EQUITY IN

JACK-POT OR LONG

Top US law firms in the technology sector, including Silicon Valley heavyweights such as Wilson Sonsini Goodrich & Rosati and Venture Law Group (VLG) and their San Francisco-based counterparts such as Brobeck, Phleger & Harrison LLP and Cooley Godward LLP, have been taking equity stakes in clients for years. Some have been doing so for over a decade. In December of last year, Linklaters & Alliance, one of the leading five London-based firms, announced a multi-million pound plan to defer or waive fees in return for equity in tech-when its computer hardware client VA Linux Systems went public at US$30 and rocketed in one day to US$239.25, a 698 per cent gain. At the close of trading, the law firm's 102,584 shares of its client's stock were valued at US$24.5 million. As Ira Gershwin put it, nice work if you can get it. A new Zero-Sum Marketplace.

The law firms that are best able to attract desirable high-tech clients are those with a strong technology law practice and who can provide value added services. High-tech clients are increasingly seeking lawyers who have significant industry experience, can help polish a business plan, raise money

for some time, the recent exponential growth in the valuations of Internet-related ventures has thrust the issue on the radar screens of most firms, particularly those with either a strong technology practice or, alternatively, the ambition to build such a practice. The hard reality is that where the investment is proposed by a potential client, a firm which does not have a mechanism in place to quickly address the issue may find the client quickly going elsewhere. A number of major firms such as Bennett Jones, Fasken Martineau DuMoulin LLP, and McCarthy Tétrault have made such investments. Others, such as McMillan Binch, have programmes in place but have yet to make an investment. Still others, such as Osler, Hoskin & Harcourt LLP, are actively the same terms as other investors such as venture capitalists. Chicago-based McDermott, Will & Emery, for instance, has set up a share option scheme whereby partners take a stake in clients that are raising funds and the shares go into a central pool, with the profits divided up among partners and associates. Alternatively, the law firm may take equity in lieu of or in partial payment of its fees. The benefits to the client include an ability to reduce or defer legal fees (which may be difficult for new ventures to absorb) and the opportunity to obtain a stronger level of commitment from their suppliers of legal services.

A related development, as noted above, is that some Silicon Valley firms have found themselves in the position where demand for their services has outstripped their capacity to deliver. Consequently, such firms carefully evaluate new clients before taking them on. One of the evaluation criteria used by Wilson Sonsini is the client's willingness to provide the firm with equity in the amount of 1-2 per cent of the firm's capitalization as an "access fee" on top of the firm's regular fees. Such equity participation is required, according to these firms, in order for them to retain lawyers who would otherwise jump ship to the clients where their compensation would include an equity component. Such concerns on the part of firms regarding the mobility and importance of legal talent in the high-tech world are not self-serving rationalizations. Chris Erickson, formerly an associate at Fasken Cambell Godfrey (now Fasken Martineau DuMoulin LLP) is said to have profited handsomely since going in-house with 724 Solutions Inc., as has Steven Chisholm with Metronet.

For many, equity in lieu of fees captures the best of both worlds, i.e. the excitement and incentive of significant gains to be made in the high-tech sector coupled with the opportunity to establish long-lasting relationships with dynamic clients. London-based Field Fisher Waterhouse was one of the first UK firms to accept equity. Partner Michael Chissick says his firm took a very pragmatic approach. "We picked up on the fact that everyone works with share options in the e-commerce field. Everyone is incentivised by them—the employees, the directors, the partners. We're not financiers, we're not here to fund businesses, we're here to develop partnerships with our clients."

Conflicts

In the vast majority of cases, investments are kept to a minimum due to internal policies implemented to limit exposure for the firm and to avoid potential conflicts of interests. Many clients do not perceive a conflict and may even believe that the investment by the law firm will help them get better attention and service. Some clients may even consider it a sign of loyalty.

