LAWYERS AS VENTURE CAPITALISTS: AN ECONOMIC ANALYSIS OF LAW FIRMS THAT INVEST IN THEIR CLIENTS

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I. INTRODUCTION

Consider the following two situations:

1. A software developer in Silicon Valley has an idea for a new program that will facilitate access to the Internet and that will make web-browsing easier for novice computer users. The developer wants to start a new company to further develop the program, market it, and distribute it to consumers. He is sure that the project, if it ever gets off the ground, will be a huge financial success. However, initiating the project requires more capital than the developer can readily access, and traditional lenders, such as commercial banks, are unwilling to finance such a risky venture. While there are a number of venture capital funds in the area, some of which might be interested in providing capital for his project, the developer is concerned about his ability to negotiate an agreement that will not require him to give up too much ownership or control. The developer thinks he should hire a law firm experienced in the Internet software industry to help him navigate through the start-up and funding processes. Now, he is faced with another problem of financing — how to raise enough capital to pay for legal services.

2. The same developer’s company, sometime later, has obtained financing, has developed and patented the internet program, and is beginning to market and to sell the software. Suddenly, the company notices that its program is being copied and that its price is being undercut by a mega-software company in order to drive the smaller company out of business. The developer wants to initiate a patent infringement suit against the mega-software company, but realizes that the limited capital it obtained to start the company will be insufficient to pay the lawyers’ fees associated with such a suit.

The scenarios described above are not unrealistic. Indeed, with the fast-growing high-tech industry, similar liquidity problems will arise with increasing regularity. Not surprisingly, market mechanisms have responded by providing some unique financing options for Silicon
Valley-type firms, like the software company in the above scenarios. For instance, the venture capital ("VC") funds that are in abundance on Sand Hill Road in Menlo Park, California specialize in evaluating and funding promising ventures in the high-tech industry in exchange for partial ownership and control. It is not surprising that the legal market has responded as well, with law firms specializing in start-up and development-stage enterprises and creating new options for their clients to pay for the firms' legal services. Because these law firms recognize that there frequently will be a liquidity crunch at the outset of a venture, and because these same firms are experienced in this segment of the industry and can evaluate which start-up ventures likely will be successful, these same law firms often are willing to defer fee collection until the client obtains its initial financing. The premium for essentially loaning the firm's legal services and for assuming the risk of default on payment is the opportunity to invest in the stock of these start-up clients at a stage when the firm can profit handsomely if the venture succeeds.

This Article asks and answers the questions: Should there be a concern about law firms that take equity interests in their clients? Does a law firm's stake in a client create a conflict of interest in some situations? If so, should such a law firm be regulated? And if such a law firm is regulated, what consequences will that have for its clients?

Section II.A describes in more detail how these venture capital transactions work and gives an overview of law firms' involvement in the financing process. Section II.B presents a case study based on Venture Law Group, one of the law firms that invests more aggressively in its clients. Sections II.C and II.D analyze alternative fee arrangements generally, and the nature of equity interest agreements specifically. Section II.E considers why there are not equity interest agreements in more contexts outside of the lawyer-client relationship. Section III discusses the implications of law firm equity interests in clients in the context of transactional matters. Section III.A discusses how accepting equity interests instead of cash facilitates clients' ability to obtain financing and how these arrangements better align lawyer-client interests in the context of these financing transactions. Section III.B analyzes the incentives of a law firm that owns a stake in a company and that also is involved in the company's public offering. Section III concludes by arguing that disclosure, rather than more restrictive regulation, is the appropriate policy even in the case of public offerings. Finally, Section IV analyzes law firm equity interests in the context of litigation. This section compares these arrangements to other types of alternative structures, such as contingent fees, and
demonstrates why equity interests are superior at aligning the interests of the law firm with those of its client.

II. LAW FIRMS’ EQUITY INTEREST IN CLIENTS

A. A Brief Description of a Financing Transaction in Silicon Valley

As the introductory hypothetical suggests, many companies find themselves in need of capital infusions from outside investors in order to grow and to develop their business. This is particularly true in Silicon Valley, where the high-tech industry is typified by entrepreneurs with great ideas but without much money. Often, these entrepreneurs and their companies would be very successful if they could obtain some amount of initial investment, but the cost of obtaining capital is prohibitive. As a result, profits could be foregone by the entrepreneur and valuable goods or services could be withheld from the consuming public — an obvious social loss. While this situation is not unique to the high-tech industry, it is proliferating in this rapidly developing marketplace.

Consequently, the market, including the market for legal services, has responded by developing some unique engagement and financing arrangements for Silicon Valley-type firms. Venture capitalists have become a common source of funding for development-stage companies. These VC funds provide capital for a start-up company to develop, to market, and to distribute its goods or services, in exchange for some ownership percentage or other stake in the company. For example, the entrepreneurs may give venture capitalists a percentage of the company’s equity and representation on the company’s board of directors. Both parties may anticipate that the company will eventually make a public offering “that will make everyone insanely rich.”

Before the start-up company enters into any deal with the venture capitalists, however, the company will likely seek to engage a law firm to represent it during negotiations, to help draft and review the financing agreement, and generally to look out for the best interests of the company. Obviously, these legal services are not cheap, and the company could be faced with the problem of prohibitive costs in obtaining representation. In order to remedy this problem, a few law

2. Note that if more traditional financing mechanisms, such as bank loans, are
firms, mainly in Silicon Valley, have begun accepting stock ownership in their clients in lieu of traditional fee compensation. Firms such as Venture Law Group ("VLG"), Wilson, Sonsini, Goodrich & Rosati ("Wilson Sonsini"), Cooley Godward Castro Huddleson & Tatum ("Cooley Godward"), and others that represent high-tech companies are among the law firms that frequently offer these "alternative" fee arrangements. Even when the firm does not initially take an ownership interest in the client, the firm may allow the client substantial leeway in paying its bills. The up-side profit potential afforded by a firm's ownership in these start-up companies helps compensate the firm for the risk it assumes that some clients may not obtain VC funding and may never pay their bills.

unavailable to the start-up for funding its development, such financing may also be unavailable for the legal services needed to facilitate obtaining other sources of funding. The bank's original decision not to fund the company, whether it is because the venture is too speculative or for any other reason, applies with equal force to a loan application to obtain legal representation. See id. at 36 ("A bank would never finance anything so speculative."). See also infra Section III.A.

3. There is little public information about these types of arrangements. The companies usually are not publicly traded, and, for the publicly-traded companies, the law firms' ownership interest would only be disclosed in a listing of stockholders and would not disclose whether this stock ownership was in consideration of services performed rather than some other form of stock purchase. This listing of law firms comes from discussions that the author had with members of several of these law firms, and from an attorney at VLG, who listed the above cited law firms and other firms as utilizing these types of arrangements. See Letter from VLG to Kevin J. Miller (Feb. 1, 1999) [hereinafter February 1999 Letter] (on file with author). In addition, there is anecdotal evidence of these types of arrangements in the literature. See, e.g., Beck, supra note 1, at 40 (discussing Wilson Sonsini's investment in some of its clients).

