

## WHEN LAWYERS AND LAW FIRMS INVEST IN THEIR CORPORATE CLIENTS' STOCK

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Not long ago, the practice of law firms with high-tech clients accepting their clients' stock in lieu of more traditional hourly billing for the firm's legal services was a hotly-debated topic.<sup>1</sup> Some firms (or lawyers therein) reportedly were making extraordinary profits after their clients later experienced a "liquidity event" like an initial public offering. Reports of the portfolio values held by law firms like Wilson, Sonsini and the Venture Law Group were staggering. Predictably, these portfolios became recruitment and retention devices designed to attract lawyers and keep them from choosing in-house jobs, positions with investment banks, or venture capital firms.<sup>2</sup>

Now, with the depressed high-tech market and corporate attorneys scrambling for job security, the fascination with the aforementioned portfolios have dimmed considerably. Undoubtedly some lawyers wish they had gotten secured debt from their clients rather than common stock or options. Some of the accounts in the legal press now have a dated, "Bonfire of the Vanities" tone. Perhaps this is the time to "take stock of taking stock"<sup>3</sup> with intellectual curiosity rather than indignation or envy.

Rather than undertake anything resembling a treatise-like approach to the many diverse issues that this practice raises,<sup>4</sup> I want to focus on two issues that I have previously written about in other contexts.<sup>5</sup> The first issue is the extent to which these kinds of arrangements can seriously

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1. See, e.g., Debra Baker, *Who Wants to Be a Millionaire?*, A.B.A. J., Feb. 2000, at 36; Robert C. Kahrl & Anthony Jacono, *Rush to Riches: The Rules of Ethics and Greed Control in the Dot.com World*, 2 MINN. INTELL. PROP. REV. 51 (2001).

2. See Paul Braverman, *The In Crowd*, AM. LAW., Mar. 2001, at 37.

3. Poonam Puri, *Taking Stock of Taking Stock*, 87 CORNELL L. REV. 99 (2001).

4. In particular, I will not address the malpractice and insurance issues raised by this practice—matters that practitioners considering equity as fees should consider. See GEOFFREY HAZZARD & WILLIAM HODES, 1 THE LAW OF LAWYERING § 1.8.202 (2d ed. Supp. 1998). For a good overview of the malpractice and insurance issues, see Puri, *supra* note 3; Gwyneth McAlpine, *Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients' Stock?*, 47 UCLA L. REV. 549 (1999). See also James Q. Walker, *Lawyers Take Risks by Taking Equity in Clients*, N.Y. L.J., Dec. 11, 2000, at 1.

5. For a discussion on the questions raised about professional responsibility, see generally Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629 (1997) [hereinafter Langevoort, *Epistemology*].

impair the lawyer's objectivity in rendering advice to the corporate client, and why this can happen. Many people, including some bar authorities, have expressed concern about the objectivity of a lawyer's advice when he holds stock in the client's corporation. The second issue I will focus on are the insider trading implications of these portfolio investments, especially in the aftermath of Rule 10b5-1.<sup>6</sup> While I will comment on the planning and design of preventive programs, I want mainly to connect my musings about objectivity and good judgment to the world of lawyers as investors. As the reader will see, these two issues have interesting connections.

I will state my conclusion at the outset. I am not convinced that lawyers' investments in clients in lieu of fees are problematic enough from a conflicts standpoint that the rules of professional responsibility should treat them as presumptively inconsistent with the lawyer's fiduciary responsibility. Lawyers' investments in their clients do raise interesting and unsettling issues, but these issues are not qualitatively different from issues raised by many other norms or practices within the legal profession that also threaten lawyerly objectivity. Indeed, in contrast to some other practices, these fee arrangements can, in some respects, *enhance* objectivity, or at least balance out some of the agency-cost problems that otherwise infect attorney-client relationships in the corporate setting. If so, broadly banning these fee arrangements in the name of fiduciary responsibility makes little sense. My aim here, in large part, is to speak to the "good lawyer" about what objectivity and prudence really mean in a world where serious wealth has become the metric for professional success, and how both law and ethics ought to respond to the residual problems caused by these fee arrangements.

#### I. PROFESSIONAL RESPONSIBILITY: ON BEING OBJECTIVE WHEN RENDERING LEGAL ADVICE

The explosion of interest in equity-based compensation for lawyers quickly generated many requests for guidance from bar ethics committees.<sup>7</sup> Recognizing that these arrangements can vary widely based on the type of client, the type of lawyer and the size of the equity, bar ethics committee advice has been fairly general, posing questions to think about instead of black letter answers. But the most striking thing about the opinions is their general consistency. No opinion has declared equity-

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6. 17 CFR § 240.10b5-1.

7. For a good collection of guidance from bar ethics committees, see Barbara S. Gillers, *Law Firm as Investor: Ethical and Other Considerations*, 1259 PRACT. L. INST./CORP. 457 (2001).

based compensation objectionable per se, or even strongly sought to discourage this practice.<sup>8</sup>

For outside lawyers, the ethical question breaks down into two main parts. One—required for any kind of fee arrangement—is the determination of whether the size of the fee is excessive rather than reasonable.<sup>9</sup> Given the variability of future outcomes at the time when the parties agree on a fee arrangement, no simple rules are practical. Hence, the question largely becomes one of informed written consent by the client, which, at the very least, imposes upon the lawyer a duty of candor. When the client is less sophisticated, many of the bar opinions draw from the rules that deal with “business transactions with [clients]”<sup>10</sup> to require the lawyer to urge the client to seek separate legal representation about the fee arrangement—a curious concept because the parties are simply negotiating the initial undertaking of legal representation.<sup>11</sup> A thoughtful New York City Bar opinion<sup>12</sup> on the issue refused, under the particular language of the rules in that state, to require the advice of seeking separate legal advice about the fee arrangement, but merely *recommended* that the lawyers involved urge the client to seek independent advice. I do not express any views here about the significance of either the reasonableness or the issues of informed consent, as I do not want to pursue those issues further at this time.