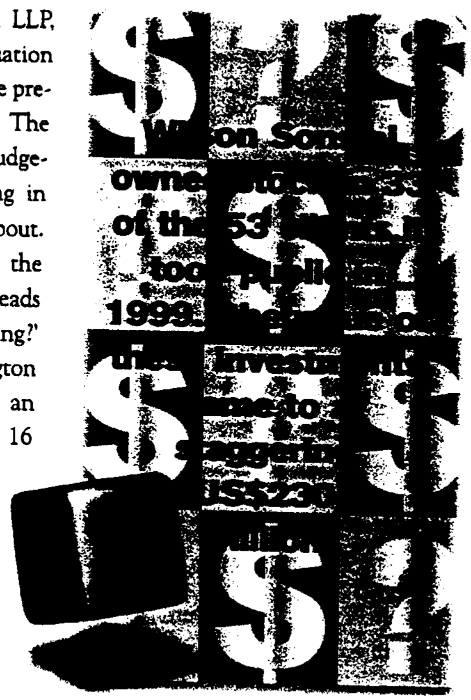
A conflict of interest can arise, for instance, where a law firm is performing securities law work for a public company and may be obligated to provide objective information to the public. If such firms hold an equity investment in a client, then there will be an economic incentive to provide a rosy picture. Consequently, most firms who invest in clients limit their initial investment to a small ownership interest to avoid any appearance that their equity investment will affect their legal advice or judgment.

Wilson Sonsini typically limits its investments in private companies to under $50,000 and one per cent of the company's outstanding stock. On the other hand, VLG will invest up to US$35,000 per round of financing. McCarthy Tétrault will generally not take more than 1 to 2 per cent of a client's issued capital coupled with a case-by-case comfort zone dollar ceiling. LaBarge Weinstein acknowledges the 1 to 2 per cent range but prefers to make decisions without fixed limits judging each proposal on the basis of comfort zone, potential for conflicts, and the relationship with the entrepreneur. McMillan Binch, on the other hand, has a dollar ceiling in the range of $20,000.

While seemingly small, an ownership stake of even one per cent can be worth millions of dollars by the time a company goes public. In some cases, the investment may be even more significant. Last December, the UK firm of Tarlo Lyons took a stake worth almost 5 per cent of the capitalization of its client, Netcentric, in lieu of part of its fees. However, not everyone is convinced that conflicts can be avoided. Sullivan & Cromwell, the prestigious New York-based corporate firm which is second only to Wilson Sonsini in the value of initial public offerings (IPOs) it acted as counsel on last year, has steadfastly refused to alter its policy of not investing in clients.

In large part the conflict issue involves the question of perception of professional objectivity, i.e. the assumption that a financial interest in any transaction will lead to self-dealing. This fear, of course, is greatly enhanced when the staggering profits currently being earned in the IPO-mania of dot coms is taken into account. According to a senior attorney with a major US legal malpractice insurer, who spoke on the condition of anonymity, there have not been large numbers of claims made regarding IPOs where lawyers have represented the issuer and held equity. However, where they have been made, they are expensive. According to counsel with the US insurer, "the problem from a malpractice standpoint is perception. In the one out of 100 or 200 cases where a law firm gets sued for Securities And Exchange Commission (SEC) or other legal violations, its primary defense is a lack of *scienter*."

Putting aside the role played in such cases by US juries, comments from other American attorneys strike a more ominous chord. Jerome Coben, a lawyer practising at the Los Angeles office of Skadden, Arps, Slate, Meagher & Flom LLP, says "We have been in the situation where clients offer equity but we prefer to help in different ways. The reality and perception is that judgement is impaired and investing in equity is not what lawyers are about. I have seen situations where the founders have scratched their heads and asked, 'Why is this happening?' Stephen Bent of the Washington office of Foley & Lardner, an almost 800 lawyer firm with 16 offices across the United States, is more direct. "I encounter situations all the time where I am aware that someone I am dealing with is somehow acting in a way that suggests their objectivity is being compromised."