4. See Beck, supra note 1, at 40 (quoting a VLG lawyer who noted that "[w]e send them a bill so they know what the fees are, but we don't expect to get paid until they're funded" and noting that such a law firm often will invest in its clients). This does not imply necessarily that all of these firms, or even VLG in particular, experience poor collection rates. For example, a 1995 article noted that "Venture Law Group boasts a 98 percent collection rate." Jessica Guynn & Nina Schulyer, The Killer Biller: The Venture Law Group Takes the Adventure Out of Legal Billing, 15 CAL. LAWYER 23, 24 (1995). VLG director Craig Johnson credited the firm's high collection rate in part to the fact that VLG does not over-charge clients for overhead or miscellaneous expenses which can lead to client dissatisfaction. See id. Johnson noted, "VLG sometimes strikes delayed-payment or modified-fee-agreement deals with start-up clients attempting to secure financing, but even those clients, for the most part, pay on time." Id.

5. The important point in this context is that law firms' stock ownership in clients often enables clients and law firms to enter into mutually advantageous agreements that might not otherwise be possible without this or similarly creative financing. This Article does not claim that other mechanisms or sources of financing are not feasible or would not arrive at a similarly advantageous agreement or
B. Venture Law Group: A Case Study

One law firm, VLG, is considered to be at the forefront of utilizing equity ownership in clients in order to (1) facilitate a start-up company’s ability to obtain legal representation and VC funding and (2) create a long-term relationship with the client that the law firm would like to retain for its profit potential.⁶ VLG claims that “[t]hese equity interests are not . . . in lieu of hourly fees.”⁷ However, VLG often delays its bill collection for start-up companies, and VLG’s equity interests can be a significant portion of overall partner compensation, especially for the partner who brings in a successful client. Consider the following description of how VLG’s investment fund, VLG Investments, operates:

VLG asks its start-up clients for the opportunity to buy into their businesses, purchasing common stock first and preferred stock after a company receives financing. All the firm’s senior lawyers and partners contribute a pro rata share of their profits to VLG Investments, which in turn takes a small equity position in the firm’s start-up clients. In addition, a partner responsible for bringing in a particular client also buys into the start-up personally. As a policy, VLG partners are required to take from 10% to 20% of the equity opportunity that VLG is offered in the client, with the remaining 80% to 90% reserved for the firm’s fund.⁸

In this way, VLG, much like a VC firm, is concerned with the long-term success of its clients. Several factors combine to ensure that the

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⁶ In response to the idea that VLG is regarded as among the law firms most aggressively investing in its own clients, Craig Johnson, Director of VLG, noted that “[i]t’s not so much that we take larger stakes, it’s just that a higher percentage of our work is with early-stage technology companies, where investments are most likely to be possible.” D.M. Osborne, Start-Up Fever, AMERICAN LAWYER, Jul./Aug. 1996, at 75 [hereinafter Osborne, Start-Up Fever].

⁷ Id.

client-lawyer relationship should be for a relatively long term and to ensure that partners will screen clients for profit-potential and investment risk very carefully: (1) the 10% to 20% mandatory investment by partners; (2) the fact that lawyers’ investments in the fund do not vest for four years, thereby providing an effective tool for retaining lawyers; (3) the securities laws’ requirement that investors purchasing pre-offering shares are bound by a typical look-up period that prevents investors from trading such shares within 180 days of the public offering; and (4) because most of the stock held by VLG is defined as “restricted securities” under Securities Exchange Commission (“SEC”) rules, the firm is required to hold its pre-offering shares for at least two years after purchase.9

As indicated above, VLG’s investments take the form of both common and preferred stock, and VLG (or VLG Investments) receives any dividends paid on the stock. Indeed, VLG enters into a stock subscription agreement similar to that of any other stockholder. VLG also requires a client to sign a “Conflict Waiver and Consent of the Company” statement informing the client of potential conflicts of interest, as required under California Rules of Professional Conduct. The form states that the client consents to VLG’s participation in the relevant stock financing in which VLG also represents the client, and further states that the client is informed that it may seek the advice of independent counsel in connection with VLG’s participation in the financing. With this approval, VLG then invests some amount in its client’s offering, typically less than 1% of the total equity.10 As noted earlier, the investments are usually long-term, with VLG typically retaining the interest even if the lawyer-client relationship ends.11

This investment strategy has often proven to be very successful for VLG. For example, in the case of telecommunications client XYLAN Corporation (“XYLAN”), VLG bought 7,500 shares at just under $2 per share in a private placement in the fall of 1994. When XYLAN went public in the spring of 1996, the stock quickly began trading at $67 per share. In under two years VLG turned a profit of about $990,000 on an initial investment of $15,000.12 VLG has also represented Yahoo!

9. See generally Osborne, Start-Up Fever, supra note 6 (describing these requirements).
10. See Osborne, Start-Up Fever, supra note 6, at 75.
11. See February 1999 Letter, supra note 3. In a few instances, this is not the case. The client and VLG may have agreed to some vesting restriction whereby the two parties must maintain their lawyer-client relationship for VLG’s equity interest to continue to vest. See id.
12. See Osborne, Start-Up Fever, supra note 6, at 75.
Inc. ("Yahoo") in a series of financing and other corporate transactions, including Yahoo's 1996 initial public offering ("IPO"). Yahoo was a huge success, with *The New York Times* reporting that the IPO was one of the most sought-after offerings to date. 13 Again, VLG owned shares in its client — in this case 100,000 shares — but refused to disclose the amount of profit it made on a subsequent sale of the majority of those shares. While the firm presumably profited handsomely, this investment was not without risk. Because VLG deferred its billing, the firm assumed the risk that Yahoo might fail and, consequently, that VLG would never be paid for its work.

**C. A Growing Trend of Alternative Fee Arrangements**

The increasing instances of law firms taking equity interests in their clients in lieu of, or in addition to, other fee arrangements is not surprising. Some of the same economic factors and resource constraints discussed in connection with Silicon Valley-type firms apply to many other types of clients in various transactions and legal disputes. As a result, the last decade has seen an increase in the use of alternative fee arrangements ("alternative" to more typical hourly billing). 14 These fee arrangements can take many forms, including caps or "not to exceeds," flat fees, contingent fees, and other forms of hybrid fee arrangements that combine elements of one or more of these. 15

Among the most important benefits of agreements like contingent fees is that they remedy situations where a client cannot bring a meritorious claim because of insufficient resources and prohibitive litigation costs. 16 In the same way that a law firm can help defer some of these costs of trial by agreeing to accept a percentage of any recovery (either from a court determination, or from a settlement) rather than billing the client initially for its services, a law firm that accepts some ownership interest in its client in lieu of some amount of

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13. See id.
16. See id. at 25.
hourly billing or to compensate for the risks of collection deferral can help the client gain access to VC financing or some other client goal. Moreover, both types of arrangements have the advantage of more closely aligning a law firm’s and its client’s financial interests in a matter.\textsuperscript{17} Section IV will argue that a law firm’s equity interest in its client often will better align lawyer-client interests than any other type of fee arrangement.