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8. See, e.g., ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 00-418 (2000); D.C. Bar Legal Ethics Comm., Op. No. 300 (2000). See generally Richard Brust, *Stocking Up on Fees: Clients May Pay Attorneys with Shares If They Understand the Transaction, Panel Says*, 86 A.B.A. J., Sept. 2000, at 69. For the views of the new ABA “Ethics 2000” Commission, see Puri, *supra* note 3, at 137-38. The bar ethics opinions’ favorable treatment of this type of fee arrangement is hardly surprising. Putting aside the standard lament that ethics opinions rarely threaten elite lawyer wealth in any serious way, the ascent of the inside general counsel—whose compensation almost always involves a sizable equity-based incentive component—makes it difficult to criticize the practice without risking serious disruption within the profession. See generally Robert Eli Rosen, *The Inside Counsel Movement, Professional Judgment and Organizational Representation*, 64 IND. L.J. 479 (1989).

9. See MODEL RULES OF PROF'L CONDUCT R. 1.5(a) (2000-01). For an extensive discussion of the reasonableness of a fee, see Puri, *supra* note 3, at 125-36. There are many variations on the kind of equity interests that lawyers may take. Some lawyers, for example, insist on an equity stake *in addition* to their hourly fees. *Id.* at 125. My discussion here will assume fair value as consideration for the stock. If the company's managers offer stock at bargain prices, a different set of problems arise. I am indebted to John Dzienkowski for emphasizing the risk that managers may seek to “bribe” the lawyers with cheap stock.

10. See MODEL RULES OF PROF'L CONDUCT R. 1.8(a) (2000-01).

11. For an example of a bar opinion that analogizes to the rules regarding business transactions with clients, albeit under odd circumstances, see Comm. on Prof'l Ethics and Conduct v. Humphreys, 524 N.W.2d 396 (Iowa 1994).

12. Comm. on Prof'l Ethics of the Assoc. of the Bar of the City of N.Y., Formal Op. 2000-03, in 1996-2000 Lawyers' Manual on Prof'l Conduct (ABA/BNA) No. 227, at 1101:6405.

The other main requirement for representation under an equity-based compensation arrangement is that the lawyer must reasonably believe that the fee arrangement will not adversely affect the exercise of his professional judgment.<sup>13</sup> New York, with its older Code-based standards, articulates a distinct approach.<sup>14</sup> If the lawyer's professional judgment "reasonably may be affected by the lawyer's own financial, business, property or personal interests,"<sup>15</sup> representation is barred "unless a disinterested lawyer would believe that the representation of the client would not be adversely affected thereby"<sup>16</sup> and the client gives informed consent. To be preclusive under this approach, the conflict must be real, rather than fanciful, theoretical or *de minimus*.<sup>17</sup>

The New York City Bar, interpreting this standard, gave the following illustration:

[W]hen a lawyer has agreed to accept securities in a client corporation as compensation as a fee for negotiating and documenting an equity investment, or for representing it in connection with an initial public offering, there is a risk that the lawyer's judgment will be skewed in favor of the transaction to such an extent that the lawyer may fail to exercise . . . professional judgment. It is possible that the lawyer's interest in the securities may create economic pressure to "get the deal done," which pressure in turn may impact the lawyer's independent judgment on disclosure issues.<sup>18</sup>

Elsewhere in the opinion, the New York City Bar elaborated about the potential risk:

The risk of such an adverse effect would be especially high, for example, in the case of a potentially very large fee paid in client securities which represents both a significant portion of the law firms' revenues and a substantial stake in the client's business. In these circumstances, it is conceivable that the desire to obtain such a fee might diminish the willingness of the attorney, albeit

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13. See MODEL RULES OF PROF'L CONDUCT R. 1.7 (2000-01). There are two conflicts issues. One, discussed here, is whether the investment status itself creates a conflict. The other is whether some specific representation, for example, handling a derivative suit, might be precluded by the ownership position.

14. See N.Y. LAWYERS' CODE OF PROF'L RESPONSIBILITY DR 5-101(A).

15. *Id.*

16. *Id.*

17. *Id.*, citing NY State 712 (1999).

