NON-TRADITIONAL FEE ARRANGEMENTS OUTSIDE LITIGATION, AND DOING BUSINESS WITH CLIENTS

By David Rabinowitz[1]

When is it permissible to accept something other than cash at an hourly rate for legal services?[2]

What, if anything, does the lawyer have to do differently when he/she does agree to accept something other than cash at an hourly rate for legal services?

What kinds of problems can arise when a lawyer accepts an interest in a client's assets in payment for legal services, and how can they be avoided?

<u>Fees – General Rule – Reasonableness</u>

The ethical rules about fees are relatively few and impose little obvious limit on the kind or amount of legal fees. In substance, fees must be reasonable, not excessive or illegal. New York Code of Professional Responsibility ("New York Code"), DR 2-106(B); similarly ABA Model Rule 1.5(a) ("A lawyer's fee should be reasonable.") Reasonableness, in New York is to be determined by weighing eight factors, which are non-exclusive ("include the following"). They are:

> 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 or made known 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 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.

New York Code DR 2-106(B) (1981); similarly, ABA Model Rule 1.5(a).

A diversion, since the topic here is unusual fee arrangements. Can a billing based on hourly rate be unreasonable? Although such determinations in an ethical context are rare, the answer is yes. In one of the few decisions on this point, a Massachusetts court held that a $50,000 fee for the successful handling of a minor criminal matter, which was three times more than the fee any regular practitioners in that area charged, was unreasonably large. *Matter of Fordham*, 423 Mass. 481, 485, 490, 668 N.E.2d 816, 822 (1996)

---

[1] The author would like to thank Harvey Prager of Hinshaw & Culbertson LLP for his assistance in preparing this article. This article was prepared for a talk given at the Copyright Society of the U.S.A. on September 28, 2007.

[2] This article does not address litigation fee arrangements, such as contingent fees.

© 2007 David Rabinowitz. David Rabinowitz is a partner in the law firm of Moses & Singer LLP.

Another brief diversion. Can a fee be non-refundable? The consensus is that it cannot. The New York Court of Appeals said in *Matter of Cooperman*, 83 N.Y.2d 465, 472, 611 N.Y.S.2d 465 (1994), that non-refundable fees were impermissible because a legal fee is not reasonable until and unless it is earned and because non-refundable fees hamper clients in exercising their right to change counsel. The lawyer there was suspended for two years for using non-refundable fees. *See also Cotton v. Kronenberg*, 111 Wash. App. 258, 44 P.3d 878 (Ct. App. 2002) (Non-refundable fee void; disgorgement ordered); *Matter of Sather*, 3 P.3d 403 (Colo. 2000) (flat fee to represent client in a civil case; held an ethical violation to spend money and treat it as earned, rather than putting it in a trust account pending earning it, but lawyer not sanctioned for that due to novelty of issue).

The first thing to note about taking an interest in a client's business as a fee instead of billing hourly is that there is a long standing prejudice against such arrangements. The New York Court of Appeals in 1982 succinctly described such arrangements as "not advisable." *Greene v. Greene*, 56 N.Y.2d 86, 451 N.Y.S.2d 46 (1982). This is because of the potential conflicts between lawyer and client that may arise when the lawyer is a kind of partner with the client, which are discussed below.[3] But first a note on how the reasonableness standard is applied to such fee arrangements.

There is some debate about whether the fee should be judged for reasonableness at the beginning of the engagement, when the fee agreement is made,[4] or when the fees are actually paid.[5] While courts make categorical pronouncements one way or the other, the "judged at the outset" cases tend to be where the fee is relatively modest and in proportion to the services rendered and the risk assumed by the lawyer. The "judged when paid" cases tend to be when a permanent interest is received in the client's property or venture and the pay-out is long and large. The practice pointer is, therefore, whether you are in a judged-at-the-outset state or a judged-when-paid state, it is dangerous to take an interest in the client's business that is unlimited in time and unlimited in ultimate value to the lawyer.[6]

---

[3] *See also SEC v. National Student Marketing Corp.*, 457 F. Supp. 682, 688, 691-94 (D.D.C. 1978), where a lawyer was held to have aided and abetted a securities fraud by failing to delay a deal and re-solicit shareholders after learning of inaccuracy of interim financial arrangements. The Court noted that the lawyer, an officer and shareholder of the merging corporation, stood to profit from the transaction.

[4] See ABA Formal Opinion 00-418 (2000), at 5.

[5] *See Holmes v. Loveless*, 122 Wash. App. 470, 477, 94 P.3d 338, 342 (2004) (Held that contingent fee for 5% of revenues in exchange for two years of discounted legal services became unreasonable after 30 years of payments. Agreements for fees reviewable at all times while they remain in effect. Thus, if client offers interest in new company and company is very successful, fee may become unreasonably large. Fee may be reconsidered continually.)

