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Equity Billing Arrangements: An Ethical Conundrum

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ABSTRACT

This paper at the outset, sheds light on the emergence of 'equity billing arrangements', wherein lawyers and law firms are reimbursed through equity in a company instead of cash, for legal services rendered. This paper at the preliminary level seeks to understand the legal regulation surrounding equity billing arrangements, from the its inception in the United States to its governance in India. The paper will delve into the professional rules for lawyers in both countries, and analyze the respective provisions that regulate legal compensation. Following the establishment of its legal position in both countries, this paper deliberates the ethical issues arising from this billing arrangement, and the obligations it poses on lawyers and companies alike. Lastly, this paper establishes the need for clarification by the Indian regulators on the legitimacy of these arrangements, and the manner in which they ought to take place.

I. INTRODUCTION

The forms of compensation that lawyers undertake have been significantly reconsidered over the last two decades. The fundamental determinant of their fee is often their industrial repute, coupled with their practical knowledge. While some traditional pricing techniques like hourly fee, fee per hearing and transactional fee are used widely, lawyers have innovated novel billing methods in order to increase their bandwidth and better provide access to justice.

At the turn of the century, lawyers in Silicon Valley started testing alternate fee arrangements with clients, in order to claim a piece of the cake on the start-up boom at the time. One such billing arrangement that held good was the equity billing arrangement ("**EBA**"), wherein clients, usually start-ups or cash strapped companies, would compensate their lawyer through equity in their company in consideration of the legal services provided. The prospect of EBA's becomes interesting for entitles looking to save costs on legal fees, while onboarding beneficial shareholders. However, the ethical implications that arise from an EBA must be carefully analyzed due to the questions it poses regarding its ethical viability.

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This paper will delve into the legal regulation surrounding EBA's in the United States and India, while attempting to understand the consequent implications of these regulations. Moreover, this paper will deliberate the ethical complications arising out of such arrangements on part of the legal practitioner.

II. EBA'S IN LIGHT OF START-UPS

The drastic increase in the number of start-up ventures over the last two decades have cemented the need for ancillary industries to support and nurture its growth. The potential economic up-side of these ventures makes it indefinitely lucrative for stakeholders to finance, support and involve themselves in. While there are numerous hurdles that these entities may face during their life-span, acquiring funding at a low cost is one of the biggest hindrance to their growth. Moreover, these ventures rack up various costs in order to develop their idea, legally protect it and finally operationalize. Legal support at this juncture becomes vital for companies, be it registering intellectual property or drafting share purchase agreements.

An EBA certainly comes with its advantages in a situation like this, wherein start-ups require extensive legal support to run their business. The benefit is added, when the need for quality legal representation is paramount to the success of the company. For example, in cases where the intellectual property of the company plays a significant role in its success, the value of having a competent lawyer on board is immense. Apart from also establishing a relationship of trust between the company and the lawyer, it allows the company access to easy legal representation without having to spend a considerable amount of money.

While an EBA structure certainly eases the burden on companies, it poses a plethora of ethical problems for the lawyers involved. By virtue of being a profession with codified rules of practice, lawyers are bound by these statutory requirements laid down by the respective governing body. While certain governing authorities like American Bar Association ("**ABA**") have notified the rules regarding the operation of an EBA, the Bar Council of India ("**BCI**") is yet to do so, leaving its permissibility ambiguous.

III. AMERICAN REGULATION SURROUNDING EBA'S

America's impressive portfolio of start-ups and companies can be attributed to their innovative nature as a regulatory authority. Easy access to funding, infrastructure, role-models and monetization capabilities are some of the factors behind its success at incubation[2]. Their success at providing suitable environments for growth and success can also

[2]Robert Scoble, *Why do Most of the Successful Start-ups Come Out of the USA?*FORBES (July. 29, 2013),

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be attributed to their free market and capitalistic outlook at big business, allowing innovation at every step of the stage. It is this innovation that has also allowed lawyers and law firms alike to cut themselves a piece of the cake, with respect to EBA's.

The rules regarding the professional demeanor of lawyers in America is put forth by the ABA in the Model Rules of Professional conduct[3] ("**Model Rules**"). Rule 1.8(a) of the Model Rules sheds light on the specific rules pertaining to a client-lawyer relationship, and situations wherein a lawyer may enter into a business transaction with a client. While certain broad rules are mentioned under this Rule, the ABA had not clarified the permissibility of an EBA within these Model Rules.Due to this lack of clarity, many lawyers wrote to the ABA at the turn of the century seeking guidance regarding the propriety of such fee structures.