18. Formal Op. 2000-03, *supra* note 12.

unconsciously, to advise the client company to disclose negative information or increase the lawyer's willingness to issue a questionable legal opinion required to close the deal. In such situations, the conflict would be non-consentable and the fee arrangement ethically prohibited.<sup>19</sup>

To evaluate these risks, let us begin with a series of observations.<sup>20</sup> First, there are numerous stress points that would test the kind of lawyer's resolve described in the opinion.<sup>21</sup> If a lawyer or firm gets in on the ground floor, roughly at the time the client is first capitalized or shortly thereafter, each successive financing hurdle will create this apparent conflict. The time of the initial public offering or other "liquidity event" will also pose a dilemma, albeit in a different form. Here, the lawyer will encounter the familiar battle between the issuer and the underwriters on the pricing of the deal. For a variety of reasons, underwriters systematically underprice initial public offerings (IPOs), arguably against the issuer's best interests.<sup>22</sup> Non-selling managers often are tempted to acquiesce to this practice because the post-issuance "pop" may attract investor attention and help sustain a higher aftermarket price for some period of time. This post-issuance "pop" may also tempt non-selling lawyers to do the same if that is likely to facilitate their resales once the lock-up period expires. Moreover, if the offering price is a measure of some of the lawyer's compensation at the time of the offering, underpricing the deal will, for a given dollar amount of fees, translate into a greater number of shares owed to the lawyers.<sup>23</sup> The severest test of loyalty to a client's interests comes whenever the lock-up period expires. Recent finance work shows that issuer management tends to distort the flow of information (perhaps with analyst acquiescence) around the expiration of its lock-up period, artificially boosting the price of the company's stock to facilitate their

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19. *Id.*

20. One matter that I will not discuss in detail is the concern that lawyers may be led by their equity stakes to prefer investor interests over other constituencies (e.g., labor). This favoritism is problematic insofar as the lawyer treats as unequally important non-investor interests. Although I think a good normative case can be made for a non-shareholder primacy regime, I think the current state of the law clearly reflects a preference for shareholder interests vis-à-vis those other constituencies. One situation where there might be a clearer conflict, however, is when the issuer is nearing bankruptcy, so that arguably under Delaware law, fiduciary obligations shift to creditor protection. See Puri, *supra* note 3, at 141.

21. See Remarks of Karl Groskaufmanis, in *Corporate Citizenship: A Conversation Among the Law, Business and Academia*, 84 MARQ. L. REV. 723, 754-57 (2001).

22. See, e.g., Krigman et al., *The Persistence of IPO Mispricing and the Predictive Power of Flipping*, 54 J. FIN. 1015 (1999); Loughran & Ritter, *The New Issues Puzzle*, 50 J. FIN. 23 (1995).

23. See John C. Coffee, Jr., *Stock for Legal Work*, NAT'L L.J., Jan. 8, 2001, at B5.

sales. To the extent that the lawyers' lock-up coincides with time period, the alignment will be contrary to client interests.

My other preliminary observation is somewhat more provocative. Many people assume that the conflict of interest rules are meant mainly to prevent venality—the deliberate suppression of client interest for personal gain. I think that the more pervasive set of problems within the legal profession from conflicting interests arises subconsciously rather than consciously.<sup>24</sup> Like nearly all human beings, most lawyers are prone to what psychologists call self-serving inferences. Self-serving inferences arise when there is a reasonably high level of ambiguity surrounding a situation. With that kind of cognitive freedom, the mind tends to form stronger-than-justifiable inferences in the direction of a person's self-interest. More simply, people see as correct what is more properly described as convenient. Having rationalized their inferences, people feel little guilt in acting upon them.<sup>25</sup>

Two bodies of research on self-serving inferences are particularly interesting. One set of studies deals with lawyers. Ted Eisenberg conducted an interesting study of fees claimed by bankruptcy lawyers for their work.<sup>26</sup> He asked his research subjects—whom represented both attorneys on a case—to assess the “fair” compensation for the work that each attorney did. Not surprisingly, each group overvalued their work product vis-à-vis the other. Equally unsurprising was that neutral observers determined that *both* sides overstated the value of their work. Similarly, attorneys settling cases tend to believe that the merits are more favorable to them than is objectively reasonable, which makes settlement much more difficult.<sup>27</sup>

An even more extensive body of psychological research deals with a group of special interest to the corporate disclosure setting—auditors.<sup>28</sup> A wide-ranging set of both laboratory experiments and field studies found that auditors have a bias toward siding with management's preferences

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24. See Langevoort, *Epistemology*, *supra* note 5; see also Donald C. Langevoort, *Taking Myths Seriously: An Essay for Lawyers*, 74 CHI.-KENT L. REV. 1569 (2000).

25. See George Loewenstein, *Behavioral Decision Theory and Business Ethics: The Skewed Trade-offs Between Self and Other*, in CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 214 (David Messick & Ann Tenbrunsel, eds., 1996).

26. See Theodore Eisenberg, *Differing Perceptions of Attorney Fees in Bankruptcy Cases*, 72 WASH. U. L.Q. 979 (1994).

27. See George Loewenstein et al., *Self-Serving Assessments of Fairness and Pre-Trial Bargaining*, 22 J. LEGAL STUD. 135 (1993).

28. For an extensive survey of the research on corporate auditors, see Robert Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597 (2000).

whenever there is sufficient ambiguity to make this choice plausible.<sup>29</sup> The weight of this research led a prominent social psychologist, Max Bazerman of the Harvard Business School, to write about the “impossibility” of true auditor independence.<sup>30</sup>

Researcher's couple self-serving inferences with a second form of potential cognitive compromise. Imagine that a lawyer or auditor acquiesces to some act, believing (based on the incomplete set of information available at the time) that the act does not pose sufficient harm. This inference may be, but is not necessarily, self-serving. Thereafter, however, new information surfaces that calls the first inference into question. People's tendency, unfortunately, is not to rethink the original decision but to bolster it by rationalizing that choice—and in the process, commit themselves more deeply to what has now become a questionable course of action.<sup>31</sup> Whatever cognitive independence remains begins to diminish rapidly.