It has been noted that law firms may also use alternative fee arrangements to increase profits in areas where it has great expertise by charging flat fees for the same advice to a number of clients, seriatim. This cost amortization will allow a flat fee lower than both the cost of doing the work initially and what a competing firm would have to charge to develop the work product for the first time.\textsuperscript{18}

In a similar manner, Silicon Valley law firms like VLG or Wilson Sonsini utilize their expertise in evaluating start-up companies for their profit-potential. For example, VLG’s new-business committee looks not only to the legal aspects of a potential client matter, but it also weighs the business risks. “Because the firm can make more money by getting involved in the earlier stages of a business [by investing in stock of the company], partners have incentives to take on high-risk projects.”\textsuperscript{19} Firms like VLG do not take on this risk lightly. They become much more involved in the “planning phase of a venture,” including working with the client to structure stock and options packages to attract certain types of investors and introducing the client to prospective investors and board members.\textsuperscript{20} The more these law

\textsuperscript{17} See id. at 29.

\textsuperscript{18} Id. at 25–26.

\textsuperscript{19} Ritchenya Shepherd, \textit{Radical Plan: Turn Down Work}, NAT’L L. J., Oct. 26, 1998, at A20. Some of the types of risk may not initially be obvious. The law firm risks not being able to collect some of its fees because the client may go bankrupt, either because it could not obtain funding, or because the venture is ultimately unsuccessful. The firm also risks being placed last in priority for some of its debt collection. If the law firm substitutes some fee billing with stock ownership in the client, then it will be last in priority under the Bankruptcy Code’s distribution provisions. \textit{See} 11 U.S.C. § 726 (1999).

\textsuperscript{20} See Osborne, \textit{Start-Up Fever}, supra note 6, at 75.
firms work with these high-tech start-up companies, the more expertise they develop in evaluating and advising them.

D. The Nature of Equity Interest Agreements

While there are probably as many different structures as there are law firms and clients that enter into these types of arrangements, for analytical purposes it is only necessary to note a few general categories. First, a law firm, like any other investor, might purchase stock in its clients, and the firm would not adjust its fees or billing schedule at all. Of course, it likely will require the client to sign some type of waiver form like the one used by VLG in order to avoid conflict of interest problems, but this does not alter the underlying economics of the relationship. This type of arrangement is called the "straight investment model." Here the most interesting issues (and indeed, the issues focused on in Sections III and IV of this Article) relate to how the law firm's equity interests will affect subsequent legal services provided in both transactional and litigation contexts.

The second category of law firm equity interests involves the typical Silicon Valley situation — i.e., where the law firm defers its billing for the start-up company, anticipating that this risk will be repaid by the profit opportunity provided by some amount of future investment in the client. This is labeled the "deferred billing model." In addition to the issues affecting the straight investment model firms, a firm under the deferred billing model faces some initial risks of bad debt expense with many of its clients. Interesting issues, unique to this model, could be explored further; for example, how does this higher collection-uncertainty affect a law firm's representation of the client from the period when they accept the client to the time when the client obtains sufficient funding?21 While one might expect that the law firm would be more conservative in bargaining with venture capitalists because it only wants to ensure that there will be sufficient capital to pay the firm for its services, the opposite might actually be true. The law firm's position could be influenced by the amount of risk it is willing to accept in this particular venture, and if it has a diversified investment portfolio or has enough "cushion" in the form of other reliable clients, it may be willing to be very aggressive in trying to secure a "home run" deal in

21. The term "higher" implies that all billing involves some uncertainty or risk of default. In this context, however, law firms are knowingly taking on a higher risk of non-payment in order to recoup some later benefit, and these situations are different than typical billing uncertainties.
this particular case (because it will later receive stock that could benefit from such a deal). Obviously this is a complex calculus, and the issues mentioned here only scratch the surface. It is enough to note that there are separate issues raised under the deferred billing model that are beyond the scope of this Article. Instead, Sections III and IV will focus on the issues common to both of the above models, and common to the third model discussed below.

The third category is, in some ways, the most extreme. Under the "stock-as-fees model," a law firm actually receives stock, or stock options, in lieu of cash compensation. This category is not limited to situations involving straight substitution of X dollars worth of stock in place of X dollars of fees. It also includes situations where the company pays lower legal fees because it has granted the law firm stock options whose exercise price is discounted significantly below the stock's value. Like the second category, the stock-as-fees model involves some unique issues. For example, a law firm that takes stock in lieu of cash is not waiting to collect its fees until the client obtains financing or completes the underlying transaction. Instead, the law firm has already collected. Again, this can change the incentives of the law firm throughout the lawyer-client relationship because the firm may be thinking not only as outside counsel, but also as an investor. Here the stock-as-fees model takes on two different characteristics. On the one hand, because the law firm has already received the securities, there is an element of typical hourly or flat-fee billing. While the value of the stock to the firm is by no means certain, the firm will be able to count on some minimum stock value. On the other hand, these uncertainties could be very large in some cases. In such situations, the stock-as-fees model looks more like a contingent fee arrangement, whereby the law firm will only receive payment if the company actually succeeds (in its IPO, its financing, or in its venture more generally).

E. What Is So Unique About the Lawyer-Client Relationship?

Since a start-up company faces a liquidity problem with respect to most of its larger operating expenses, it is interesting that it does not grant other service providers or suppliers equity interests in lieu of other forms of payment. For example, when an engineering expert provides the company with consulting services, or when a computer hardware manufacturer sells the company computers, the company could offer these suppliers stock in the company as payment (similar to the stock-as-fees model for law firms). Alternatively, the company could negotiate a deferred billing arrangement in exchange for promising that
the supplier could later purchase shares of the company (similar to the deferred billing model). In this way, both the problem and the solution mirror those encountered in the solution in the legal services context, discussed in the sections above and later in Section III.A. Accordingly, it may seem odd that these arrangements rarely exist outside of the lawyer-client context.

There are distinctions, however, between the lawyer-client relationship and the relationship between the company and its other suppliers and service providers. The dearth of such agreements within the latter group is explained by comparing bargaining costs with (1) the typical duration of the purchaser-supplier relationship, particularly in the dynamic high-tech industry and (2) the benefits the supplier can obtain from its increased opportunity to monitor the venture. Whereas the start-up company is likely maintain its relationship with its outside legal counsel for a considerable time — e.g., because the law firm will help the company navigate the VC funding process and will help it structure its business in anticipation of a possible public offering — the company’s relationship with suppliers may be more transitory. This is true of both large and small suppliers because the dynamic nature of the high-tech industry requires the formation of new alliances and contracts to stay competitive. Because granting an equity interest to an outside party implies an increased level of interaction between the company and its passive shareholders, the costs of negotiating these more complicated transactions, and the costs of maintaining the relationship after the stock has been transferred, often will prove prohibitive in relation to the benefits obtained.

