"REVISED" UCC ARTICLE 9 PREVIEW

The 2001 Oregon legislature will undoubtedly pass most of the new "Revised Article 9" of the Uniform Commercial Code, introduced as Senate Bill 171. The intent of the National Conference on Commissioners of Uniform State Laws ("NCCUSL") is for Revised Article 9 to take effect on July 1, 2001. The purpose of this article is to alert Oregon practitioners that the change is coming, preview the more significant changes in existing law, and highlight some potential malpractice issues.

RESEARCH TOOLS

The Official Comments prepared by the NCCUSL for each section of the uniform draft of Revised Article 9 should be your first resource. The Comments will likely become part of the legislative history of the version adopted by the Oregon legislature. The Comments provide the reasoning of the drafters and illuminate the changes made from old Article 9. The 1999 (West) Supplement to J. White & R. Summers Uniform Commercial Code (paperback called "Uniform Commercial Code Secured Transactions Fifth Edition") contains an extensive analysis of Revised Article 9. Also, the ABA Section of Business Law has published The New Article 9 Uniform Commercial Code (paperback) edited by Corinne Cooper.

TRANSITION RULES

The first and perhaps most significant malpractice trap is presented by the new law's national effective date of July 1, 2001. The new law's complex "transition rules" provide several "grandfathering" provisions covering both security agreements and financing statements. Under new UCC 9-703, if a security agreement is enforceable under the old law prior to July 1, 2001, but the security agreement would be unenforceable under the new law, the security agreement remains enforceable for a period of one year (through July 1, 2002). If the defect in the security agreement is corrected under the new law within the one-year grace period, the security agreement is enforceable after July 1, 2002.

All financing statements that are effective under the old law as of the effective date of July 1, 2001 remain effective until their 5-year lapse date occurs under the old law. The statement may then be continued by the filing of an "initial financing statement in lieu of continuation statement." New UCC 9-702 to 9-706. The initial financing statement in lieu of continuation must be filed in the appropriate state under the new law (in the state where the debtor is located). The new statement can be filed at any time and the new statement will lapse five years after the date it was filed. For the first five years after July 1, 2001, creditors searching for financing statements may have to search in multiple jurisdictions because of the new rules providing for filing financing statements in the state where the

DISCLAIMER

This newsletter includes claim prevention techniques that are designed to minimize the likelihood of being sued for legal malpractice. The material presented does not establish, report, or create the standard of care for attorneys. The articles do not represent a complete analysis of the topics presented and readers should conduct their own appropriate legal research.
If a security interest is perfected under the old law by a method other than filing and the new law requires a filing to perfect, the security interest remains perfected for one year until July 1, 2002. If the defect in perfection is cured by filing within the grace period, the security interest remains perfected thereafter.

SCOPE ISSUES

The new law now includes commercial bank accounts (new UCC 9-104), “health-care-insurance receivables” (new UCC 9-109(d)(8)), and software that has been “licensed to the debtor” (new UCC 9-408) as collateral in which a security interest may be granted.

Banks perfect a security interest in bank accounts automatically if the account is maintained at the bank. Creditors other than banks need an agreement authenticated by the debtor and the bank that the bank will pay the money over to the creditor pursuant to the creditor’s instructions or by the opening of an account in the creditor’s name.

“Health-care-insurance receivables” are the obligations of health care insurers to doctors and other medical services providers.

“Software” is now included in Article 9’s definition of “general intangibles.” New UCC 9-102(a)(75) and 9-102(a)(44) provide that the definition of “goods” includes software that is “embedded in goods,” but that software is not “goods” if the software “consists solely of the medium in which the program is embedded.” An example of software embedded in goods is a computer chip incorporated in an automobile engine. Software licenses can be collateral even in the face of anti-assignment clauses; however, the secured creditor is not allowed to use, sell, or otherwise dispose of the license without the licensor’s consent.

