & Supp. V 1999).

²⁶⁶ *See* *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 652-53 (9th Cir. 1988).

²⁶⁷ 15 U.S.C. § 77k (1994 & Supp. V 1999).

²⁶⁸ PALMITER, *supra* note 227, at 164-71.

²⁶⁹ *Id.*

bility on third-party gatekeepers such as outside directors, underwriters, and experts including accountants, lawyers, and engineers who consented to the use of their opinion in the registration statement.²⁷⁰ Section 11 defendants need not be in privity with the purchasers of the securities and need not have created or distributed the misrepresentations.²⁷¹

*Escott v. BarChris Construction Corp.*²⁷² is the leading case on Section 11 due diligence defenses. Experts such as lawyers who prepare legal opinions with respect to the legality of a transaction and accountants who prepare or certify financial statements must show that they conducted a reasonable investigation and had reasonable grounds to believe that the portions of the registration statements upon which they commented were true and not misleading.²⁷³ Ignorance is not an excuse for experts.²⁷⁴ Non-experts such as directors can rely on an expert's opinion so long as they have no reason to believe the information is false.²⁷⁵

3. Section 12: Liability for Selling Unregistered Securities Without an Exemption

Under section 12(a)(1) of the Securities Act, a person who offers or sells unregistered securities without an available exemption can be held civilly liable.²⁷⁶ A purchaser may not recover from an issuer or any other seller unless there is a direct link between the purchaser and the seller, a requirement that potentially limits gatekeeper liability under section 12(a)(1).²⁷⁷ However, in *Pinter v. Dahl*,²⁷⁸ the Supreme Court held that Congress intended to define "seller" broadly for purposes of section 12(a)(1), and that those who solicit the purchasers of securities in any capacity can be held liable under the provision.²⁷⁹ Consequently, an underwriter, lawyer, accountant, or outside director who in any way solicits a purchase can be subject to section 12(a)(1) liability.

Section 12(a)(2) provides that any person who offers or sells a security by means of a material misstatement or omission is liable to the purchaser.²⁸⁰ While the *Pinter* Court explicitly stated that it was

²⁷⁰ *Id.*

²⁷¹ See SODERQUIST & GABALDON, *supra* note 227, at 245-46.

²⁷² 283 F. Supp. 643 (S.D.N.Y. 1968).

²⁷³ *Id.* at 682-84.

²⁷⁴ See *id.* at 683.

²⁷⁵ See PALMITER, *supra* note 227, at 166; SODERQUIST & GABALDON, *supra* note 227, at 246.

²⁷⁶ 15 U.S.C. § 771 (1994 & Supp. V 1999).

²⁷⁷ See SODERQUIST & GABALDON, *supra* note 227, at 270.

²⁷⁸ 486 U.S. 622 (1988).

²⁷⁹ *Id.* at 653; see also SODERQUIST & GABALDON, *supra* note 227 (analyzing *Pinter*).

²⁸⁰ SODERQUIST & GABALDON, *supra* note 227, at 283.

his client is engaged in "the substantial and continuing failure to meet disclosure requirements" violates professional standards if he does not take "prompt steps to end the cl[i]ent's non-compliance."²⁹¹ These steps could include counseling accurate disclosure, approaching the board of directors or other senior management, or resigning if the conduct becomes "extreme or irretrievable."²⁹²

C. Does Equity Billing Undermine the Gatekeeping Role of Lawyers?

The reason that gatekeepers are effective at detecting and controlling misconduct is that they are outsiders.²⁹³ Managers, who are insiders, have insufficiently diversified interests to act as effective gatekeepers. Their salaries, compensation, and careers are tied to the firm. Their personal success depends on the success of the firm. Managers may stand to gain handsomely if the firm gains by engaging in misconduct. On the other hand, outsiders such as law firms are diversified. They do not only act for one client. The law firm has a reputation and the individual lawyers comprising the firm have reputations and careers that have been built up over time. Relative to inside managers, outside lawyers have more to lose than to gain by participating in a client firm's misconduct.²⁹⁴

Taking equity in clients shifts the incentives of lawyers so that they become more aligned with the interests of their clients. If the effectiveness of outsiders and insiders as gatekeepers were placed along a spectrum, then by taking equity, lawyers move from being more like outsiders to being more like insiders. As a result, the securities market gatekeeping regime described above would be made marginally less effective by lawyers' taking equity in their clients.