A start-up company also may hesitate in giving an ownership percentage to a company that could be its competitor in the future, or it may be concerned more generally with extending this practice beyond the unique fiduciary relationship shared by a law firm and its clients. Perhaps the accountant-client relationship is an analogous fiduciary context. However, accountants are forbidden from taking equity interests in their clients by American Institute of Certified Public Accountants (“AICPA”) ethical rules and SEC independence requirements.

22. See infra Section III.

Another explanation for the lack of equity interest arrangements outside the lawyer-client context may come from the suppliers’ side of the transaction. A supplier may be unwilling to accept ownership percentages in lieu of cash compensation because, unlike law firms, a supplier has neither the advantage of being able to monitor the client and thereby mitigate its risk nor the expertise in evaluating the “fundworthiness” of start-up ventures. Professor Avery Katz makes a similar point in his article about guaranty contracts. He argues that such contracts are only economically efficient when “there is a potential guarantor who can monitor the debtor more cheaply than the creditor can.”

Most suppliers of goods and services are not in a position to monitor and control a debtor corporation. Similarly, without these added monitoring and control benefits, the risk-reward calculus yields a less attractive result for other suppliers than it does for law firms. By contrast, a firm like VLG often can overcome its liquidity costs by taking advantage of its reduced monitoring costs.

The employee compensation context provides a useful analogy. Within the last twenty years, stock-based compensation has been on the rise. This is particularly true in the high-tech industry, where such compensation structures provide start-up companies the opportunity to pay lower cash compensation and to compete with larger companies for talented employees. Indeed, one commentator notes that the ability of possessing financial interests in, or other relationships with, their clients. See AICPA CODE, Interpretations 101-1, 101-5 (1997). Some consultants have the same long-term relationships with their clients that law firms have, and they may have the same opportunities to closely monitor the client’s business that are afforded to lawyers. However, it is not surprising that we have not often seen these equity ownership arrangements between clients and consultants as most of these start-up companies typically do not hire consultants during the early stages of their ventures.


25. Like Professor Katz, I am including in my definition of monitoring “any and all activities that reduce the expected cost of nonpayment, including up-front investigation into the debtor’s credit history and financial situation, supervision of the debtor and his project during the life of the loan, and enforcement, collection, and salvage in the event of default.” Id.


small firms to compete with larger companies and the frequent
movement of talented engineers from one company to another have
together contributed to the success of Silicon Valley: “This
accumulation of technical knowledge enhances the viability of Silicon
Valley start-ups and reinforces a shared technical culture.” 28

Traditionally, even in the high-tech industry, stock-based or
incentive-based compensation has been granted primarily to executives
and key employees, while other personnel have been compensated with
cash, perhaps combined with welfare benefits, such as health and life
insurance and retirement plans. 29 Stock-based compensation for
executives responds to two of the problems facing a start-up company:
(1) “[i]t must decide how to adequately compensate its executives at a
time when it may lack the funds to pay competitive salaries;” and (2)
“[i]t needs to compensate its executives in such a way as to provide
them with the incentive to continue their employment with the
[company] and to motivate them to do their best to make the [company]
successful.” 30 Non-key personnel historically have not received stock
compensation for reasons similar to why companies do not offer, and
suppliers do not request, stock in exchange for services. Bargaining
costs may be prohibitive where the company would have to negotiate
compensation arrangements with all employees, regardless of their
salary level and their decision-making authority. Additionally, certain
employees may not be willing to take stock in lieu of cash because they
have a need for current income, or because they do not feel that their
position affords them enough control over the success of the venture
to justify accepting compensation tied to stock performance. 31

It is worth noting, however, that stock-based compensation is
becoming more common, even for “rank-and-file” employees,

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1995, at 58, 58.
28. Hanna Bui-Eve, To Hire Or Not To Hire: What Silicon Valley Companies Should
Know About Hiring Competitors’ Employees, 48 HASTINGS L.J. 981, 982 (1997) (citing
ANNALEE SAXENIAN, REGIONAL ADVANTAGE 37 (1994)).
29. See Lewis, supra note 26.
30. James D.C. Barrall & Sandra B. Epstein, Using Equity and Equity Based Plans
to Compensate Executives of Venture Capital Companies, 583 PLI COMM. 321, 323
31. Note that the duration concern discussed above can be somewhat mitigated in
this context by restricting the securities or by having a vesting period before the
employee owns the stock outright. See id. at 328–29 (discussing restricted stock plans).
However, duration is not the only issue, as the concerns of excessive bargaining costs
remain where the contribution of the employee may not be as much as that of an
executive or key engineer.
particularly in large public companies.\textsuperscript{32} Granting equity interests to non-executives entails an additional cost to the company, since the company relinquishes some control to a party that did not previously have a significant influence over the management of the company. Where equity is granted to key executives, the effect of relinquishing control is lessened because these employees already have decision-making authority by virtue of their positions.

In short, then, companies typically grant equity interests to parties who are likely to have a long-term relationship with the company and to parties that can make a significant contribution such that the greater incentives provided by ownership interests justify the initial bargaining costs and the on-going equity ownership control. Likewise, parties with superior monitoring opportunities and with opportunities to control the direction of the venture are most likely to accept stock or other forms of equity.

III. SOME ISSUES IN TRANSACTIONAL REPRESENTATION: FINANCING, IPOS, AND REGULATIONS VERSUS DISCLOSURE

A. Access to Capital for Start-Up Companies

Section II.A provided a brief description of why and when companies might offer their law firms the opportunity to invest in the company during its early stages. Sections II.B through II.E offered some reasons why law firms like VLG accept clients' invitations to invest, and why law firms take equity interests in lieu of traditional fee arrangements. This section will explore more deeply why these types of arrangements benefit companies seeking initial financing and how law firms can facilitate bargaining with the major players in the venture

\textsuperscript{32} Lewis, supra note 26. Admittedly, there still remain differences for start-up companies who may be focused on retaining only a few key employees at the outset of the venture, and because some employees may be unwilling to accept stock in a risky start-up (as opposed to a more-established public company). Still, there should also be some filtering-down of these types of compensation agreements, at least to the mid-level key employees. One commentator notes that "[u]nlike large corporations where ambitious employees have the opportunity to advance, closely-held businesses may not have significant advancement opportunities. As a result, the employee's immediate incentive for sustained, quality work . . . is probably the compensation package." Robert V. Beaudry, \textit{Compensating the Nonshareholder Executive}, 264 PLIT\textsc{ax} 233, 239 (1987). This compensation package could include the profit potentials that come from equity ownership in a start-up venture.
capital market. It will also offer reasons why some companies that are searching for financing prefer an alternative fee arrangement.