PERFECTION AND FILING ISSUES

As noted above, banks perfect security interests in bank accounts automatically if the debtor’s account is maintained at the bank. Creditors other than banks need an agreement by the debtor allowing the bank to pay the money over to the creditor pursuant to the creditor’s instructions or directing the opening of an account in the creditor’s name. Under either scenario, perfection is via “control” as provided in new UCC 9-104(a). The control agreement among the bank, debtor, and secured party must be authenticated. Under new UCC 9-104(b), the secured party has control, even if the debtor retains the right to direct disposition of funds from the deposit account (most cases).

New UCC 9-301 and 9-307 provide that financing statements must be filed only where the debtor is “located.” Corporations, LLCs, and limited partnerships are “located” in the state where they are organized. Other businesses are “located” at their “chief executive office.” Individuals are “located” at their principal residence. All of the complex multiple state perfection rules in old UCC 9-103 that were based on types of collateral such as “mobile” goods have been eliminated, except for the transition period discussed above. New UCC 9-316 provides several rules governing changes in the debtor’s location to another jurisdiction and transfers of collateral to a person in another jurisdiction that becomes a debtor. There is a four-month grace period for filing in the new jurisdiction after the debtor changes its location from one state to another, and a one-year grace period for transfers of collateral to a person in a different state.

Two significant new filing rules that do not change existing Oregon law are the mandatory central filing rule (financing statements other than

BANKRUPTCY LAW CHANGES

Legislation is currently pending before Congress to enact “bankruptcy reform.” The House and Senate have each passed separate bills to address the issues (H.R. 833 and S. 625). A general explanation of the proposed provisions is discussed in the July 2000 In Brief article Bankruptcy Law Changes on the Horizon.

The full text of both bills (and related commentary) can be viewed at the American Bankruptcy Institute’s web site: www.abiworld.org/legis/newlegfront/html.

Experts following these bills anticipate that the final legislation will be pro-creditor and that the legislation may be finalized this summer.
fixture filings are filed with the Secretary of State) (new UCC 9-501) and the filing of financing statements for agricultural liens (new UCC 9-109(a), 9-310(a), and 9-322). Oregon will likely not adopt Revised Article 9’s requirement that agricultural lien claimants file financing statements. The existing agricultural lien statutes in ORS Chapter 87 should remain on the books and banks and other farm production lenders should not have the advantage over suppliers, storers, shippers, and laborers that they will have in most other states.

Another significant change is that financing statements may, under new UCC 9-504(2), describe the collateral as “all assets” or “all personal property.” Warning! This is not the case for collateral descriptions in security agreements. Lawyers should continue to describe collateral in security agreements using Article 9’s classifications such as “all equipment,” “all inventory and accounts receivable,” and “general intangibles.” Be sure to include the after-acquired property clause, when applicable.

A change brought about by electronic filing technology is that under new UCC 9-502 and 9-509, the debtor need not sign the financing statement. The security agreement must, however, authorize the secured party to file the financing statement under new UCC 9-502. There is also a provision under new 9-518 that allows for challenging “bogus” electronic filings. With respect to the security agreement, the debtor need only “authenticate” the agreement by an electronic signature, a “mouse click,” or verbal assent in a recorded telephone conversation.

FORECLOSURE ISSUES

New UCC 9-626 adopts the “Oregon Rule” on the issue of whether violations of the commercial reasonableness standard for disposing of collateral after default bar a secured creditor’s claim for a deficiency judgment. Thus, there will be no change to existing Oregon law which already provides for a rebuttable presumption that the value of the collateral was equal to the price obtained on disposition. The debtor must come forward with evidence that the alleged defects in notice, time, or manner of sale caused the creditor to realize less on disposition than it should have. The burden then shifts to the creditor to prove otherwise. In cases where the collateral is bought by the foreclosing secured party or a related party and the debtor can show that the sale price was “significantly below” the price that an unrelated party would have paid, the court must calculate the deficiency based on the price that an unrelated party would have paid at a commercially reasonable disposition. New UCC 9-615. Also, under new UCC 9-620, a secured creditor may conduct a “partial strict foreclosure” by taking the collateral in partial satisfaction of the debt. Under the old law, only “full strict foreclosures” were permissible.