However, two issues need to be addressed. First, are law firms truly outsiders even in the absence of equity billing? Second, how much of a difference does taking equity really make? On the issue of whether law firms are really outsiders, one can question how much law firms rely on individual clients for business. Even when paid in cash on an hourly basis, law firms are quite financially dependent on their clients for a future stream of income. They may already have the incentives to ignore or support client misconduct because they do not want to lose a particular client's business. While equity billing may push the lawyer's incentives toward complicity, the more important

²⁹¹ *Id.* at 84,172.

²⁹² PALMITER, *supra* note 227, at 372. On this point, professional rules of ethics require more drastic action by the lawyer. ABA Model Rule 1.16(a) mandates resignation of a lawyer who by continuing the representation would assist the client's fraud. MODEL RULES OF PROF'L CONDUCT R. 1.16(a) (2000).

²⁹³ See Kraakman, *supra* note 231, at 891.

²⁹⁴ See *id.*

not addressing the scope of the term “seller” for the purposes of section 12(a)(2),²⁸¹ many courts and commentators define the scope of the term similarly for the purposes of the two provisions,²⁸² and it is not unreasonable to expect that gatekeepers can potentially face liability under section 12(a)(2) as well. Furthermore, a due diligence defense similar to that available under section 11 is also available under section 12(a)(2).²⁸³

4. *Administrative Sanctions*

In addition to seeking injunctive action, pursuing civil penalties, and issuing cease-and-desist orders,²⁸⁴ the SEC also has the power to discipline securities professionals such as lawyers and accountants. The SEC Rules of Practice authorize the SEC to deny the privilege of appearing or practicing before it if it determines after a fair hearing that a person lacks qualifications, character, or integrity, or willfully violates or aids or abets a violation of federal securities laws.²⁸⁵ Notably, in actions imposing civil penalties, the SEC is also authorized to prohibit a person who has violated section 12(a)(1) from acting as an officer or director of a publicly held corporation.²⁸⁶

In *In re Carter*,²⁸⁷ the SEC sanctioned two Wall Street corporate lawyers who were advising a financially troubled client on the liquidation of its business.²⁸⁸ The lawyers failed to intervene when their client released overstated financial projections and positive press releases to the market but withheld information on the company’s financial problems.²⁸⁹ In its opinion, the SEC stated that “the effective implementation of investor safeguards mandated by the securities laws depends heavily on the performance of attorneys engaged in advising their clients.”²⁹⁰ The SEC further held that a lawyer who is aware that

²⁸¹ See *Pinter*, 486 U.S. at 642 n.20.

²⁸² See *Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, 634–35 (3d Cir. 1989) (stating that “[s]ince *Pinter*, other courts of appeals have addressed this question and have concluded that the *Pinter* approach to § 12(1) should be applied to § 12(2)” and citing cases).

²⁸³ *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1228 (7th Cir. 1980); *SODERQUIST & GABALDON*, *supra* note 227, at 296.

²⁸⁴ See *SODERQUIST & GABALDON*, *supra* note 227, at 244.

²⁸⁵ See 17 C.F.R. § 201.102(e) (2001); see also *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979) (upholding the SEC’s authority to make Rule 2(e)—now Rule of Practice 102(e)—an adjunct to assuring the integrity of its administrative procedures and the goal of protecting the investing public).

²⁸⁶ *SODERQUIST & GABALDON*, *supra* note 227, at 244.

²⁸⁷ Release No. 34-17597, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,145 (Feb. 28, 1981).

²⁸⁸ See *id.* at 84,150–64.

²⁸⁹ See *id.* at 84,165–69.

²⁹⁰ *Id.* at 84,173 (concurring and dissenting opinion by Commissioner Evans) (citing *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 536, 541–42 (2d Cir. 1973); *Felts v. Nat’l Account Sys. Ass’n*, 469 F. Supp. 54, 67 (N.D. Miss. 1978)).

question is how much the incentives will shift relative to existing incentives, which brings us to the second issue.

The extent of the shift will depend on how much of an equity interest is at stake. The greater the equity interest, the more the law firm's fortunes are tied to the success of the client. All else being equal, a five percent equity interest is more threatening to a gatekeeping regime than a one percent equity interest. However, not all clients are created equal. A five percent stake in Company A may actually shift the incentives less than a one percent stake in Company B if Company A has a market capitalization of \$100 million and Company B has a capitalization that is many times that. Additionally, not all law firms are created equal. An equity interest in a client has to be assessed in the context of the value of the law firm's reputation and its wealth and income from other clients. If a law firm and its lawyers have invested significant capital in creating a strong reputation, a greater equity stake will be required to shift their incentives.