As noted earlier, the high-tech market of Silicon Valley is characterized by an abundance of entrepreneurs with creative and potentially profitable ideas. The problem is that this wealth of ideas can be overwhelming to potential investors. As a result, law firms that develop some expertise in evaluating start-up companies can facilitate deals between entrepreneurs and venture capitalists. Because the law firms often defer legal fees until the client obtains financing, one lawyer at Wilson Sonsini notes that "[t]he premium is on us to make an evaluation as to how fundable the entity is." 33 Venture capitalists then use these law firms as filters to establish a client's "fundworthiness." 34

Screening clients for initial funding does not end the lawyer's role. Prudent investors must monitor the company in order to maximize the probability of return on their investment. Where a new, small, non-public company is involved, the cumulative costs of monitoring could be high, particularly where venture capital funds invest in many such companies. 35 These high monitoring costs have led one commentator to suggest that "the state can profitably invest in information-related public goods, provide incentives for the formation of private intermediaries with a comparative advantage in funding and monitoring promising ventures, and remove obstacles to the flow of capital toward these intermediaries." 36

Law firms like VLG and Wilson Sonsini often are performing the role of private intermediaries in Silicon Valley. The incentive to perform this role is clear. Law firms can profit from investing in clients whom they can help obtain financing. Indeed, these law firms may behave more like VC funds than legal counsel, as firms like VLG seek to increase their profits more through investment returns than through increased legal fees. 37 In fact, they appear to be reasonably successful

34. Id.; see also Shepherd, supra note 19, at A20 (quoting VLG new-business committee chair Steven Tonsfeldt: "The primary consideration: 'Is this an area that the venture capitalists we work with are interested in?'").
36. Id. at 180.
37. See, e.g., Osborne, When is a Law Firm, supra note 8 (quoting VLG Director Craig Johnson as noting: "We hope in the future to close the gap [between VC firms' wealth from stock distributions and VLG's profits] a little through our own investments.").
based upon the increased trend towards this type of legal representation in Silicon Valley. To the extent that law firms are successful at performing these private intermediary and monitoring roles, too much regulation could lessen the incentives lawyers have to continue to facilitate VC funding and to monitor their clients. Currently these firms are very involved in the business decisions and strategies of their clients, with partners often serving on their clients’ boards of directors.\(^{38}\) Clearly, this provides the law firms the opportunity to monitor the ventures closely and this reduction in monitoring costs can help law firms overcome their costs of liquidity.\(^{39}\) If the firm is thinking not only as a legal adviser, but also as a shareholder, other investors such as VC funds can benefit from the law firms’ monitoring efforts. Thus, the existence of “obstacles to the flow of capital” to these private intermediary/law firms affects the costs of private information and of monitoring and could increase the information and monitoring costs for outside investors who might no longer feel their interests are closely aligned with those of the law firm.\(^{40}\)

Start-up companies like the fact that granting equity interests to their outside counsel provides incentives for the law firm to act as a facilitator for their financing transactions. In addition, there is reason to believe that using an alternative fee arrangement does a better job at providing these incentives than other types of billing. First, properly structured alternative fees, such as contingent fees, can align client’s and outside lawyer’s interests better than hourly fees.\(^{41}\) In the context of financing transactions, for example, a law firm who bills hourly might not be concerned about performing more work than the client wants or about pursuing more than an optimal number of potential investors. Although the lawyer should certainly have the client’s best interests in mind, there remains a tension because the client likely will want to limit the time spent more than will the law firm, who often will want to be more thorough. These are agency costs that result from the separation of ownership of the underlying assets, on the one hand, and control of the day-to-day representation of those interests, on the other hand.\(^{42}\)

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38. See Osborne, Start-Up Fever, supra note 6.
39. See supra notes 24–25 and accompanying text.
40. Milhaupt, supra note 35, at 182.
42. See infra Section IV and text accompanying notes 80–83 for more discussion of agency costs.
With a contingent fee or fee deferral, however, the lawyer only will get paid when the financing is obtained. While this could arguably provide an equally bad opposite incentive — i.e., an incentive to rush to obtain financing without being thorough enough — combining the fee deferral with some percentage-of-the-deal compensation can help achieve a shared understanding of value between the law firm and client. Law firms who own equity interests in their clients already have this shared conception of value because transactions that benefit the company and its stock value will also benefit the law firm in the form of a better return on its investment. This points to the second reason clients might prefer alternative fee arrangements such as a stock-as-fees model: equity investment provides an incentive for superior results.43

Finally, in addition to providing short-term incentives for law firms to do what is in the client's best interest in a single financing or other transaction, alternative fee arrangements provide an opportunity for both parties to develop a long-term relationship.44 Law firms recognize this, as indicated by a recent comment by a VLG partner in describing the lawyer-client-venture capitalist relationship: "It's a lot more than a contract negotiation or a pure economic transaction. You are picking a partner for the life of the company, or at least a substantial part of it."45

B. Public Offerings

For many start-up companies and venture capitalists, one of the goals is to become successful enough to take the company into a public securities offering. Often, if the company has been successful since the time it originally obtained a capital investment, the company will retain the same legal counsel that represented them during the early stages of their venture. For Silicon Valley law firms, this means that they could

43. Zeughauser, Improve Client Relationships, supra note 14, at 25, makes a similar point about alternative fee arrangements generally.

The most important factor is the feedback provided by an outside attorney who sees her client's budgetary constraints not as a threat to her own bottom line, but rather, as an opportunity to solidify and grow the existing relationship. . . . As a result, many law firms are eschewing some short-term financial rewards in exchange for a commitment to a long-term relationship.

Id. Obviously, these same points are true outside of the litigation context.
45. Beck, supra note 1, at 36 (quoting VLG Director Mark A Madearis).
be representing a client during an IPO and also hold an equity interest in that company.

While the above discussion demonstrated that this ownership can help align lawyer-client interests, it might also create a unique conflict of interest in the context of public offerings. In representing an issuer in an IPO, the law firm operates not only as an advocate for the best interests of the client, but also ensures that the company complies with the securities laws requirements governing public offerings. Like many of the other parties involved in the public offering — e.g., the underwriters, the accountants, and the board of directors and top management of the company — the law firm may have some due diligence requirements with respect to documents, schedules, and disclosures it reviews. Some potential investors who receive a prospectus or other offering documents also might expect that the outside legal counsel will serve a role similar to that of independent auditors — i.e., that the law firm will provide a neutral, objective assessment of the disclosures. Typically we can expect ethical and competent attorneys to perform exactly this function. Skeptics might argue, however, that a law firm that owns a significant amount of stock in a client that is about to go public might be less than objective. The law firm could have the same incentives to cheat on the disclosures as would any other interested party, as the firm might benefit financially, at least in the short-term, from any misrepresentation or nondisclosure that leads to a higher initial trading price for the stock. For example, the law firm might be forced to decide whether to make certain disclosures in the “Risk Factors” section of the proxy statement, or whether to suppress potentially harmful information in an attempt to maximize its own gains through an appreciation in stock value. This dilemma could

46. See, e.g., Escott v. Bar-Chris, 283 F. Supp. 643 (S.D.N.Y. 1968) (discussing due diligence requirements of various parties involved in a public offering). But compare commentators’ views regarding the typical lack of due diligence requirements for lawyers issuing 10b-5 opinions, as discussed in notes 60–63 and accompanying text.