The actual figures in the U.S. regarding lawyers representing issuers in which they hold equity are surprising. Highlights from an ABA *Journal* analysis of SEC records, cited in a subsequent ABA *Journal* cover story (*Who Wants To Be A Millionaire*, Debra Baker, February 2000), included:

- one in three lawyers representing the more than 500 companies that went public in 1999 held stock in the client at the time of offering;
- 63 law firms handled the IPOs, either representing the issuer or the underwriters. Lawyers from these firms held equity in 174 of these companies;
- lawyers' holdings in more than 40 per cent of the companies were worth in excess of $1 million each. Firms investing in nine of the companies saw the value of their holdings soar to more than $10 million each; and
- in addition to their equity positions, lawyers also served as officers or directors in about 23 per cent of the 500 plus companies.

Investing in Clients

Firms that elect to take stakes in their clients must be careful in the ones they choose to back. Before making an investment, such firms must evaluate the prospects for the business. In the case of dot com businesses, while potentially very lucrative, these ventures may be very risky, particularly for firms without specialists who have been working in the area. Firms must also ask detailed questions about the client's previous track record, work experience and educational background. Not many firms would feel comfortable interrogating a potential client with such questions. To do so can be very destructive of the client relationship suggesting as it does a lack of confidence in management.

Such evaluations usually include consideration of the likelihood that the client will be able to successfully secure venture capital financing. Wilson Sonsini may turn down three out of four potential clients who approach the firm. VLG says it takes on only 3-10 per cent of potential clients.

Even after accepting a new start-up, firms will typically try to limit the amount of work they perform until the company receives its first round of financing. Such limitations may conflict with a client's best interest. In traditional "fee-for-service" arrangements, lawyers will typically be less reluctant to advise a client that it would be prudent for the client to have certain legal work performed, and then seek to obtain a financial retainer before undertaking the work. Even when a client cannot afford to have the recommended work performed, at least they become aware of the risks they are choosing to assume.

It is the difficulty associated with initial valuations of high-tech clients which was given as the reason by most, but not all, Canadian firms interviewed for the article for declining to commit to equity in lieu of fees until after the initial round of financing was in place. In this regard, firms strongly prefer to let the venture capitalists take the point position, as it were. One exception is LaBarge Weinstein which is sufficiently comfortable with its own judgement and knowledge of the high-tech community, and also perhaps the judgement of its related company Prescient Advisory Services, that it does not feel it necessary to always let venture capitalists pave the way. Another interesting aspect of LaBarge Weinstein's approach is that should the client later become uncomfortable with the equity for fees arrangement, the firm will reverse the transaction at the original transaction value. As LaBarge says, "the crux of the relationship…is based on trust."

Firms contemplating taking stakes in clients should obtain a written waiver from the client. In California, lawyers must obtain an informed consent in writing. The consent should recommend that the client seek independent legal advice.

Jackpot

How are the Silicon Valley firms making out with their investments? Not too badly. Wilson Sonsini owned stock in 33 of the 53 clients it took public in 1999. As of the end of last year, the value of these investments came to a staggering US$230 million—a higher amount than the US $215 million that the firm billed in legal fees during 1998. If this amount was to be divided evenly among its 120 partners, each would receive US$1.9 million—a much higher amount than the firm's 1998 profits per partner of US$620,000.

Wilson Sonsini's investments include stakes in bamboo.com Inc., E-Loan Inc., Juniper Networks Inc. and VA Linux. The firm's investment in online grocer Webvan was worth over US$51 million at the close of the company's first day of trading. Past investments included stakes in Pixar and Ticketmaster-City Search.

Other Silicon Valley firms have also witnessed large windfalls. VLG's 1999 investments in 16 clients was worth US$62 million at the end of last year, compared to US$53 million in 1999 revenues. Craig Johnson, Chairman of the Menlo Park-based firm, has set the objective of earning more from investment returns than from legal fees. Investments by VLG included Etoys.com, Yahoo! and Hotmail. VLG is perhaps in a league of its own in terms of the firm's aggressive approach. VLG lawyers play important roles in the development of their high-tech clients, frequently taking a seat on the board or, alternatively, attending all board meetings.

Cooley Godward's 1999 investments in 17 clients were worth $45 million. Last year it divided up stock in Lycos Inc. Other holdings in well-known technology companies included the search engine Ask Jeeves, music site MP3.com and online community Theglobe.com.