Thus, it is easy to see how a financial stake in the client could interfere with a lawyer's objectivity. The New York City Bar opinion<sup>32</sup> was savvy enough to explicitly recognize the risk of subconscious bias here, not just abject disloyalty. This risk does not depend on an unusually large financial stake in the client or an excessive weight in the lawyer's investment portfolio; much lower-powered incentives can trigger self-serving inferences. To be sure, the risk of bias will vary in its intensity among circumstances and the varying dispositions that lawyers bring to the representation. The best lawyers can resist the temptation. But for many lawyers, much of the time, the bias will have a material effect.

As a result, we should admit that financial incentives created by a lawyer's equity stake in a client *can* compromise that lawyers' objectivity. That, however, still does not lead me to object strongly to the practice. Before we get too upset about conflicting interests in the presence of equity stakes, we have to consider what the incentives are in their absence. We would not want to ban a practice as contrary to the lawyers' fiduciary obligation unless it leads to lower quality advice and representation than

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29. See, e.g., Karl Hackenbrack & Mark Nelson, *Auditors' Incentives and Their Application of Financial Accounting Standards*, 71 ACCT. REV. 43 (1996); Mark Nelson & William Kinney, Jr., *The Effect of Ambiguity on Loss Contingency Reporting Judgments*, 72 ACCT. REV. 257 (1997).

30. See Max H. Bazerman et al., *The Impossibility of Auditor Independence*, 38-39 SLOAN MGMT. REV., Summer 1997, at 89.

31. See Donald C. Langevoort, *Where Were the Lawyers?: A Behavioral Inquiry Into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75 (1993); Barry Staw, *The Escalation of Commitment to a Course of Action*, 6 ACAD. MGT. REV. 577 (1981).

32. See *supra* note 12.

the status quo.

Let us return to the research on auditors. Although some of this research explores the special incentives that arise when an accounting firm has a large amount of non-audit income from a client,<sup>33</sup> most of the research predates that issue. What we discover, to the surprise of no one familiar with the research generally, is that management's control over the audit engagement motivates the self-serving inference. Company management controls the choice of the auditor, and even if the firm itself has a diverse portfolio of clients, the individual auditors assigned to a client are heavily invested in that work. The auditors' income and status are closely connected with management's power over them, and they are reluctant to displease their superiors. Remembering that the self-serving inference works subconsciously, the desire to preserve the relationship with management is more than enough to trigger the bias.

Subsequently, other factors bolster the bias. The more the auditor (or lawyer) tries to become part of the social fabric of the client—not an insignificant goal from a firm-marketing perspective—the more the familiar cluster of “in-group” biases work to support a managerialist tilt.<sup>34</sup> Commitment biases also compound the slant towards management. Having chosen to represent the client, there is already a motivation to see the client in the most favorable light. Once the professional subconsciously compromises his choice, though innocently and in good faith, the inability to recognize and accept disconfirming evidence increases. Gradually, this bias compromises objectivity enough so that even if black does not become white, the subtle shades of gray become less distinguishable.

This managerialist bias is significant, even if it does not inevitably dominate. To me, this bias presents *the* most serious issue of professional objectivity in corporate practice.<sup>35</sup> Hence, we should at least entertain the possibility that an equity stake in the client may sometimes lessen a more powerful bias. Equity can give the lawyer and the firm a motive to resist dangerous inferences that are otherwise so easy to make, and to see things they would not otherwise be inclined to see.<sup>36</sup>

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33. The SEC's auditor independence rules are at least based, in small part, on fear of the self-serving inference.

34. See James D. Cox & Harvey L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS., Summer 1985, at 83; Langevoort, *Epistemology*, *supra* note 5.

35. See Cox & Munsinger, *supra* note 34. See also Langevoort, *Epistemology*, *supra* note 5.

36. See Jason Klein, *No Fool for a Client: The Finance and Incentives Behind Stock-based Compensation for Corporate Attorneys*, 1999 COLUM. BUS. L. REV. 329 (1999).

Obviously, the managerialist bias is contextual. It will operate most strongly on lawyers and other professionals whom are highly invested in a particular client or representation, but less so when the lawyer or firm has a diverse client base or practice.<sup>37</sup> The impact of the self-serving inference, however, does not necessarily disappear in the latter context—it simply shifts the definition of self-interest. The displacement, I suspect, often comes in the form of lawyers using the private nature of the representation and their significant informational advantage to view as reasonable what is objectively a set of self-protective or income-enhancing behaviors. In this setting, lawyers, by insisting on too much boilerplate negotiation of terms, “overwork” the representation<sup>38</sup> and skew their portrayal of legal risk so that the client thinks it needs the lawyers’ expertise more than it really does.<sup>39</sup> Once again, this is not deliberately venal. The self-serving inference encourages the lawyer to believe in the value of the inflated work product.<sup>40</sup>

When this kind of self-serving inference is at work, the equity stake, in lieu of cash fees, might again have a moderating effect on lawyer objectivity. The lawyers’ focus becomes the value added to the client’s financial picture by representation, rather than simply billing hours or establishing a future need for legal services. I am willing to credit the perception that Silicon Valley lawyers are, on average, less prone to over-lawyering a transaction to a culture that sees the representation as a form of investment.<sup>41</sup> I will not go so far as to say that this perception is driven by the equity compensation phenomenon; it is just as likely designed to enhance the firm’s reputation as a powerful gatekeeper to local sources of capital.<sup>42</sup> At the same time, it is entirely plausible that these two forms of investment operate as an efficient bundle, because each depends on a high level of skill (hardly possessed by all lawyers) at evaluating and

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37. See Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869 (1990).