47. While the law firm’s duties are not the same as those of an independent auditor — law firms do not have the same independence requirements as do accountants — it is arguably not unreasonable for an investor to expect some amount of independence. See supra note 23 and accompanying text. However, this is not necessarily an uncontested point. Other investors might view law firms purely as advocates for their clients. Nonetheless, there is some merit to the former point, and the American Bar Association has responded by advising law firms not to take significant ownership interests in clients who are about to go public. See infra notes 54–56 and accompanying text.

48. See generally Robert S. Risoleo, Completing Your Offering on a Timely Basis, 751 PLI COMM. 65 (1997) (discussing the sections and the general requirements of
itself be a conflict of interest, regardless of what the law firm ultimately decides.

The risks associated with interested parties participating in the public offering are salient enough to have attracted the attention of regulators in other contexts. Underwriters are regulated by the National Association of Securities Dealers, Inc. ("NASD") in some of the these same public offerings. Commentators have noted that "[a] potential conflict of interest arises between a member of [NASD] and the public when the NASD member participates in a public offering of its securities . . . in which the NASD member has an interest." Thus, NASD has promulgated the Corporate Financing Rule, which identifies and requires the use of a Qualified Independent Underwriter ("QIU") in certain situations where a potential conflict of interest could arise. The following situations, among others, are defined as conflicts of interest requiring the participation of a QIU: (1) Proceeds Directed to a Member — when more than 10% of the net offering proceeds are intended to be paid to NASD members participating in the distribution of the offering; (2) Venture Capital Restrictions — when a member participates in the public offering of an issuer's securities and sells such securities during the offering or within 90 days thereafter, regardless of when such securities were purchased; (3) General Investment Conflicts of Interest — if a member of the NASD participates in the underwriting syndicate or selling group, a conflict of interest is presumed to exist when such member beneficially owns 10% or more of the equity of the issuer. Regarding regulations like the Venture Capital Restrictions, one commentator has noted:

[T]he economic incentive of the firm or persons may be contrary to the financial interests of public investors because, instead of seeking to identify and disclose any adverse information on the issuer and to establish a fair public offering price, the firm or persons arguably would have an incentive to set a high

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50. See NASD RULES OF FAIR PRACTICE, Art. III, §§ 44(c)(7)(C), 44(c)(8) (1988); see also Schulte, supra note 49, at 191–97 (explaining the Corporate Financing Rule).

price and adhere to less stringent disclosure standards.\textsuperscript{52}

In these situations, a QIU must participate in the preparation of the offering documents and perform due diligence, and the offering price of the securities must be no higher than the QIU’s recommendation.\textsuperscript{53}

However, these NASD regulations are only directed at members, and there are no uniform rules covering potential conflicts of interest involving issuer’s legal counsel, regardless of the equity interest held by such law firms. Instead, the American Bar Association (“ABA”) in 1991 issued a course of study advising attorneys how to avoid legal malpractice.\textsuperscript{54} In this manual, the ABA warned law firms to:

\begin{flushleft}
[n]ever invest in the underwriter’s original allotment (as distinguished from the aftermarket) if you are counsel for the issuer or underwriter in an initial public offering under the 1933 Act. Often there is a rapid increase in the market price of IPO stock, and that windfall profit potential will be a fatal conflict of interest if the interest later fails and the other investors sue.\textsuperscript{55}
\end{flushleft}

In other situations, the ABA warned that stock purchases by law firms need only conform to Model Rule 1.8(a), which requires that (1) the terms are “fair and reasonable to the client” and are communicated in a form he can understand, (2) the client is given a chance to seek outside counsel, and (3) the client consents to the transaction in writing.\textsuperscript{56} In its recent Restatement (Third) of the Law Governing Lawyers, the American Law Institute (“ALI”) proposed no significant modifications to these ABA requirements.\textsuperscript{57} Agreements such as VLG’s “Conflict Waiver and Consent of the Company” form seem to comply with the requirements of Rule 1.8(a) and of the ALI’s Restatement.

\textsuperscript{52} Dennis C. Hensley, NASD Regulation of Corporate Securities Distributions, 335 PLI/COMM. 325, 398 (1984).

\textsuperscript{53} See Halperin, supra note 51, at 694.


\textsuperscript{55} Id. at 145 (emphasis added).

\textsuperscript{56} See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(a) (1998).

Some states have promulgated their own standards of professional conduct that go beyond the general suggestions of the ABA. For example, California Rule of Professional Conduct 3-310 provides that a conflict of interest could arise "where an attorney has a financial interest in the subject matter."58 Yet even this general rule falls short of the explicit NASD regulation of underwriters under the Corporate Financing Rule, and it does not appear to be a practical limitation on firms such as VLG or Wilson Sonsini who continue to take equity interests in their clients and continue to represent them during their IPOs.59

Part of the explanation that law firms are not regulated as strictly as underwriters lies in the different functions the two parties perform in connection with public offerings. Unlike underwriters, law firms neither establish the offering price of the securities nor participate in the distribution of the offering documents or prospectuses. This difference does not completely obviate the need for some regulation, however. Issuer’s and underwriter’s counsel often do issue so-called “10b-5 opinions,” whereby, at the underwriter’s request, the law firm will grant “negative assurance” on issues such as the registration statement’s compliance with the securities laws.60 These opinions raise a question of the amount of investigation a law firm must conduct to render such a statement. Law firms are not required expressly by any federal securities laws to engage in due diligence procedures in connection with 10b-5 opinions.61 Nevertheless, at least one commentator has argued that practical considerations typically lead issuer’s or underwriter’s counsel to perform some due diligence — e.g., the underwriter’s expectation of reasonable investigation and the risk of negligence liability for not performing even minimal diligence — and that law firms giving 10b-5 opinions should be liable only in the presence of fraud on the part

59. See, e.g., Osborne, Start-Up Fever, supra note 6 (noting that in 1995 VLG handled 18 IPOs for issuers and underwriters, ranking sixth nationally on the issuer’s side).
61. See id. at 181–82. A lawyer rendering a 10b-5 opinion to underwriters is not among those persons liable under Section 11 of the 1933 Securities Act as a "person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement." Id. at 187.
of the opinion giver. However, both the ABA and California have articulated concerns about the conflicts of interest resulting from counsel’s equity interest in an issuer or underwriter. The commentator’s proposal assumed that the “lawyer rendering the ‘10b-5 Opinion’ is seldom a controlling person,” and the commentator probably would require more extensive regulation where the law firm owns a significant equity interest in the issuer.