San Francisco-based Brobeck, Phleger & Harrison has invested in more than 100 companies in the last two years alone. Its return on the investments, made in ten clients that have gone public during that period, is reported to average 100 times its investment.

Long Shot

Investing in clients is not without its risks. The attractiveness of such investments hit a bump last summer when the share prices of technology companies took a short-lived tumble. As well, it should be noted that investments by lawyers are subject to the same mandatory holding periods, known as lock-ups, that are applicable to other company insiders. The market can change significantly during that time. However, since law firms, like venture capitalists, typically invest in companies early and frequently receive their stock at a price substantially below the offer price, their returns are likely to be superior to those available to the market, even if a downturn does occur.

However, high-tech investments are not for the faint of heart. The generally accepted rule of thumb is that in this high-stakes, high-risk game (lottery?) losers outnumber winners by as high as 20 to 1. For the normally risk-adverse legal profession, these are sobering numbers. And, of course, law firms face exposure on two fronts. First, there is the financial loss if the investment turns sour. Second, there is possible liability from disgruntled investors. Lawyers are the proverbial "deep pockets" that can practically bank on being sued if there is an arguable case to be made. Thus, as one would expect, it is firms with the successful track record that take a somewhat jaundiced or, at best, worldly view of such investments. As Wilson Sonsini's Donald Bradley points out, it is important to remember that the start-up's chances of success are not great. According to Bradley, his firm's experience is that out of every ten investments, one will probably be successful and perhaps two or three will return the investment. And this is when you *really* know what you are doing.

Internal Issues

Some of the key internal issues within a firm include who decides in which clients to invest, how the investment is held and how the fruits of the investments are to be distributed within the firm.

The latter issue gave rise to some recent unwelcome publicity for the Toronto office of Goodman Phillips & Vineberg which represents 724 Solutions Inc., one of the current high-tech darlings of the market. 724 went public in January at US$26 and in early March peaked at US$231. A number of GPV lawyers were on the "president's list" (such guaranteed access programmes are discussed in detail later in this article) and consequently had the option of purchasing stock at the initial offering price. Speculation is that the windfall may have been as high as US$1 million. Depending on who you speak to, the only problem was that there was no agreement in place, or alternatively a misunderstanding as to the agreement previously reached, as to how the profits would be distributed within the firm. After considerable internal debate, it was decided the monies (or, again depending on who you speak to, a considerable portion of the monies) would be donated to charity. Ouch.

In some firms (including Wilson Sonsini, Cooley Godward, and VLG) the investment is made through a separate partnership investment fund set up for such purposes and policies are put in place which require individual partners to offer investment opportunities to the fund. Firms without such funds and even some with investment funds, may typically permit investment by individual partners, with the partner being required to first offer the opportunity to other partners of the firm.

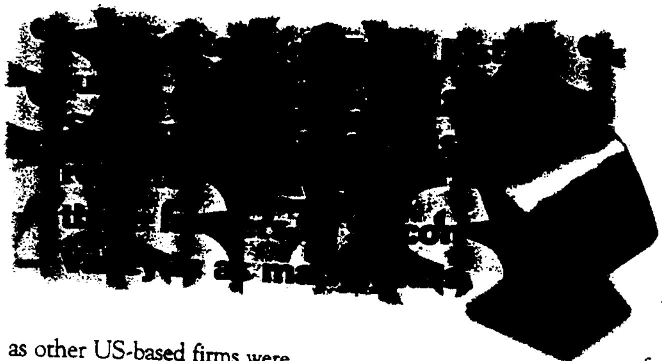
In firms with a separate investment fund, the investment decisions are typically made by a committee set up for such purpose. For instance, at Brobeck, Phleger & Harrison, the investment committee consists of three corporate securities partners who have the authority to make all investment-related decisions. At Olswang, a well-known UK-based high-tech firm which has been taking stakes in clients since the '80s, investment decisions are made by a management committee. Some firms utilize a blind trust to hold the investment where the decisions to