The need for clarification was heightened when the California Court of Appeals held its validity in the Negative. In *Passante v. McWilliam*[4], the plaintiff-lawyer agreed to arrange a loan of $100,000 to a struggling business as it had difficulties raising the necessary funds for operation. In lieu of this loan, the board of the company decided to give three percent of its equity to the lawyer-plaintiff. However, when the lawyer-plaintiff sought to enforce this agreement, the company disputed it. The Court held that the contract was unenforceable due to the lack of valid consideration, and failure on the lawyer's part to advice the company to seek independent legal advice.

The ABA subsequently issued a Formal Ethics Opinion regarding the multiple nuances and permissibility of an EBA[5] ("**Formal Opinion**"). To the relief of many Silicon Valley law firms, the Formal Opinion validated this form of alternate billing arrangement, subject to the adherence of certain other rules laid down in the Model Rules. The Formal Opinion states that any lawyer engaging in EBA's must comply with Rule 1.8(a) of the Model Rules, by fulfilling the four conditions stipulated therein. The lawyer considering taking stock in lieu of fees from the client must ensure compliance with the following conditions:

i. The terms on which the lawyer acquires a stake in the company must be *fair and reasonable* to the client;

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https://www.forbes.com/sites/quora/2013/07/29/why-do-most-of-the-successful-startups-come-out-of-the-usa/#51b2802f3166.

3American Bar Association, Centre for Professional Responsibility. *Model Rules of Professional Conduct*. (2019), https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/

4Passante v. McWilliam,53 Cal.App. 4th 1240 (1997)

5American Bar Association, Centre for Professional Responsibility, Formal Opinion no. 00- 418 (2000), "*Acquiring Ownership in a Client in Connection with Performing Legal Services"*. https://www.americanbar.org/products/ecd/chapter/219981/

ii. The terms of the transaction must be *disclosed in writing* to the client, in a manner that can be reasonably understood;

iii. The client must be advised in writing by the lawyer, that the client may *seek independent legal advice* by a counsel of his/her choice; and

iv. The client must furnish a document with his signature giving the lawyer his *informed consent* regarding the transaction.

In addition to the aforementioned stipulations, the Formal Opinion discusses Rule 1.5(a) of the Model Rules which requires the fees payable to the lawyer to be 'reasonable'. It advices the lawyers to reach a reasonable fee quote using the factors enumerated within the rule[6].

Prima facie, this requirement of a reasonable fee may be appropriate, but it puts the parties involved in a precarious position regarding the valuation of the company. Since most companies are not publicly listed at this stage, the value of its shares are unascertainable. The ABA states that in such cases, the percentage of stock divulged to the law firm, must reflect the value that the firm brings to the company.

A careful reading of the Formal Opinion shows that the ABA has unambiguously allowed EBA's, and stressed on the importance on innovations like these in order to allow and facilitate the growth of both industries concerned. However, the ABA has stressed for caution on part of both parties, before concluding such contracts. On one hand, the lawyer may stand to make a windfall from the equity if the company does well, and on the other hand, the lawyer may collect nothing if the start-up fails, which remains the statistical probability[7].

IV. INDIAN REGULATION SURROUNDING EBA'S

The rapid growth of start-ups in India can be attributed to the steady development of its infrastructural ecosystem. With the addition of over 1,300 start-ups in 2019 itself, India

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

[7]Neil Patel, *90% of Startups Fail: Here's What You Need to Know About the 10%*, FORBES (Jan 16, 2015), https://www.forbes.com/sites/neilpatel/2015/01/16/90-of-startups-will-fail-heres-what-you-need-to-know-about-the-10/#5645786a6679

continues to reinforce its position as the third largest start-up ecosystem in the world[8]. While these developments influence business in India,law firms are yet to use alternative billing structures while transacting with companies.

The rules pertaining to the professional conduct of lawyers in India are issued by the BCI in the Rules of Professional Standards[9]. The Rules of Professional Standards are further divided into four subsections, namely the duty of the advocate towards the client, duty of the advocate towards the court, duty of the advocate towards the opponent and duty of the advocate towards fellow advocates.

At this juncture however, it is important to understand the meaning of the term 'advocate' within the rules, and analyze whether the term would cover all forms of legal practitioners and not only advocates registered under the Advocates Act, 1961 ("**the Act**"). Since most lawyers employed by law firms deal with transactional law, they are not required to litigate and thus needn't get enrolled under the Act.