There are several new foreclosure notice requirements under the new law. In commercial cases, all parties that have filed financing statements must be given notice of the foreclosure disposition. New UCC 9-611. Under the old law, if other filers wanted notice of the disposition, they had to so notify the foreclosing creditor. In consumer cases, new UCC 9-614 provides a specific form for notice to consumer debtors of the planned foreclosure. Also, where the secured creditor makes a written attempt to collect a deficiency in a consumer case, the creditor must provide the debtor with a statement of how the deficiency was calculated, including costs and attorney fees. New UCC 9-615.
CONCLUSION

By far the most significant changes in the law for Oregon lawyers are the changes in the location of filing and choice of law rules. Although these changes make perfection of security interests simpler and less complicated, the need for the complex transition rules that get us from the old ways to the new ones unfortunately create many malpractice traps for the unwary. Please look for a future In Brief article dealing specifically with the transition rules and these malpractice traps once the legislature has passed Revised Article 9 and the July 1, 2001 effective date looms large.

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Our thanks to Richard A. Canaday, Miller Nash LLP, for reviewing this article.

The following are internet resources on this topic:

Commercial Finance Association:
www.cfa.com
(Site index at bottom - select Revised Article 9.)

Intercounty Clearance Corp.:
www.intercountyclearance.com
(Select RA9 Resource Center on left of screen.)

Consumers Union:
www.consumersunion.org/finance/summwc100.htm

CT Corporation:

American Bar Association-Business Law:
www.abanet.org/buslaw/cfs-ucc/ucc/article9

CORPORATE START-UPS – ISSUES TO CONSIDER

Lawyers who have business contacts often are asked to assist with the start-up of a new business. Before accepting representation, it is important to consider the issues outlined in this article.

WHO IS THE CLIENT?

Identifying the client may not be as simple as it seems initially, and it is a step that many lawyers either stumble over or simply fail to do. It is especially important and particularly challenging to clarify this issue when handling start-up businesses. Here are a few examples:

Three individuals have approached you to help them start a new corporation. One of the individuals will provide cash, the second individual will provide a license to certain patented technology, and the third will provide labor. In addition, the three would like to obtain a bank loan.

Can you represent more than one of the shareholders? Can you represent a shareholder and the corporation? Can you represent all of the shareholders and the corporation? Depending on the facts, the simultaneous representation of incorporators and the corporation can give rise to an actual or likely conflict of interest, or there may be no conflict at all. See DR 5-105(A)(1),(2); DR 5-105(E),(F); The Ethical Oregon Lawyer § 11.4, 12.14, 12.17 (OSB CLE 1991, Supp 1998) (EOL). See, e.g., OSB Legal Ethics Op No 1991-123; In re Samuels/Weiner, 296 Or 224, 674 P2d 1166 (1983). As stated in the official comment to ABA Model Rule 1.7:

The question is often one of proximity and degree.

For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference of interest among them.

The lawyer in the previous example has several choices. One option is to represent only the prospective corporation. In this circumstance, the
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A lawyer would have only a single client. Disclosure and consent letters therefore would not be necessary, because the multiple client conflict rules contained in DR 5-105 only apply when an attorney has two or more current or former clients whose interests are adverse. See EOL § 12.2.

On the other hand, the individuals form three basic groups: cash, technology, and labor. A lawyer could represent one or more of those three groups as well as the prospective corporation. In that circumstance, it is wise to send disclosure and consent letters even though at the time they may not technically be necessary because there is neither an actual nor a likely conflict.

Finally, the lawyer could represent all three of the individuals, with consent after full disclosure.

Once the initial question of whom the lawyer is representing is resolved, appropriate engagement and non-engagement letters should be sent to the three individuals and to the corporation. Properly drafted, these letters will clarify and document the lawyer’s duty – or non-duty – to the individuals and the corporation. (For sample engagement, non-engagement, and disengagement letters, see insert, Free Practice Aids from the PLF in this issue of In Brief.) In addition, if the lawyer is representing multiple clients, he or she may need to send disclosure and consent letters. (For a useful collection of disclosure and consent form letters with commentary, contact the PLF for a copy of “Beating Discipline and Malpractice: The How and Why of Effective Disclosure and Consent Letters (OSB CLE December 1993).

IF YOU REPRESENT THE CORPORATION – DO YOU ALSO REPRESENT ANYONE ELSE?