- Do the associates have a means to share in the potential riches, and if so, is it through a separate investment pool, a predetermined percentage of the same pool (and if so, what percentage), or above market compensation. Brobeck, Phleger & Harrison has separate partner, associate and staff funds. It invests US$2,500 into the fund for each associate, which is then invested in clients. The fund vests 20 per cent each year, and becomes fully vested in five years. VLG operates two pooled investment funds, one for partners and one for associates, which are renewed annually. The partner's fund accounts for about 80 per cent of the firm's total investments.
- Many firms establish annual funds which close off each year and only those lawyers who were in the firm during that year participate. Some firms are considering whether to also require that lawyers must still be working at the firm when the investment becomes liquid. At VLG, lawyers who leave early receive only a portion of their fund's return.

Recruitment

Investments in clients can be a powerful recruitment tool for attracting lateral partners and bright associates in an increasingly competitive legal market. The investment funds can also serve as an enticement to keep lawyers from leaving to join start-ups that can offer stock options, or other firms that do offer the opportunity to participate in investment funds.

The increasing levels of compensation offered by Silicon Valley firms have had a startling impact on the (salary plus bonuses) of associates from US $100,000 to a maximum of US $160,000. Orricks apparently felt it had no choice if it was to compete for legal talent in the US market and wanted to import this compensation scale to the U.K., as other US-based firms were doing. Bird & Bird is said to have simply felt that the costs could not be passed on to U.K. and European clients. The intent of the aborted merger had been to create a global technology firm. With Bird & Bird's strength in new technology and Orrick's strength in project finance, it would have been a powerful combination.



The increasing levels of compensation offered by the Silicon Valley firms have also had an impact on the Canadian legal market. For instance, last September, Torys lost a junior associate to Wilson Sonsini. Smith Lyons is reported to have lost three lawyers to Silicon Valley in as many years. A search through Wilson Sonsini's web site reveals seven lawyers now working there who had originally practised or attended law school in Canada.

Professional Ethics and Liability Insurance Issues

In most jurisdictions, the law society or state bar does not prohibit lawyers from investing in clients, but may require disclosure if a lawyer's judgment would be affected by the firm's investment in the client's business. Firms may be required to explain the potential for a conflict of interest and obtain the client's consent before proceeding.

Current guidelines issued by the ABA do not prohibit lawyers from investing in their clients (although the ABA is studying the issue and plans to issue a report later this year). While ABA guidelines do not carry the force of law, many state bars that do have enforceable regulations base their rules on ABA guidelines. The California State Bar requires that lawyers set fair and understandable terms for an investment, inform their clients they can seek outside counsel and obtain a written conflict waiver agreement from a client for the investment.

In making investments in clients, law firms must be careful to ensure that such investments will not negatively impact their coverage for professional liability insurance. For instance, the terms of insurance policies provided by the Lawyers' Professional Indemnity Company (LPIC) permit lawyers to acquire an investment not exceeding 10 per cent of a client. If the investment (held collectively by all members of the firm, including their spouses) exceeds 10 per cent then there is a proportional decrease in coverage. For example, in a successful claim against a law firm holding 12 per cent of a client, the law firm would be liable for 12 per cent of a claim otherwise covered by LPIC. According to Malcolm Heins, LPIC's CEO & VP, the insurer's greater concern is the impact that investing in clients may have on negligence claims, particularly where lawyers are acting for a company in an IPO. An investment in a client can create an inherent conflict and potential liability to shareholders.

Directed Share Programs

An opportunity to invest in a client may also arise when the client is ready to go to market with its IPO. Such companies typically set aside a portion of their shares for special groups of people. Referred to as a "directed share program" in the U.S., and as the "president's list" in Canada, such programs can allow the company to reward family, friends and business partners or lawyers with guaranteed access to a portion of the IPO. For instance, last year Red Hat set aside a portion of its IPO for programmers who had contributed to the development of Linux. MP3.com, a music site, also diverted a portion of its IPO to artists and customers that had contributed to its success.