In *Bar Council of India vs A.K Balaji*[10],the Supreme Court of India held that the practice of law includes drafting of documents, rendering legal opinion and other similar non-litigious functions. These non-litigious functions would fall within the ambit of 'practice of law' as envisioned by Section 29 of the Act[11], and thus, non-litigious lawyers would also be subject to the Rules of Professional Standards.

After establishing the applicability of these rules to all legal practitioners, it is pertinent to understand the regulations surrounding EBA's. Rule 9 of the rules regarding the Advocate's Duty Towards the Court states that an advocate should not appear in or before any judicial authority for or against any establishment if he is a member of the management of any establishment. A preliminary reading of this rule would point to the blanket prohibition of EBA's, by virtue of shareholders being members of a company. However, the provision is riddled with loopholes and ambiguities in its interpretation.

The first part of the provision states that the prohibition only extends to advocates appearing in or before any judicial authority. It does not prohibit transactional lawyers or non-litigious

[8]*Over 1,300 startups added in 2019, over 8,900 tech-startups in India now: Nasscom*. ECONOMIC TIMES (November. 05, 2019), https://economictimes.indiatimes.com/small-biz/startups/newsbuzz/over-1300-startups-added-in-2019-over-8900-tech-startups-in-india-now-nasscom/articleshow/71925791.cms.

[9]Bar Council of India, Rules on Professional Standards, *Chapter II, Part VI of the Bar Council of India Rules*(2019), http://www.barcouncilofindia.org/about/professional-standards/rules-on-professional-standards/

[10]Bar Council of India vs A.K Balaji,AIR 2018 S.C. 1382.

[11]Advocates to be the only recognised class of persons entitled to practise law. —Subject to the provisions of this Act and any rules made thereunder, there shall, as from the appointed day, be only one class of persons entitled to practise the profession of law, namely, advocates.

practitioners from being members in establishments it represents. It is common for companies to hire corporate lawyers for transactional matters and litigators for any matter that require court appearances. Thus, in a scenario where the lawyer needn't appear in court, the legitimacy of an EBA's remains in the grey.

The obscurity is amplified under Rule 10 of the rules regarding the Advocate's Duty Towards the Court. The Rule states that an advocate may not act or plead in any matter which he has pecuniary interests. Once again, the interpretation of 'act' and 'plead' under this provision remains vague. Would these terms extend to the manifestation of legal opinion and drafting transactional documents, or would it be limited to litigious activities like pleadings and trial proceedings?

Indian regulation surrounding EBA's remain extremely ambiguous and tight lipped. There exists no clarity regarding its validity with no judicial decisions rendered on the subject. While a plain reading of the aforementioned rules would certainly point towards the prohibition of EBA's, it is not hard to imagine a case being made given the lacunas within the relevant rules and wide nature of language used.

V. THE ETHICAL CONSIDERATION BEHIND EBA'S

The pith and marrow of a lawyer-client relationship rests on the underlying principle that the lawyer is to provide equitable legal advice and independent judgement to the client that is not impacted by the lawyer's personal financial gain. Once an EBA is entered into by the parties, the element of independence on the lawyer's part becomes questionable. A lawyer can no longer hide behind the designation of an advisor or a consultant to the firm. By virtue of the lawyer losing this independence test, a number of ethical aspects need to be reconsidered.

(A) LOSS OF INDEPENDENCE OF COUNSEL

The relationship between a lawyer and a client is significantly different from the relationship between the shareholder and a company. While the essence of the former is premised on the delivery of sound and independent legal advice, the latter emphasizes on the maximization of returns and increase in valuation. When both these relationships coincide, the acute problem of a conflict of interest arises on part of the lawyer. On one hand, it is the lawyer's duty to render independent legal advice to the client, and on the other hand, the lawyer may stand to suffer a pecuniary loss due to the conveyance of this legal advice.

For example, in a situation where the lawyer-shareholder is called upon by the client to negotiate with a potential investor, the lawyer is duty bound to accurately share the true and

correct details of the company. There is also the cogent possibility of the lawyer withholding adverse information about the company in order to increase the probability of the deal going through, which would certainly benefit the lawyer[12]. In such cases, the company ought to be vary about the possibility of a conflict and therefore, it may be advisable to seek the independent counsel of a third party lawyer.

(B) DISCLOSURE COMPLIANCE

The hindrances to disclosure compliance on part the company is an extension of the previous section, pertaining to the independence of counsel. Lawyers are considered to be the sentinel of corporate disclosure, insofar as the discovery of red flags and the representation of statutorily required information. Lawyers are considered the final authority on the same, and in the event of misrepresentation of this information, it is the companythat will likely be held liable.