Furthermore, in a public offering, both the issuer and the underwriter have legal representation, so that even if the issuer's counsel is holding equity in its client and not performing its gatekeeping role, counsel for the underwriter will continue to have unaltered incentives to perform its gatekeeping function.²⁹⁵ Presumably, the underwriter's counsel will exercise heightened scrutiny once the issuer's counsel's equity position is disclosed pursuant to Regulation S-K of the Securities Act ("Regulation S-K") which imposes an obligation on an issuer's law firm among others to disclose stock ownership in an issuer.²⁹⁶ While Item 403 of Regulation S-K requires that any beneficial ownership of more than five percent of any class of a company's voting stock be disclosed, most law firms that engage in equity billing will not exceed the five percent threshold partly because they have voluntarily imposed lower maximum limits.²⁹⁷ In addition, a law firm may be required to disclose its ownership interest under Item 509 of Regulation S-K which requires that any expert or counsel who is to receive a "substantial" interest in a company in connection with the offering provide a brief statement of the interest in the related prospectus.²⁹⁸

However, the quality of the mandated disclosure tends to be sparse. The WebVan prospectus, for example, includes language stating that "[a]s of the date of this prospectus, members of Wilson Sonsini Goodrich & Rosati, P.C. and an investment partnership composed

²⁹⁵ It has been stated that issuer's counsel is the quarterback in securities transactions, but when he is junior or inexperienced, underwriter's counsel picks up the slack. Loss & SELIGMAN, *supra* note 64, at 1199.

²⁹⁶ 17 C.F.R. § 229.10-1016 (2001).

²⁹⁷ *Id.* § 229.403.

²⁹⁸ Substantial is defined as greater than \$50,000 for the purposes of Item 509 of Regulation S-K. *Id.* § 229.509.

of current and former members of and persons associated with Wilson Sonsini Goodrich & Rosati, P.C. beneficially owned an aggregate of 2,068,944 shares of common stock."²⁹⁹ A strong argument can be made that the SEC should require heightened disclosure of the detailed terms of equity billing arrangements between law firms and their clients, similar to the extensive disclosure that is required of compensation of directors and officers and related-party transactions.³⁰⁰

V

THE REGULATION OF EQUITY BILLING

In light of the concern over whether the practice of equity billing will cause a significant ethical erosion within the legal profession, this Article will now address the relative merits of the preventative measures that society might use to limit or avoid the practice's more undesirable consequences. These preventative tools include an outright prohibition on equity billing, a limit on the amount of equity that a client could exchange for legal services, or a free-market approach that depends on heightened disclosure requirements for equity holdings by law firms. A brief discussion of the relative merits of each of these options follows. Even a brief analysis reveals that the third option, that of heightening disclosure requirements, is the most effective and practical solution to the equity billing dilemma, and best fits the realities of the current legal system.

A. Outright Prohibition

The most extreme proposal that can be put forth to regulate equity billing would be to prohibit it. An argument can be made that equity billing should be prohibited along the same lines that contingency fees are prohibited in divorce and criminal-law matters. However, it seems that a client who agrees to equity billing is not in the same position, generally speaking, as a family-law or criminal-law client, and that the benefits of equity billing outweigh the real or perceived threats to the public interest.

Alternatively, one could attempt to rationalize a rule prohibiting equity billing on the basis that the arrangement creates too great a conflict between lawyers' self-interests and clients' best interests. However, as Parts II and III conclude, lawyers are not necessarily more conflicted under equity billing arrangements than under more traditional billing models. In addition, a rule prohibiting equity billing

²⁹⁹ WEBVAN GROUP, INC., PROSPECTUS, Form 424(b)(1), at 65 (Registration No. 333-84703, filed Nov. 4, 1999), available at <http://www.sec.gov/Archives/edgar/data/1092657/0000891618-99-004914.txt>.

³⁰⁰ See 17 C.F.R. § 229.402 (2001).

would be inconsistent with the rules and principles governing relationships between other types of fiduciaries and the individuals or entities for whose benefit they act, for example, directors and corporations.³⁰¹

An alternative policy basis for prohibiting equity billing is that it undermines the gatekeeping role traditionally performed by securities lawyers. While the analysis in Part IV above concludes that a securities lawyer's gatekeeping role will be made marginally less effective by taking equity in her client, it also questions whether issuer's counsel is truly an outsider as envisioned by the theory of gatekeeping.³⁰² A compelling case can be made that, even in the absence of equity billing, the effectiveness of the securities law firm as a gatekeeper is undermined by the simple fact that the firm is financially dependent on its clients for future streams of income. Furthermore, in situations in which counsel for the issuer is required to disclose its holding of a client's equity, underwriters' counsel can be expected to be on alert and take a more active role in its gatekeeping function.