OSB Legal Ethics Op No 1991-85 holds that, as a general proposition, an attorney who represents a corporation represents the corporation alone and not its shareholders. However, two limitations must be noted.

First, the Oregon Supreme Court has stated that representation of a corporation that is wholly owned by a single family or by one person is per se representation of the shareholders. See, e.g., In re Banks, 283 Or 459, 474-75, 584 P2d 284 (1978); In re Brownstein, 288 Or 83, 86-87, 602 P2d 655 (1979). Although the full scope of the Banks rule is not precisely defined, where there is a distinct minority shareholder in the corporation so that separate interests of a majority and a minority are identifiable, the Banks rule likely will not be applied. See, e.g., In re Kinsey, 294 Or 544, 562 n10, 660 P2d 660 (1983).

Second, it is important to note that attorneys can owe a duty to “clients” because the client reasonably expected that the lawyer was representing him or her. See EOL §§ 6.3-6.5. If an attorney leads a shareholder to believe that he or she is an individual client, it is quite likely that the Oregon Supreme Court would hold that the shareholder is an individual client under this test.

WHAT HAPPENS IF A DISPUTE ARISES?

Assume that you represent one shareholder and the corporation. If a dispute arises between the shareholder you represent and the other two shareholders, what are you required to do?

Because your firm has an attorney-client relationship with the corporation and the shareholder, you cannot withdraw from representing one of those clients to avoid a current client conflict of interest rule and bring the less restrictive client conflict rules into play. OSB Legal Ethics Op No 1991-11; Unified Sewerage Agency, etc. v. Jelco Inc., 646 F2d 1339, 1345 (9th Cir 1981). Consequently, the issue is whether your firm may represent the shareholder notwithstanding your ongoing relationship with the corporation.

This situation again requires an analysis of the current client conflict of interest rules. If there is no real dispute between the corporation and the individual shareholder (for example, if the
corporation is indifferent to the dispute), it is possible that disclosure and consent would not even be required. If disclosure and consent is required, however (and in all events it may be prudent to go through the disclosure and consent process), it is the corporation that needs to consent. This may, as a practical matter, require consent from the two shareholders that you do not represent. Cf. EOL § 12.17.

In order to avoid this problem, and in light of OSB Legal Ethics Op No 1991-122 which holds that advance or blanket waivers may be used in some circumstances, an attorney could ethically seek to secure an agreement “up front” that if one or more conflicting issues arise, the attorney may continue to represent the shareholder while seeking to oppose, at least in principle, the corporation. Whether an advance waiver will be effective in such circumstances will likely depend upon the nature of the conflict that emerges and the adequacy of the disclosure and consent process. See also, EOL § 12.17.

Additionally, an attorney in this situation ought to consider the potential effect of DR 5-101(A)(1), which prohibits a lawyer from representing a client if his or her professional judgment will be affected by the lawyer’s own financial, business, property, or personal interest.

This rule is discussed extensively in EOL Chapter 11. Depending on the nature of the dispute and the attorney’s relationship with the unrepresented shareholders, it is at least theoretically possible that DR 5-101(A)(1) could require disclosure to, and consent from, the individual shareholder and the corporation.

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THE PLF IS MOVING

The PLF will move later this summer (approximately August 3, 2001) to Kruse Woods II. Kruse Woods II is located kitty-corner from the current Bar building—across the street and two buildings west. The new address will be: Professional Liability Fund, 5335 SW Meadows Road, Suite 300, Lake Oswego, Oregon 97035. The phone number and post office box will remain the same.

INVESTING IN CLIENTS

Prior to April 2000, the “New Economy” – with its perceived predominance of emerging growth, high technology, e-commerce and internet companies – provided a particularly fertile arena in which alternative billing arrangements were explored and used. Companies adopted a culture in which equity interests (whether in the form of stock, restricted stock, stock options, warrants, convertible debt, or any combination thereof) were the primary currency and in which the perceived commonality of purpose to increase shareholder value took on emotional, if not moral, overtones. These clients no longer offered stock to their lawyers because they lacked, or more appropriately desired to conserve, cash. Rather, acceptance of such stock by their attorneys was seen as a vote of confidence in, if not a measure of loyalty to, the common enterprise represented by the client’s business.