When the lawyer also becomes a shareholder in the client, the growth and success of the company becomes a priority for the lawyer since the valuation of his portfolio depends on it. The possibility of conflicting motivations here may encourage the lawyer to take those extra steps in order to ensure the well-being of the company. Of course, those extra steps may not always fall on the right side of the law. The question that arises here is whether EBA's encouragelawyers to curb securities law in order to maximize their economic returns? The logical question that follows is whether we need a billing arrangement that gives rise to such opportunities.

(C) RESEMBLANCE TO A CONTINGENCY FEE ARRANGEMENT

Contingency fee arrangements refer to a method of billing wherein the fee payable to the lawyer for legal services depends on the result or outcome of the litigation. The legality of such agreements vary in different jurisdictions. While the ABA allows for contingent fee agreements in all civil cases[13], BCI expressly prohibits it within the Rules of Professional Standards[14].

Contingent fee agreements share a similarity with EBA's insofar as the exact monetary value for the services provided is not disclosed at the time of engagement. While a contingent fee agreement is largely determined by the outcome of the litigation (attributable to the efforts of the civil lawyer), the capitalization of an EBA is determined by the success of the business, of

[12] Sheldon Banoff, *When Can Law Firms and Lawyers Accept Stocks or Stock Options for Services?* KMZ ROSENMAN (June. 28, 2002), https://katten.com/files/22063_when_firms.pdf
[13]Rule 1.5(c), *Model Rules of Professional Conduct.*
[14]Rule 20, Section II, Duty to the Client, *Rules of Professional Standards.*

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which the onus is on the company.

The similarity can be drawn between the two types of arrangements by assessing the problems they mutually face. Since the fees depends on the occurrence of future events, the lawyer either stands to make a substantial amount of money, or absolutely nothing. It remains interesting to understand whether this resemblance to a contingent fee arrangement would render it impermissible within the ambit of Indian law.

(D) REGULATORY COMPLICATIONS

All said and done, the potential advantages of an EBA remains too material to ignore, and it is clear to see how such an arrangement benefits companies and lawyers alike. The opportunity of having quality legal representation at a considerably reasonable cost becomes a lucrative option for companies looking to save cash and invest the same in its growth. Moreover, another benefit of having a minority investor in the form of your legal counsel is that the lawyer is probably not looking to increase his stake in the entity, and is likely to stay out of the operational scheme of things.

However, the problems with EBA's are more deeply rooted, from an ethical point of view. Regulating an EBA requires a lot of clarity and oversight as to the responsibility of the lawyer involved, and obligations that fall on his part throughout the course of the relationship. Conflicts such as those that arise due to the lawyers' other clients, or any matter that they litigate in court are common within the profession. We must consider just how realistic it is for lawyers to anticipate scenarios wherein their ability to render independent legal advice is compromised. In addition to the ability to anticipate these conflicts, lawyers are expected to communicate this to the client, in order to enable the company to take a rational decision regarding the advice of its counsel.

Even in a situation wherein the lawyer is able to anticipate and disclose the impending conflict to the client, there still remains the question as to whether such anticipation and disclosure is sufficient to mitigate any liabilities that may arise in the future due to said conflict. It is unrealistic to think that we can adequately regulate all aspects of an EBA, due to the wide nature of conflicts that may arise.

VI. CONCLUSION

The viability of an EBA for interested parties is certainly evident from a commercial standpoint. The opportunities it presents for both parties are certainly worth taking up under the right circumstances. Due to the increasing costs of legal representation, the opportunity of

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saving cash on this front proves to be very cost effective for companies. The concurrent logic applies to law firms, who stand to make a higher income as compared to regular billings. Furthermore, as start-ups are more likely to default on payments due to cash constraints, securing equity in these entitiesmay benefit the lawyers while coming to a liquidation plan.

The ethics behind this arrangement are dubious due to the higher professional standards imposed on lawyers. While the west has already addressed the matter, India lags behind in this aspect and it remains unclear as to whether such arrangements are permissible. The lack of clarification and judicial decisions on the matter significantly discourages lawyers adopting such billing structures, due to the potential backlash by regulators.

At a time when the legal industry is perceived to be fueled by billings, EBA's will certainly reignite the mundane fiduciary relationship shared between the lawyer and the client. Ultimately, it comes down to which side the BCI chooses to swing its pendulum: the adoption of contemporary industrial practices or the maintenanceof the indubitable ethical standards.

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