38. See Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347 (1996).

39. See Lauren Edelman et al., *Professional Construction of Law: The Inflated Threat of Wrongful Discharge*, 26 LAW & SOC’Y REV. 47 (1992); Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INDERDISC. L.J. 375 (1997).

40. The legal profession also in many ways contributes to the effectiveness of this rationalization. See Edelman et al., *supra* note 39; Langevoort & Rasmussen, *supra* note 39.

41. See Mark Suchman & Mia Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 LAW & SOC. INQUIRY 679 (1996).

42. Cf. Ronald J. Gilson & Robert Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 COLUM. L. REV. 509 (1994).

monitoring the businesses of their clients.<sup>43</sup> Whatever the story, the mindset shifts away from that which prompts the rationalization of over-lawyering to something else.

When we look at the question of the lawyer's objectivity in comparative terms, therefore, any strongly generalized case against equity-based compensation weakens.<sup>44</sup> On the other hand, this analysis also points to specific circumstances where equity fees can be pernicious. The key is whether and when the lawyers intend to sell the stock in question (or large blocks of it). If the conflict of interest rules bar lawyers from selling the stock at a time when management is likely to do so, there will be a useful counter-balance. By contrast, the most pressing problem arises when both management and lawyers have parallel incentives with respect to cashing out their stock. This would occur, for example, when the lock-up periods for both the managers' and the lawyers' restricted or cheap stock expire at roughly the same time. It would also happen, somewhat more naturally, when there is a liquidity event pursuant to which both managers and lawyers expect to sell their shares.

Following the New York City Bar analysis,<sup>45</sup> a "disinterested lawyer" should analyze the impact on objectivity not by looking at the size of the equity stake or the proportion of the lawyer's portfolio that it represents but by determining whether its terms and conditions too closely align the investment interest of the lawyer with the already strong tendency to favor management's preferences. Again, the principal question is, when and under what circumstances are lawyers likely to be sellers of the stock. Note, that where there is a major transaction in which lawyers will be sellers, lawyers could handle any conflict of interest question simply by having another law firm do the disclosure work for that particular transaction, rather than worry about whether the investment was inappropriate from the outset.

While we could pose these kinds of questions to the disinterested lawyer as a matter of professional responsibility, I am not sure that this is the most productive response. The analysis of any but the most blatant set of facts and circumstances quickly becomes too speculative to be useful *ex ante*. Hence, my preference is to permit most such relationships, but then

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43. See Kevin Miller, *Lawyers as Venture Capitalists: An Economic Analysis of Law Firms that Invest in Their Clients*, 13 HARV. J.L. & TECH. 435 (2000).

44. Of course, if the lawyer's stake were large enough to actually enable him to exercise control—especially as part of a group—then this would pose a new set of issues. I assume that this is rare.

45. See *supra* note 12.

use *ex post* policing through the imposition of legal liability when a lawyer is responsible for fraud, negligent misrepresentation, or some other misconduct.<sup>46</sup> In the next section, we shall examine the law of insider trading to see how effective it is as a policing device. In fact, there are many other legal controls. For example, a reasonably broad definition of “underwriter” might include the law firm that participates in the distribution process as both a significant seller and transaction engineer, creating a risk of liability under Section 11 of the Securities Act of 1933.<sup>47</sup> Similarly, the control person definition arguably imposes joint and several liability when the lawyer goes beyond the conventional attorney-client role and begins to exercise power over day-to-day operations—a reasonable possibility if the lawyer’s stake is big enough to give the lawyer significant voting power.<sup>48</sup> Under Rule 10b-5<sup>49</sup> for open market sales, lawyer-sellers might confront an expansive definition of a primary participant along the lines of the Ninth Circuit’s test in the *Software Toolworks* case.<sup>50</sup> Courts will likely take into account the lawyers’ special motive to assist client fraud in order to facilitate their own sales when the courts apply the “strong inference” of fraud standard to test the pleadings in a class action that includes them as defendants. Finally, of course, the SEC has a large toolkit to work with in enforcement actions against lawyers.<sup>51</sup> I am not advocating an overly liberal standard to any of these legal principles, nor am I suggesting that the lawyers face anything akin to strict liability. Rather, I simply side with those courts that have already advocated fairly expansive standards in these areas so that when there is evidence that lawyers participated in a client’s fraud under circumstances where their special investment interests may well have led them to relax their professional objectivity, the case goes forward. That kind of policing will do more good than speculative hand-wringing before the investment occurs.

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46. It might be useful *ex ante* to require better disclosure of attorney holdings at the time of significant transactions. See Puri, *supra* note 3, at 156-57.

47. See *Harden v. Raffensperger, Hughes & Co.*, 65 F.3d 1392 (7th Cir. 1995); *Coffee*, *supra* note 23.

48. Outside of some special stake, outside counsel have avoided control person status. See, e.g., *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 494 (7th Cir. 1986).

49. 17 CFR § 240.10b.5.

50. *In re Software Toolworks Sec. Litig.*, 50 F.3d 615, 628 (9th Cir. 1994). See generally Jill Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293 (1999).