The “bursting of the internet bubble” has led to a world in which many options are underwater and worthless. Corporations are struggling to find a way to reprice their options so as to keep current employees and also avoid variable accounting treatment. Those who exercised their options prior to the market downturn and held onto their stock with the expectation of ever-rising prices and eventual capital gains treatment, must now pay huge taxes on what has become worthless stock.

The realities of today’s marketplace have radically changed the economic landscape. Cash is scarcer than ever. Many good companies and good ideas are failing for lack of funding. Stock and options as currency have been demeaned, and all employees, landlords, lenders, and service providers have become much more discerning in their selection of companies in which stock interests are taken.

In this tougher environment, the entrepreneurs need to conserve cash and the measure of loyalty and confidence evidenced by a decision to accept stock in lieu of fees has put different pressures on lawyers and law firms to accept stock in lieu of fees.

The reasons and the source of the reasons for taking equity may have changed, but the risks associated with the decision have not.

These risks are not insignificant and should be considered carefully before a lawyer or law firm makes the decision to take an equity position in a
PLF BOARD SEEKS TWO NEW DIRECTORS

The Board of Directors of the Professional Liability Fund is looking for two lawyer members to serve five-year terms on the PLF Board of Directors beginning January 2002. Directors attend approximately six two-day board meetings a year, as well as various committee meetings, and are also required to spend a considerable amount of time reading board materials between meetings and participating in telephone conference calls. PLF policies prohibit directors and their firms from prosecuting or defending claims against lawyers. Factors considered in selecting PLF Board of Director nominees include ability, experience, type of law practice, gender, minority status, and region. Interested persons should send a brief resume to: Ira Zarov, Professional Liability Fund, P.O. Box 1600, Lake Oswego, Oregon 97035-0600.

client. This article reviews some of the legal, ethical, and practical issues related to corporate representation and to payment of legal fees through corporate equity interests.

CAN I TAKE STOCK IN LIEU OF A FEE?

Equity positions in clients may be taken either in lieu of or as part payment of the lawyer's fee. In this context, the lawyer must be concerned with 1) the reasonableness of the fee and 2) the lawyer's duties as a fiduciary to ensure that the equity stake is not undermined by the lawyer's interests.

DR 2-106(A) prohibits a lawyer from charging or collecting an illegal or clearly excessive fee. DR 2-106(B) provides factors to be considered in determining the reasonableness of a fee. (See Tips for Taking Stock in Lieu of Fees, page 8.) Utah State Bar Opinion 98-13 (1998) suggests that the following additional factors be considered:

• the liquidity of the client's stock, including whether the client's stock trades publicly at the time of the fee agreement and, if the stock is not publicly traded, the risk that the client's stock will not be publicly traded in the future;

• the present and anticipated value of the client's stock, including the risks that a proposed patent or trademark may not be granted, and the necessary government approvals (such as FDA approvals) may not be received;

• whether the stock is subject to restrictions after the law firm receives it that affect the value of the stock to the lawyer;

• the quantity of stock owned by the lawyer and whether the lawyer may exercise ruling control over the client after receipt of the stock; and

• any restrictions placed by the lawyer on the consideration paid for the stock.

Although DR 2-106(B) and the Utah ethics opinion provide some guidance, taking stock of an unknown value in a corporate client as payment for fees raises significant issues relating to reasonableness. The independence and objectivity of a law firm are likely to be substantially affected. For example, if the stock ultimately rises in value, tensions with the client and other stockholders may arise. The corporation may do so well that the fee later appears to be unreasonably large for the work performed. If the equity interest in the company greatly increases, there may even be an obligation to refund some portion of the proceeds of the stock to ensure the fee is reasonable. Factors that enter into this may include, among other things, the length of time that the lawyer holds the stock and whether the value of the stock – actual or potential – was reasonable at the time of the representation. On the other hand, the business may falter. The attorney, worried about recovering a fee for work already performed, may be perceived as unable to advise the client with the necessary professional judgment. As the stock fluctuates in value, the attorney may also find law firm financial issues arising.