Perhaps no more regulation is needed, though, because current laws of more general applicability could be sufficient to mitigate most incentives issuer’s counsel might have to engage in unethical conduct. For example, the potential for malpractice or negligence liability, either under the securities laws or under state statutes or common law, provides a substantial risk of loss for law firms that are tempted to cheat on the required disclosures. Moreover, insider trading rules and regulations on selling “restricted securities” will eliminate almost all short-swing profit potential, and it will be unlikely that any material misstatement or non-disclosure will not be discovered before the sale restriction period expires.

In addition, a law firm’s ownership in equity of its clients provides incentives for ethical behavior and professional responsibility. On the one hand, the law firm’s financial interest in the issuer potentially conflicts with the public’s interest in disclosure. On the other hand, the law firm’s equity interest eliminates a potential conflict of interest between the lawyer and the client, and it reduces concerns about the means-objectives distinction of Model Rule 1.2(a). There is less concern that the lawyer will choose an inferior means to achieve a given client objective, because the two parties will have a shared understanding of value. Concerned with its stake in its clients, the law firm will have an incentive to do what is in the best interest of the client, at least in terms of maximizing the client’s stock value.

Given that 10b-5 opinions are provided to underwriters, who are relatively sophisticated parties, and given concerns about the effects that

62. See id. at 300.
63. Id. at 191.
64. See Osborne, Start-up Fever, supra note 6.
65. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(a) (1983).
66. Given that the Efficient Capital Market theory, in either its strongest or weakest forms, counsels that relevant public information is reflected in the value of publicly-traded stock, there is good reason to believe that stock value is a good proxy for what is in the best interest of the client. See FRANK H. Easterbrook & DANIEL R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 191 (1991) (explaining the Efficient Capital Market theory and providing a summary of relevant literature).
restrictions on law firms' investment in their clients could have on initial financing and on aligning a firm's interests with its client's interests, a more moderate solution, such as a disclosure requirement, may be appropriate. If law firms disclose their ownership interest — either to the public, or, at a minimum, to the underwriter requesting the 10b-5 opinion — then the users of such information can properly assess the value of the lawyer's opinion. The costs of disclosure usually should not be prohibitive for law firms that seek to obtain or retain an equity interest in their clients, and some of the concerns about conflicts of interest will be mitigated by the attention drawn to the nature of the lawyer-client relationship.

IV. THE LITIGATION OR DISPUTE CONTEXT: SETTLEMENT, DISCLOSURE, AND IMPROVING UPON CONTINGENT FEE ARRANGEMENTS

Section III discussed the benefits of law firm equity interests in clients regarding transactional matters, such as in obtaining financing or in public offerings of the client's securities. This section will discuss a few issues in the context of litigation, where both clients and lawyers can benefit from alternative fee arrangements. More specifically, this section will summarize briefly the economic literature on contingency fees and then will build upon the theories espoused to demonstrate how equity interests in clients can compliment and improve upon the advantages of contingency fee agreements. The considerations in this section are topical. The Silicon Valley and high-tech companies that often enter into stock agreements with their law firms are among those companies most frequently sued in federal securities litigation between December 1995 and February 1999.67

A. Contingency Fees

Recently, commentators have praised a marked trend towards the use of alternative fee arrangements such as contingency fees.68 The typical contingent fee agreement provides that the lawyer will receive

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67. See Stanford University School of Law, Securities Class Action Clearinghouse (visited March 2, 2000) <http://securities.stanford.edu/index.html> (reporting that the high-tech industry is the most frequently sued industry and that the Northern District of California is the most active district court).

68. See, e.g., Decker, supra note 44, at 36; Zeughauser, Improve Client Relationships, supra note 14, at 22.
a percentage of any recovery, whether obtained through the judicial process or through some other resolution such as settlement.\textsuperscript{69} There are at least three principal benefits of such arrangements: (1) because the optimal expenditure on legal services is a function of the stakes of the litigation, contingent fees help ensure that the cost of the lawyer's services will be proportional to these stakes; (2) similar to the analysis under transactional matters, contingent fees provide lawyers with a greater incentive to do a good job; and (3) some of the risks of litigation are shifted from the client to his lawyer.\textsuperscript{70}

These principal benefits do not come without a cost, though. As opposed to the hourly billing method of compensation, contingent fees that shift risk to lawyers "require complex negotiations between client and counsel at the outset of the case."\textsuperscript{71} Yet these increased transaction costs often are justified because of the efficiency and incentive gains discussed below. Additionally, more complex negotiations at the outset of a case can help to develop a better understanding of the goals and concerns of both the client and its legal counsel and can help avoid disputes later in the process. This shared understanding leads to a better long-term relationship between lawyer and client.\textsuperscript{72}

Because banks and other lending institutions are risk averse, some clients face a liquidity problem at the outset of litigation because they may not always be able to borrow against a meritorious legal claim. Judge Posner has noted that factors such as government regulation of financial institutions and the potentially high costs of estimating the likelihood of recovery in court may make the interest rate on any such loan prohibitively high.\textsuperscript{73} Contingent fee contracts help solve this problem. Operating as a lender to the client, by lending his legal services in exchange for a share of the claim, the lawyer can estimate the risks better than other lenders because of the lawyer’s specialization in legal matters and his ability to pool many claims "and thereby minimize the variance of the returns."\textsuperscript{74} Still, the law firm will likely demand a risk premium over the interest on its fees charged to compensate for the greater risk of default.\textsuperscript{75} Contingent fees, therefore,

\textsuperscript{69} See Zeughauser, Improve Client Relationships, supra note 14, at 29.


\textsuperscript{71} Decker, supra note 44, at 39.

\textsuperscript{72} See supra text accompanying notes 44–45 (discussing this idea in the transactional context).

\textsuperscript{73} See Posner, supra note 70, at 624.

\textsuperscript{74} Id.

\textsuperscript{75} See id.; see also Pennsylvania v. Delaware Valley Citizens' Council, 483 U.S. 711, 735–36 (1987) (Blackmun, J., dissenting) ("[L]awyers charge a premium when
can provide a skilled lawyer an opportunity to make substantial profits by successfully resolving disputes and pooling contingent claims to reduce variance of returns. Moreover, clients are able to bring meritorious claims that would not have otherwise been viable.\footnote{See Robert Cooter & Thomas Ulen, Law and Economics 344 (2d ed. 1997).}

Once again, these types of arrangements help to better align the lawyer’s and the client’s interests. For example, without a contingent fee, the incentives to engage in pre-trial discovery might be vastly different for lawyers and their clients. On the one hand, lawyers who bill hourly might have incentives to “run up” the hours in excessive fact-gathering. This might not result from a deliberate attempt to maximize billable hours, but instead could be a product of the lawyer’s risk aversion coupled with little or no reward for cost-cutting.\footnote{See Posner, supra note 70, at 625; Decker, supra note 44, at 40.} On the other hand, lawyers who are retained under a contingent fee arrangement are better able to assume risk that is commensurate with the stakes of the dispute and can thus adjust their discovery practices accordingly.\footnote{See Decker, supra note 44, at 40.} Also, lawyers with contingent fees are more likely to settle a case when it is in the best interests of their client than are attorneys with an hourly billing arrangement, as the latter might have an incentive to extend the matter as long as possible.\footnote{This last point assumes that there is no difference between the structure and substance of the settlement offers in the two contexts. If one of the settlement offers provided a higher percentage of the recovery to the attorneys, an agency problem would be more likely to arise.}