51. See *SEC v. Fehn*, 97 F.3d 1276 (9th Cir. 1996).

## II. LAWYERS AS SELLERS: INSIDER TRADING REGULATION AS A RESIDUAL CONSTRAINT

The lesson of Part I was that equity in lieu of fees is problematic mainly (and perhaps only) when the lawyers' too closely align cash-out incentives with those of the firm's managers. Even if they do not actively assist the managers in misrepresenting or concealing the true state of affairs, the lawyers may be tempted to remain silent while this happens and then exploit the mispricing that results. While there are a number of legal rules that might operate to deter this, the law of insider trading applies most directly. If insider trading regulation is effective at its task, our concerns about lawyers as investors in their clients' stock might diminish further.

### A. Insider Trading Generally

At this stage in the development of insider trading law, relevance to the issue of lawyers as investors in their clients' stock is fairly clear. First, the courts and the SEC have accepted the notion that lawyers are fiduciaries of their clients under Rule 10b-5<sup>52</sup> and cannot buy or sell client stock while in possession of material nonpublic information.<sup>53</sup> Any lingering doubt about whether the prohibition against trading by lawyers only applies when the trading actually causes harm to the client seems to have disappeared.<sup>54</sup> The prohibition applies not only to lawyers actually involved in the client representation, but also to other lawyers in the firm, if they learn of the information within the scope of their employment. Finally, the definition of material nonpublic information is fairly broad, reaching knowledge of any set of facts not accessible to public investors, even if the public is generally on notice about the corporate event in question.<sup>55</sup>

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52. 17 CFR § 240.10b-5.

53. See *United States v. O'Hagan*, 521 U.S. 642, 650-53 (1997). As is well known, there are two basic approaches to insider trading, the abstain or disclose approach (which deals with fraud on other marketplace traders) and the misappropriation theory (which deals with fraud on the source of the information). Most lawyer cases deal with the latter. However, both approaches apply to the lawyer trading in his own client's stock.

54. For some background in this area, see Stephen Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 J. CORP. L. 1 (1993); Ann M. Hart, Note, *The Model Rules Are Close and the Restatement is Closer—But, Neither Is Quite Right—Lawyers Who Trade in Their Clients' Securities: Why This Should Be Unethical*, 10 GEO. J. LEG. ETHICS 185 (1996).

55. See *SEC v. Mayhew*, 121 F.3d 44 (2d Cir. 1997) (finding liability regarding merger negotiations where the insider knew more than the public, even though the public was generally aware of the likelihood of the deal).

Based on the above reference to insider trading law, there is seemingly little to worry about. The lawyer who knows of some misrepresentation or omission by client management and takes advantage of the mispricing by selling his or her own client stock, or causing the firm to sell such stock, squarely violates the law. While this is roughly correct (and lawyers act at their peril if they think otherwise), we ought to acknowledge the presence of two well-known gaps in the law.<sup>56</sup> First, the prohibition applies only to purchases and sales; it does not apply to “non-trading” by the lawyer.<sup>57</sup> That is to say, if the lawyer was planning to sell stock and learns positive information from the client, the cancellation or delay of that sale is not actionable under Rule 10b-5.<sup>58</sup>

The second gap is the murky line between facts and inference under the law. The prevailing law requires a showing that the insider possessed some kind of fact or facts that create a specific informational advantage.<sup>59</sup> The effect of this, as Jesse Fried has shown,<sup>60</sup> is to create a setting in which insiders are relatively free to—and seemingly do—trade on their general awareness of the firm’s circumstances, so long as those circumstances have not ripened into concrete facts. For example, a savvy insider or lawyer might well be able to pick up on increased anxiety among senior managers,<sup>61</sup> or their inchoate sense that the company might not be able to sustain the inflated stock price. While such trading is hardly without risk, should events ripen right after the trading, this is not the sort of trading that tends to attract the SEC’s attention. Studies showing that insiders do tend to trade profitably, even in the presence of the prevailing prohibition, suggest that the so-called “submaterial” information gap is a significant one that the Commission can do relatively little about because of the way Congress drafted the law.<sup>62</sup>

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56. See DONALD C. LANGEVOORT, *INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION* § 1:03[3] (2002 ed.); Steven Salbu, *Tipper Credibility, Noninformational Tippee Trading, and Abstinence from Trading: An Analysis of Gaps in the Insider Trading Laws*, 68 WASH. L. REV. 307 (1993).

57. Langevoort, *supra* note 56, at § 3:16.

58. *Id.* at 3-37.

59. *Id.* at 5-1, 5-2.

60. See Jesse Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303 (1998).

61. See *SEC v. Truong*, 98 F. Supp. 2d 1086, 1100 (N.D. Cal. 2000) (stating that knowledge of “general discomfort” among managers is too general to be material).

62. See Fried, *supra* note 60.

*B. Rule 10b5-1*

Notwithstanding the foregoing gaps, the insider trading prohibition remains strong as it applies to lawyers trading in client stock, especially to a legally risk-averse attorney or firm. Indeed, the natural question that arises from the issue of insiders is whether stock that is legitimately acquired can *ever* be sold without fear that some knowledge, apparently possessed by the trader at the time of the trade, constituted material nonpublic information.

The SEC bases liability under Rule 10b-5 on scienter, and for some time, there were open questions about what state of mind was necessary for insider trading liability. Was it necessary to show that the information was the motivating factor behind the purchase or sale, or was mere possession enough?<sup>63</sup> The former standard appealed to those who wanted some extra defense by demonstrating that they would have traded anyway, regardless of the information. The courts were excessively unclear on this subject,<sup>64</sup> prompting the SEC to adopt Rule 10b5-1 in 2000.<sup>65</sup> This rule states that possession is enough, but then offers insiders a set of safe harbors. These safe harbors are useful to lawyers with equity positions in their clients and want to sell some of that stock.