It makes sense, therefore, for a lawyer who is considering accepting stock as payment of a fee to take extra care to ensure that the transaction sustains any foreseeable scrutiny. One approach is to obtain an independent evaluation of the present value of the interest. Although the future value of the stock may be considered later by a court or disciplinary body, a present valuation will provide an important baseline that will help to establish the reasonableness of the transaction at the time. The lawyer may also want to make other disclosures to
TIPS FOR TAKING STOCK IN LIEU OF FEES

- Establish a reasonable fee using the guidelines stated in DR 2-106:

  (1) The time and labor 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.

  (8) Whether the fee is fixed or contingent.

- Accept stock that at the time of the transaction is worth the reasonable fee. If feasible, the stock should be valued at the amount per share that cash investors, knowledgeable about its value, have agreed to pay for their stock at about the same time. As an alternative, when the value of the shares is not reasonably ascertainable, a reasonable fee may include an agreed percentage of the stock issued, or to be issued. In such cases, the percentage of stock agreed upon should reflect the value that the legal services will contribute to the potential success of the enterprise (as agreed upon by the client and the lawyer at the time of the transaction). Another alternative is to condition the purchase of stock on a stock value determined at an "equity event" — where investors other than firm members receive stock.

- Clearly document the agreement, especially if the agreement is that the lawyer is to keep the stock interest regardless of the amount of legal services performed by the lawyer. The designation of a fee as nonrefundable must be made by a clear and specific written agreement between client and lawyer. Without a clear written agreement that fees paid in advance constitute a nonrefundable fee earned on receipt, the funds must be considered client property. See In re Biggs, 318 Or 281, 293, 864 P2d 1310 (1994); Oregon Formal Ethics Op 1998-151.

- Disclose to the client that if the value of the shares increases significantly, the fee could be significantly greater than if the work had been charged on a customary hourly rate.

- Discuss the investment with your firm and determine if stock should be accepted, including how much, how the stock will be held, who will retain voting rights, and who will decide when and under what conditions the stock will be sold.

Whenever an ownership interest is taken as a fee, a lawyer must comply with DR 5-104(A) which prohibits a lawyer from entering into a business transaction with a client if they have differing interests and if the client expects the lawyer to represent the client. The rule allows representation if consent and full disclosure are provided. Full disclosure pursuant to DR 10-101(B)(1) requires a written explanation "sufficient to apprise the recipient of the potential adverse impact on the recipient..." DR 10-101(B)(2) also requires that the lawyer recommend that the recipient seek independent legal advice and contemporaneously confirm the consent in writing. The disclosures should explain the consequences of the conflict in language that is easily understood by the client. The safest approach is to have the client and the lawyer sign the disclosure, after the client has had an opportunity to consult with independent counsel. If applicable, the disclosures should state that the stock acquired by the lawyer will limit the client's control of the corporation.

PLF coverage for claims arising out of business transactions with clients depends on whether the lawyer complied with DR 5-104(A) and DR 10-101(B). (See discussion on page 9 of this article.)
TRUST ACCOUNT HANDBOOK

The Professional Liability Fund has published a new handbook for Oregon practitioners: A Guide to Setting Up and Using Your Lawyer Trust Account. This free handbook explains when to establish a trust account, what type to use, how to reconcile the trust journal and the bank trust account statement, and provides other practical information. For a free copy – fax or mail the PLF CLE Order Form included in this issue of In Brief or order one from our web site: www.osbplf.org.

In addition to the duties under DR 5-104 (Limiting Business Relations with a Client), a lawyer also has a duty to fully disclose if the lawyer’s professional judgment will be or may be reasonably affected by the lawyer’s own financial business, property, or personal interests. A lawyer is prohibited from representing the client in such matters, unless the client consents after full disclosure. DR 5-101(A)(1) (Conflict of Interest: Lawyer’s Self Interest).