With the share prices for some technology companies multiplying in price at the IPO, the opportunity to purchase such shares at the IPO price can be a valuable reward. For example, TheGlobe.com, which went public in November 1998, saw its stock price jump from US$9 to US$97 in its first day of trading. However, such profits are not guaranteed as a hold period may be applicable.

While a number of law firms have established investment policies, few have addressed the allocation of shares from directed stock programs. Also, since directed stock programs may include specific employees with a company's business partners who contributed to the company's success, in-house counsel working for those business partners may find themselves eligible for such shares. In-house counsel at some of 724 Solutions' business partners found themselves in exactly this situation recently when 724 Solutions went public.

Other Alternatives

The clear preference of most law firms is not to take equity in partial payment of fees. Stephen Bent at Foley & Lardner in Washington, D.C., notes that while his firm does make such arrangements, it is more of a last resort scenario, i.e. where a client will not get venture capital backing unless a well-known law firm is involved. Bent says his firm's preferred route is other options such as deferring or discounting fees with a bonus if the company achieves certain milestones.

Bennett Jones has in the past taken equity in exchange for a portion of its legal fees and, like many other firms, is currently evaluating expanding this practice. Nevertheless, former CEO Martin Lambert prefers the use of "success fees" as a method of sharing the risks and rewards with a client. Another further option, says Lambert, is to use fixed fees to eliminate the irritations and problems caused by the hourly rate approach. Many clients are used to paying other professionals, such as investment dealers, on such a basis. Yet another option is to defer or discount fees with a bonus payable if the company achieves a certain milestone. According to Lambert, such structures enhance the way professionals feel about the work they perform—"they get rewarded for creativity, not for moving gravel by the hour." Such arrangements usually result in stronger relationships with the client because lawyers are seen as part of the team, not as someone with a financial interest in prolonging a transaction. The real payoff comes if the acorns grow into oaks—"they remember who their friends were."

You Should Be So Lucky

The conflicts and ethical issues related to equity investments by lawyers in clients do not raise great alarm in the U.S., Canada, or the U.K. The key appears to be the relative modesty of the investment. In any event, logic dictates that conflicts between the corporate client as issuer and the lawyer as investor will be relatively uncommon. They are *ad idem* in their objective; that is, to make as much money as possible. While more murky disclosure issues may arise in of the few if not the only North American jurisdiction where contingency fees are not permitted, has created a statutory exception respecting such fees in class action proceedings. As everyone knows, the financial rewards which contingency fees can generate in personal injury or product liability litigation can be truly impressive. Similarly, there has been little if any adverse criticism regarding the success fee arrangements on the AOL/Time Warner merger by one of the most prestigious law firms in New York.

There is similarly little question that equity in partial payment of fees is a client-driven proposition. There are numerous upsides such as facilitating innovation on the part of cash-poor start-ups and establishing strong client loyalty that one day may pay back in spades. One should not forget that San Francisco-based Brobeck, Phleger & Harrison took equity in partial payment of fees in Cisco Systems when that client was a start-up. Cisco now has one of the largest market capitalizations in the world and Brobeck are still its lawyers, recently acting for the computer giant in its US$6.9 billion acquisition of telecommunication equipment manufacturer Cerent Corporation.

In any event, for the really promising high-tech start-ups which hold out the promise of astronomical returns, it is often only the likes of Wilson Sonsini, VLG or Cooley Godward who have the bargaining power to require two per cent of equity in addition to normal fees as a "get-in-the-door" policy. Most firms cannot be so selective with respect to clients, particularly if their game plan is to build a significant practice in the burgeoning high-tech world. And even then, law firms are discovering that some start-ups, given the current eye-popping valuations attributed to dot coms, are reluctant to exchange shares in lieu of fees. Equity, even if only one per cent, in a successful high-tech start-up is seen as a very expensive way to secure legal advice. Deferred payment arrangements and cash success fees may well be on the plate instead.

Indeed, two major Canadian law firms interviewed for this article recently had the jarring experience on separate occasions of venture capitalists vetoing equity in partial payment of fees arrangements which had previously been agreed to with the client. As one would expect, in both sit-