Let us assume that despite the analysis above, we continue to be in favor of a rule that prohibits lawyers from engaging in equity billing. Because much of the concern with equity billing does not relate to the actual transaction between the lawyer and the client but rather to the incentives created by the lawyer holding the client's equity, a rule prohibiting lawyers from equity billing would have to be instituted in conjunction with a second rule that would prohibit lawyers from owning equity in their clients. There is, of course, no such prohibition at present.

B. Capping the Amount of Equity

A more nuanced solution would involve placing an upper limit on the amount of equity that a client could exchange for legal services. This upper limit would represent the amount of equity in a client that could be held by a law firm in order to eliminate or minimize conflict of interest concerns. The upper limit could be set as a percentage of the client's total equity, but as the analysis in earlier parts of the Article concludes, the cap would have to take into account the value of the client's equity relative to the value of the law firm's reputation, wealth, and income stream.³⁰³ Thus, what appears to be a bright-line solution rapidly disintegrates into a context-specific inquiry depending heavily on the particular client and law firm involved.

³⁰¹ See discussion *supra* Part III.

³⁰² See discussion *supra* Part IV.

³⁰³ See *supra* text accompanying notes 293–96.

C. Heightened Disclosure

The most appropriate approach in this context would allow existing legal and ethical rules and market forces to regulate equity billing, but only if coupled with heightened disclosure. Ethical rules on reasonable fees and business transactions between lawyers and clients are sufficient to ensure that the initial transaction between a lawyer and her client is fair and free of conflict. In light of *Passante*,³⁰⁴ the lawyer bears the risk that the equity billing arrangement is not enforceable unless it is fair and reasonable to the client and the other procedural requirements have been met.³⁰⁵ In relation to conflicts that may arise between lawyers and clients as a result of equity billing, ethical rules place the onus on lawyers to resign or obtain their clients' consent. The analysis in Part III highlights that many other conflicts between a lawyer and her client are regulated in this fashion and that the potential conflicts posed by equity billing are not dissimilar to those posed by a lawyer's financial dependency on her clients using traditional billing methods.³⁰⁶

While a securities lawyer's gatekeeping role may be made marginally less effective by equity billing, the extent of its negative effect depends on many factors, as noted above. It should also be noted that if a lawyer is charged with an offense relating to her client's wrongdoing in the securities context, her equity interest may be used as evidence by which a judge or jury may reasonably infer her intent to assist or aid the client in the misconduct.³⁰⁷ The possibility of liability will induce law firms to establish voluntarily rules and caps on equity billing ex ante.³⁰⁸ It should also be noted that law firms that engage in equity billing may be caught under the definition of "underwriter," exposing them to greater liability.³⁰⁹ Finally, underwriters' counsel will play a more active role once it is disclosed that issuers' counsel engaged in

³⁰⁴ *Passante v. McWilliam*, 62 Cal. Rptr. 2d 298 (Ct. App. 1997).

³⁰⁵ See *id.* at 301-03.

³⁰⁶ See discussion *supra* Part III.

³⁰⁷ "[T]he [law] firm's stake in the client will constitute evidence from which a factfinder may legitimately infer the lawyer's intent to aid any subsequently-discovered client illegality resulting from the lawyer's (perhaps unknowing) assistance." HAZARD ET AL., *supra* note 105, at 736. Brian Redding, an associate loss-prevention counsel at the Chicago-based Attorneys Liability Assurance Society, emphasizes that "[t]he problem from a malpractice standpoint is perception In the one out of 100 or 200 cases where a law firm gets sued for SEC or other legal violations, its primary defense is lack of scienter. . . . If the case goes to a jury and you appear to be closely aligned with the client, you'll lose." Baker, *supra* note 1, at 39.

³⁰⁸ Many law firms, in fact, do internally regulate equity billing. For example, VLG takes such large investments in some businesses that it refuses to provide legal services to them on the basis of conflict-of-interest concerns. *Cash? How Old Economy*, *supra* note 10, at 68.

³⁰⁹ See MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 127-29 (2d ed. 1996) (discussing the "inadvertent underwriter problem").

equity billing. As analyzed in Part IV above, the SEC should require heightened disclosure of the terms of equity billing arrangements, not unlike the detailed disclosure that is required of executive compensation of officers and directors.

CONCLUSION

While the practice of lawyers taking a stake in a client's business is not new, the recent phenomenal growth of the technology sector appears to have fueled interest in equity billing. While it remains to be seen how the popularity and terms of equity billing arrangements will change as the market for technology stock rises and falls, equity billing provides significant private and public benefits that are best regulated through the application of existing ethical rules, fiduciary principles, and liability rules.