A lawyer’s representation of a corporation in which he or she owns stock is ethically permitted if disclosure and consent is obtained. When drafting a disclosure letter, it is generally a good idea to disclose to the client that events following the acquisition of stock could create a conflict between the lawyer’s exercise of independent professional judgment and the lawyer’s desire to protect his or her stock value. In some cases, even though disclosure may make it permissible, the lawyer may – for personal reasons or due to liability exposure – withdraw from representation. See ABA Opinion 00-418. A lawyer who holds stock and continues to represent the corporation may see a wide variety of situations that require consent and disclosure or withdrawal including:

- If the corporation falls on difficult times and asks the lawyer’s advice on whether to file bankruptcy.
- If the corporation becomes insolvent and the lawyer’s duties flow to creditors.
- If the corporation has the opportunity to be acquired by a larger corporation, and the lawyer would profit from the merger but the founding corporate shareholders do not want to sell. (Whether this presents a conflict depends on who the lawyer represents – see Corporate Start-Ups – Issues to Consider, page 4 of this issue of In Brief.)

- If litigation arises under securities laws with respect to matters in which the lawyer acted as counsel.
- If the lawyer knows financial or other adverse information that is being withheld from a venture capital investor. (The lawyer may have a duty to instruct the corporation to provide the information even though to do so may cause the venture capital investor to withdraw – thus causing the lawyer a serious financial loss.)
- If the lawyer has material inside information and the lawyer’s personal interest will be affected by the disclosure.

Although any of these situations may have been covered generally in the initial consent and disclosure letter provided by the lawyer, the lawyer probably should provide his or her client with an updated disclosure letter specific to events such as these, and obtain consent again.

ABA Opinion 00-418 is a helpful resource on these issues. If you would like a copy, call Reiko Scapple at the PLF 1-800-452-1639 or 503-639-6911 or e-mail her at reikos@osbplf.org.

IF I TAKE STOCK IN LIEU OF A FEE, DO I HAVE PLF COVERAGE?

Whether you have Professional Liability Fund (PLF) coverage for claims by or on behalf of a business enterprise in which you own stock depends on (1) whether you complied with DR 5-104(A) and
provided the client with proper disclosures and (2) how much of the business entity you or others own.

Section 1.3.h. of the PLF Coverage Plan provides that there is no coverage for claims based upon or arising out of business transactions subject to DR 5-104(A), unless disclosure in the form of DR 5 (which is attached as Exhibit A to the Plan) has been properly executed and other notice requirements are met. The details of this section are contained at page 93 of the 2001 Oregon State Bar Membership Directory. In addition, section 1.3.f. excludes coverage for any claim on behalf of any business enterprise:

f. This Plan does not apply to any CLAIM by or on behalf of any business enterprise:

(1) In which YOU have an ownership interest, or in which YOU had an ownership interest at the time of the alleged acts, errors, or omissions upon which the CLAIM is based, or

(2) In which YOU are a general partner or employee, or in which YOU were a general partner or employee at the time of the alleged acts, errors, or omissions upon which the CLAIM is based, or

(3) Which is controlled, operated, or managed by YOU either individually or in a fiduciary capacity, including the ownership, maintenance, or use of any property in connection therewith, or was so controlled, operated, or managed by YOU at the time of the alleged acts, errors, or omissions upon which the CLAIM is based.

The comment to PLF coverage plan I.3.f. explains that ownership interest for the purposes of I.3.f.(1) does not include an ownership interest "now or previously held by you solely as a passive investment so long as you, those you control, your spouse, parent, child, or any member of your household, and those with whom you are regularly engaged in the practice of law, collectively now own or previously owned an interest of 10 percent or less in the business enterprise." Therefore, if your spouse owns more than 10 percent of the business enterprise and you do legal work for the business, you do not have coverage for claims arising from your representation of the business enterprise. Similarly, if your law partner owns more than 10 percent of a business enterprise, you do not have coverage for claims arising from the business enterprise. This is true even if your partner owns the interest in the business enterprise, and you or someone else in the firm does the work. The PLF Excess Plan has similar exclusions.

For these reasons, it is important to know whether your partners have a business interest in clients of the firm. If you are accepting stock in lieu of fees, be certain to comply with the disclosures required by DR 5-104 and be certain that your "ownership interest" (as defined in the PLF coverage plan) is 10 percent or less.