The safe harbors permit the insider to direct the occurrence of that sale (or series of sales) at some future time. Assuming that there is enough specificity in the insider's direction to satisfy the rule's various technicalities, the test for liability would be whether the person possessed inside information at the time of the direction, rather than at the time of the sale itself. This means, for instance, that a lawyer or firm could direct the sale of stock at the end of each month for some prearranged time period. As long as the lawyer had no inside information at the time he entered into the plan, the sale could go forward even if the lawyer later discovered highly confidential data.

This approach is conceptually sensible, although it does not eliminate either of the gaps noted earlier.<sup>66</sup> That is to say, the lawyer could

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63. See Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1332-36 (1999); Donna Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. CIN. L. REV. 1129 (1999).

64. Compare SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998) with *United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993).

65. See Securities Act Rel. No. 33-7881, Aug. 15, 2000. See generally Steven Bochner & Leslie Hakala, *Implementing Rule 10b5-1 Stock Trading Plans*, 15 InSights, no. 6 (June 2001) at 2.

66. See LANGEVOORT, INSIDER TRADING, *supra* note 56, at § 3:04[2].

implement the plan upon sensing some submaterial information, as he did not have knowledge of any material facts. Subsequently, the lawyer could cancel the planned sales if the bad news did not materialize. There are no doubt limits on how many times the lawyer could try to get away with such a malleable plan, but some room for opportunistic behavior remains. One presumably lawful step would be to direct, in advance, the sale of the lawyer's stock to coincide with the expiration of the management-insider's lock-up period. Although this step would not necessarily exploit any informational advantage, it would allow the lawyer's sale to free-ride on any gamesmanship by insiders.<sup>67</sup> Importantly for our purposes, this kind of plan would realign the interests of the lawyers and the managers, reinstating the managerialist bias described earlier.

The other option recognized (if not created) by Rule 10b5-1 is for the lawyer or firm to give discretion over the timing of the sales to some third-party, perhaps through the creation of some separate investment vehicle that takes ownership of the shares. Here, the rule is a curious one, albeit appealing in practice. At least with respect to trading by an entity, the knowledge possessed by the lawyer or the firm is not disabling if: (a) the person making the decision did not possess the information; and (b) there was a set of procedures in place reasonably designed to prevent the misuse of inside information.<sup>68</sup> This rule invites the law firm that has obtained a portfolio of client securities to create a separate account and give investment discretion to someone "walled off" from access to information coming from the clients to the lawyers in the firm. Unlike the directed selling plan described above, this plan permits much greater flexibility for investment decision-making.

The oddity here is the conjunctive nature of the test. Whether there is fraud when an institutional owner of securities knows the inside information but does not make the trading decision is a legitimately hard question to answer. The SEC probably has enough rulemaking discretion to decide one way or the other. But once the SEC makes that choice, it is difficult to see how or why the absence of reasonable procedures governing the misuse of inside information can turn what was not fraud into fraud, or vice versa. The Commission has advocated this test in

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67. Obviously, this transaction would be unlawful if the lawyers knew that there would be misrepresentation at the time of the expiration.

68. This requirement does not apply to the situation where an individual gives trading discretion to a third party. In the release proposing Rule 10b5-1, the Commission stated that no rule was necessary here because no liability follows if the person with trading discretion (e.g., a blind trust) does not know the information in question, even if the owner does. See *Selective Disclosure and Insider Trading*, Rel. 33-7787 n.91, Dec. 20, 1999.

litigation and has implemented it under the somewhat broader rulemaking authority in Rule 14e-3.<sup>69</sup> Nonetheless, it is hard to see doctrinal coherence here. Perhaps the best case for this approach is that it represents a decision that fraud is present when the owner knows the information, but then utilizes the Commission's exemptive authority to absolve the owner from liability on the condition that reasonable procedures are in place. Rulemaking authority aside, the key point here is that lawyers and law firms (among many others) who delegate trading authority over securities owned by the partners or the firm must affirmatively adopt some kind of walling-off procedures if they expect any of the lawyers in question to gain access to confidential information. On the face of the rule, it is not enough that the lawyer simply respected the confidentiality.<sup>70</sup>

If the law firm recognizes and manages this risk by adopting good procedures—and those procedures work—then many of our concerns about the misuse of information further diminish. True, the owners could pass on submaterial information and intervene to halt sales that were against interest, on the assumption that under the prevailing law, these do not constitute the misuse of material nonpublic information. However, permitting those kinds of communications comes too close to facilitating massive leakage within the system to be reasonable. The only prudent system is one that prohibits any discussion of any issuer-specific information with the investment decision-maker (as well as barring the lawyers from encouraging or recommending any particular trading activity, even if no information is passed on). If done, this further disconnects the trading motivations of the lawyers from those of the clients' managers.

This is not a complete disconnection, however. Nothing in the insider trading rules prohibits the investment decision-maker from disclosing in advance the selling plans to the partners. This disclosure would recreate the overly-aligned incentives described earlier if the managers were also likely to be sellers during this time period. Unless the investment decision-maker deliberately seeks out this alignment, however, this occurrence is likely to be random and episodic. A more plausible problem would persist if the expiration of the lock-ups was simultaneous and the lawyers simply inferred that portfolio-diversifying sales would begin promptly. Hence, the separation regime is not a perfect solution. It is, however, a buffer with some significance.