Agency costs still remain, however, even with a contingent fee. In their book \textit{Law and Economics}, Robert Cooter and Thomas Ulen describe what they call the “agency game,” whereby the client puts a legal claim under a lawyer’s control, and whereby “[t]he lawyer can serve the client or exploit the client.”\footnote{Cooter & Ulen, supra note 76, at 345.} While it has been demonstrated earlier that contingency fees help reduce this agency problem, they do not eliminate it. Judge Posner notes that:

A problem with the contingent fee is that in any situation of joint ownership (and a contingent fee contract makes the lawyer in effect a cotenant of the property represented by the plaintiff’s claim), each

\begin{itemize}
  \item their entire fee is contingent on winning
  \item The premium added for contingency compensates for the risk of nonpayment if the suit does not succeed . . . .
\end{itemize}
owner . . . may lack an adequate incentive to exploit the right, because part of the benefit of his efforts to do so will accrue to another person . . . . So there is a conflict of interests between the parties, due solely to the fact that the lawyer does not obtain the whole benefit of a trial.81

Cooter and Ulen similarly argue that the agency problem would only be solved if the lawyer took the case on "100% contingency," as the lawyer would internalize both all of the costs of working on the case as well as 100% of the payoff from a settlement or judgment.82 In effect, the client would sell the claim to the lawyer.83

B. Equity Interests in Clients: Improving Upon Contingent Fee Arrangements

If the law firm has an equity interest in the client, there are improved incentives for the lawyers to pursue the proper course of action in a dispute (from the client's perspective) in at least two different contexts.84 First, the lawyer's equity stake in the client can help mitigate the agency problem that results from less than full ownership of the contingent benefit. Consider the following example from Judge Posner's Economic Analysis of Law.85 A plaintiff's lawyer is offered $100,000 as settlement for a claim. If the case goes to trial, there is a 90 percent chance that the plaintiff will recover $150,000, but the trial will cost the lawyer an additional $25,000 worth of his time. The contingent fee is 30 percent. If there was a settlement, the plaintiff would receive $70,000, and the lawyer $30,000. If, however, the case goes to trial, the expected recovery for the client increases to $94,500 [$.9 \times ($150,000 - $45,000)],86 but the lawyer's gain decreases to

81. POSNER, supra note 70, at 625.
82. See COOTER & ULEN, supra note 76, at 347.
83. See id. Note, however, that the law does not allow this practice, which is known in the common law as "champery." Id. at 347–48 & n.7.
84. Note that although the Private Securities Litigation Reform Act does require the court to make a determination about whether there is an attorney conflict of interest "if a plaintiff is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation," this would certainly not eliminate litigation involving non-public companies, nor does the language contemplate that all such situations will be conflicts. 15 U.S.C.A. § 78u-4 (West 1999).
85. POSNER, supra note 70, at 625.
86. $45,000 is the lawyer's 30 percent fee on a $150,000 judgment. See id. at 625 n.2.
$15,500 ($45,000 × .9 – $25,000). Thus, the lawyer has an incentive to settle, even though the expected recovery at trial is higher for his client.

Suppose, however, that the law firm also owned 10,000 shares of its client. Suppose further that a combination of the expected additional $24,500 ($94,500 – $70,000) recovery for the client, along with the positive publicity that would result from a judicial or public vindication of the client’s claim, would increase the client’s stock value by $2 per share.87 Now the law firm would benefit by an additional $20,000 ($2 × 10,000 shares) by going to trial, and its expected recovery would be greater from the trial, $35,500 ($15,500 + $20,000), than from settlement, $30,000. Here, the lawyer’s and client’s interests are more closely aligned as both will now prefer trial over settlement. Thus, the agency problem has been mitigated.88

The second context in which law firm equity interests can help better align lawyer’s and client’s interests is where there is a difference between what is the maximum expected recovery in a particular case, as opposed to what is in the best interests of the firm’s stock value. Assume, for example, that the law firm has an equal incentive for trial or settlement.89 Now the only relevant consideration should be the expected value of trial versus the settlement offer. Under Posner’s example, the expected value of trial is $135,000 ($150,000 × .9) versus the settlement offer of $100,000. Given these figures, the lawyer should obviously refuse the settlement offer in order to maximize the client’s recovery. Suppose, however, that during the trial there likely will be negative publicity about the client, and this publicity could drive the stock price down more than the $35,000 difference between the two options. Under these facts, the law firm needs an incentive to take into consideration what is in the best interest of the client, not just in the context of this dispute. Again it would be easy to construct an example in which the decrease in the stock value and the law firm’s number of shares are sufficient to ensure that the law firm will have the same

87. Perhaps the settlement agreement would require confidentiality as to the terms and amount of the settlement, and as a result there would be little or no movement in the stock price.

88. The agency problem is not eliminated because one could easily construct examples where the change in stock price will not be sufficient to overcome the difference in the law firm’s recovery from settlement versus trial. Still, it is enough to note that the equity interests will help to reduce the agency problem.

89. For example, the law firm could be fully reimbursed for its costs before any recovery is divided up, and the likelihood of recovery of a greater amount could be sufficient to offset the guaranteed fee reimbursement from a settlement.
incentives as would the client. Thus, the equity interest can help better align another dimension of the lawyer's and client's interests by requiring the lawyer to internalize certain changes in the client's stock value.

V. CONCLUSION

Robert Cooter and Thomas Ulen argue that:

Like other professionals, lawyers pursue their self-interest by selling their services . . . . Within the context of law, professional ethics, and morality, self-interest ideally directs lawyers to pursue the best interests of their clients. By pursuing the best interests of their clients, lawyers help courts to reach an ideal outcome of disputes.90

This, in turn, leads Cooter and Ulen to conclude that "the incentive structure for lawyers ideally aligns self-interest and the public interest."91 While there is sometimes tension between client interests and the best interests of the public (as demonstrated in Section III.B in the context of public offerings), encouraging law firms to take equity interests in their clients should further law firms' pursuit of their clients' best interests. Moreover, there is reason to believe that the costs to the public should be minimal, while the benefits for clients who want to obtain financing, or who want to bring a legal claim that they might not otherwise be able to afford, should be great. Law firms will have stronger incentives to help their clients obtain optimal financing arrangements, and by deferring billing, or by accepting stock in lieu of cash, the law firm can actually mitigate the liquidity problems start-up companies face. In the litigation context, equity interests more closely align lawyer-client interests than do any of the more common alternative fee arrangements. As a result, any regulation of these law firms should take into consideration the benefits of such arrangements and should be careful to not provide disincentives for such creative fee structures in the future.

90. Cooter & Ulen, supra note 76, at 363–64.
91. Id.