VOTING RIGHTS AND OTHER CHALLENGES OF OWNING STOCK

Lawyers who are contemplating accepting stock in lieu of a fee must also give some thought to:

- What will be the firm’s policy on investing in an initial public offering (IPO) if the firm acted as counsel to the issuer or underwriter of the offering?
- How and by whom will the stock be owned?
- Will departing or retiring members be allowed to continue to own stock?
ESTABLISH LAW FIRM POLICIES

POLICIES AGAINST INSIDER TRADING

Law firms should consider establishing a policy against insider trading. Section 21A of the Securities Exchange Act of 1934 provides that the SEC may bring an action in Federal Court for penalties against any person who engages in insider trading and against persons who "control" insider traders. Many of the cases brought against insider traders are actions against attorneys, legal secretaries, and other law firm staff. Law firms are often considered control persons. The penalty against control persons can be three times the profit on the trade (not to exceed $1 million dollars). A control person can avoid the penalty if the control person established, maintained, and enforced policies and procedures designed to prevent insider trading. Establishing a policy against insider trading is particularly important if the law firm is distributing stock in a client to partners and employees, particularly at or around the time of a public offering, merger, or other extraordinary event that will likely cause the value of that stock to significantly increase.

POLICIES ON INVESTMENTS WITH CLIENTS

Establishing a policy on investing with clients will help the firm clarify its approach to these issues. Here are policies considered by various firms:

- Limit the investment to a small percentage of stock. (The firm should define "small.")
- Limit the amount invested in any single client to a small sum. (The firm should define "small.")
- Require a lawyer in the firm, other than the lawyer with the principal client contact, to determine if a conflict exists and to decide what action needs to be taken.
- Transfer billing and supervisory responsibility to a partner who has no stock ownership in the client.
- Prohibit a lawyer from investing in or with any firm clients without prior approval of an executive committee composed of neutral lawyers.
- Allocate investments in nonpublic clients among partners (or all firm lawyers) as investment opportunities, place the investments in a pooled investment fund, or allocate the investments to a bonus plan.
- Prohibit firm members from purchasing amounts of stock that could lead to a change of control of a client corporation, whether made by an individual lawyer or in concert with others.
- Prohibit firm members and law firm investments in the initial public offering of stock in situations where the firm is acting as counsel for the issuer or underwriter.
- Prohibit individual lawyers from investing in clients.
- Avoid law firm investments in clients unless the client is a publicly traded corporation. If the firm decides to invest in a client, give the client an appropriate disclosure and consent letter that has been reviewed by the firm's ethics committee (composed only of neutral members) or independent outside ethics counsel. Get the client's consent to the disclosure in writing. Have an attorney who is not representing the client review the disclosure and consent letter frequently to determine if it is necessary to do a supplemental disclosure and consent letter.
- Prohibit lending money to or borrowing money from clients except when (1) the client is a financial institution and borrowing occurs in connection with the firm's operation or the lawyer's routine business, (2) deferring the collection of attorney fees, or (3) approved by an executive committee of neutral lawyers.
• Will the stock be held by the individual partner(s), the firm, an investment fund or some other entity?
• Who will decide when and under what conditions the stock will be converted to cash or distributed?
• If the stock is converted, to whom will the money be distributed?
• How much stock of a particular company is appropriate for the firm (or its collective partners) to own?
• How much of the firm’s assets is the firm willing to place in equity interests of clients?
• Who will oversee the firm’s investments in clients?
• Will the stock voting rights be retained by the firm, the individual lawyer, or returned to the client’s Board of Directors?
• Will the firm defer fees and accept founder’s stock or some other arrangement?

The answers to these issues will vary from firm to firm, depending on the firm philosophy and politics. Many of the issues will require an analysis of the potential conflicts of interest and an analysis of the tax implications.

CONCLUSION

Lawyers are permitted to acquire stock interests in client companies in lieu of fees provided 1) the lawyer’s fee is reasonable, 2) the lawyer specifies for the client how the lawyer’s representation may adversely impact the client, and 3) the lawyer discloses if his/her professional judgment may be compromised. Only after receiving this information can the client evaluate whether he or she wants to proceed. Only by providing this information can the lawyer fulfill his or her fiduciary obligations.

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