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69. See LANGEVOORT, INSIDER TRADING, *supra* note 56, § 12.02[2].

70. See Coffee, *supra* note 23.

### III. CONCLUSION

If we start by imagining a wholly unconflicted lawyer-corporate client relationship—one with an old-fashioned purity—then the introduction of a substantial equity stake in lieu of cash fees is disturbing. That baseline, however, is a myth. When we situate the equity stake in the nest of already complex incentives so that lawyers have to consciously or subconsciously ignore the organizational client's best interests, the problem is reframed. Both economically and psychologically, these stakes can be positive in terms of the quality of representation offered to the corporate client, at least some of the time. For that reason alone, the bar authorities have acted reasonably in tolerating these kinds of arrangements with mild cautionary warnings, rather than with stern criticism.

As we have seen, the main problem is not the investment stake itself, but the circumstances surrounding the cashing-out of some or all of the stock. Hence, we confront one remaining issue. If the problematic conflicts come largely when both of the firm's insiders and the lawyers are likely to sell their shares simultaneously, we should observe two kinds of solutions. One solution is for separate counsel to handle the liquidity event transaction for the company. That, of course, is not particularly amenable for the firm that best knows the client and does not want to pass on the fees associated with such a major event in the client's lifecycle.

The second solution is through contract. In a Coasian world of perfect contracting, rational lawyers and clients would anticipate the adverse interests created when insiders and lawyers are both sellers and limit the lawyers' sales to times when the conflicts are minimal in order to appear honest to third parties. Rule 10b5-1 plans would be mandatory, lock-up periods would be staggered, and black-outs would be permitted (i.e., periods, at the option of the issuer, when no sales would be allowed). Large law firms, aware of the dangers that arise when partners working for a given client sense an increased profit from selling the client's stock, are not likely object to reasonable restrictions on liquidity that is designed to address the conflict problem—insofar as they want to preserve a reputation for objectivity.<sup>71</sup>

I have no idea, empirically, how often we observe such careful contracting. My suspicion is that it may be present among the most

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71. That said, we should note the fairly widespread presence of law firm investment plans that allocate substantial client stock to the account of the lawyer who brought in the business, and in most cases, remains the principal attorney to that client. For a critique of this practice, see Walker, *supra* note 4.

sophisticated clients and law firms, yet far from commonplace. That should come as no surprise. Most insiders would rather align the lawyers' interests with their own, rather than operate as a counterweight. As we have seen, executive compensation contracts rarely conform to the economic ideal, instead suggesting a significant level of rent-seeking by corporate insiders.<sup>72</sup> Contracts negotiated by insiders with the company's lawyers are likely to bear that same taint.

All this said, I am still not persuaded that there is much that the rules of professional responsibility should do to encourage better contracting. Disciplinary rules themselves need to be easily discernable, lest they become valuable more as litigation tactics than professional guidance. Unfortunately, optimal contracts are likely to be firm-specific and highly contextual. When lawyers have really exploited their position, strong *ex post* legal intervention is necessary both to compensate victims and deter future abuse. Hence, the main point of a discussion like this—at least from a professional responsibility standpoint—is aspirational. Good lawyers (and well-managed law firms) who choose to take equity fees should pay careful attention to the contract design issues with a view to the subtle incentives and disincentives that these contracts create. Additionally, these lawyers or firms should encourage their clients to do the same. By doing this in a visible way, good lawyers can shift the norms of the profession in the right direction.

If there is something in the equity fees phenomenon that has been troubling, it is not the practice itself but the style in which lawyers or law firms promote the practice. The law firm investment portfolios are a means of generating not simply reasonable risk-adjusted returns, but *serious* wealth, enough to make being a corporate lawyer competitive with investment banking or venture capital work. I do not mean simply to offer some trite lament about the loss of “gentlemanly” professional identity. Rather, I am concerned about the metric for what it means to be a successful corporate lawyer ascending the ladder of success, way beyond material comfort or even becoming well-to-do. Only a tiny fraction of corporate lawyers can ever achieve that kind of sustainable wealth. Success becomes something of a tournament competition that requires both skill and luck to win.

More lawyers think they deserve victory in this tournament than is economically feasible. If a sense of entitlement drives their ambitions,

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72. See Lucian Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

there are predictable psychological consequences. To be sure, the truly good lawyer may have enough moral character to perform the counseling role flawlessly, ambition or not. But most will make the metric of extraordinary wealth a reference point to measure their personal success (and personal worth),<sup>73</sup> and make the necessary accommodations. Psychologists have shown that people take high risks to avoid losing that to which they think they are entitled,<sup>74</sup> and the self-serving inference makes it easy to rationalize risky moral shortcuts as professionally reasonable. The pursuit of great wealth in a hyper-competitive environment itself undermines professional objectivity in all but the most ethically stout lawyer. Equity stakes in lieu of hourly fees are not the cause of any of this, but they do symbolize a troubling aspect of the profession's mental accounting.

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73. See generally ROBERT FRANK & PHILIP COOK, *THE WINNER-TAKE-ALL SOCIETY?* (1998).

74. See James G. March & Zur Shapira, *Managerial Perspectives on Risk and Risk Taking*, 33 *MGMT. SCI.* 1404 (1987).







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