[6] See Rudell, Michael and Rosini, Neil, "*Perpetual 5 Percent Fee Found to Be Unenforceable*," N.Y.L.J. August 24, 2007, reporting on *Hirsch Wallerstein v. Hirsch Jackoway*, Super. Ct., L.A. Co., Case No. BC320128 (2007), where a tentative decision found a perpetual 5% interest in all projects worked on by the firm to be unconscionable and unenforceable per se. <u>See also</u> *Rhodes v. Buechel*, NYLJ March 18, 1998 (Sup. Ct. N.Y. Co.), *aff'd*, 258 A.D.2d 274, 685 N.Y.S.2d 65 (1st Dep't 1999), *app. den.*, 93 N.Y.2d 806, 689 N.Y.S.2d 708 (1999); *Passante v. McWilliam*, 53 Cal. App. 4th 1240, 62 Cal. Rptr. 298 (Ct. App. 1997).

<u>Doing Business With Clients</u>

Looking beyond the question of the reasonableness of the fee, fees paid by shares of client property are part of the larger ethical realm of doing business with clients. In this realm, the basic rule is that the lawyer remains the client's lawyer even though the lawyer, in negotiating with the client, is not ostensibly acting as the client's lawyer. In general, because of the trust and confidence presumed to be reposed in the lawyer, the lawyer must act as the client's fiduciary, and not negotiate at arms' length.[7] While there is some disagreement in the commentary whether this rule applies to fee agreements, it is routinely applied to fee agreements by the courts.

Before going further, it should be noted that there is another principle relevant to getting involved in a client's business as part of a fee agreement: a lawyer shall not accept or continue employment if the lawyer's own interests may affect his judgment on the client's behalf.[8] This principle can, if there is a divergence of interests at some point, compel the lawyer to surrender a continuing representation.[9]

The specific rules in New York (New York Code DR 5-104(A)) concerning making a business deal with a client are that where the lawyer and the client have differing interests in the matter and the client expects the lawyer to exercise professional judgment for the protection of the client:

> (1) The transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner that can be reasonably understood by the client;
>
> (2) The lawyer advises the client to seek the advice of independent counsel in the transaction; and
>
> (3) The client consents in writing, after full disclosure, to the terms of the transaction and to the lawyer's inherent conflict of interest in the transaction.

---

[7] See also N.Y.S. Bar Opinion 784 (2005), stating that an entertainment lawyer could, through a separate company, provide management services to clients, provided that the lawyer did not represent the client as a lawyer in deals where the management company's interests were involved under DR 5-101(A).

[8] DR 5-101 Conflicts of Interest - Lawyer's Own Interests.
A. A lawyer shall not accept or continue employment if the exercise of professional judgment on behalf of the client will be or reasonably may be affected by the lawyer's own financial, business, property, or personal interests, unless a disinterested lawyer would believe that the representation of the client will not be adversely affected thereby and the client consents to the representation after full disclosure of the implications of the lawyer's interest.

[9] For a case where the lawyer's interests and the client's came into conflict, see *Matter of Strutz*, 652 N.E.2d 41 (Ind. 1995), where a lawyer's interests in his client's companies diverged from that of the client, leading to litigation between them. Ultimately, the lawyer sued the client for fees, lost, was found to have sued in bad faith, had to pay $670,000 in costs and counsel fees, and was suspended from practice for various ethical violations.

There are some textual differences between New York Code DR 5-104(A) and its successor in the ABA Model Rules, §1.8(a). The Model Rules apply to all lawyer-client dealings, not just those where the interests of lawyer and client may diverge or where the client expects the lawyer to exercise professional judgment on the client's behalf and the advice to the client to get independent counsel to negotiate with the lawyer must be in writing.

As a practical matter, however, the ABA and New York rules differ little.[10] Problems will not normally arise if the lawyer and client have non-divergent interests. New York courts have not given much weight to the condition that the client be expecting the lawyer to exercise professional judgment on the client's behalf. While the advice to get other counsel need not be in writing in New York, such a writing is prudent to avoid problems of proof later on.

Before discussing some sample cases, we must note that there is some theoretical disagreement about whether the lawyer must counsel the client to consult other counsel in making a fee agreement with the lawyer.

On one hand, the authorities that visualize the cash-poor entrepreneur coming to the lawyer and being told to hire another lawyer to negotiate with the lawyer over the fee have a good laugh at the absurdity of the idea.[11] The courts, on the other hand, are note amused. The Appellate Division, First Department in *Rhodes v. Buechel* affirmed a trial court decision invalidating such a fee arrangement, in part because of failure to advise the client to seek counsel.[12] Also, the ABA does not think there is an issue on this point and

---

[10] The application of some particulars of these rules vary somewhat from jurisdiction to jurisdiction. *See McRentals, Inc. v. McDonald*, 62 S.W.2d 684, 702-03 (Mo. Ct. App. 2001), expressing the opinion, different from New York's rule, that a lawyer making a deal with a client need not disclose all risks and downsides for the client if the client understands all the terms of the deal. *See, contra, Matter of Neville*, 147 Ariz. 106, 708 P.2d 1297 (1985) (censuring lawyer based on transaction with admittedly sophisticated client because payment provisions in agreement favored lawyer and lawyer did not make full disclosure <u>even though the client set the payment provisions himself</u>); *Abstract and Title Corp. v. Cochran*, 414 So.2d 284 (Fla. Ct. App. 1982) (lawyer failed to advise client to seek other counsel, and made insufficient disclosure of terms of deal).

[11] *Simon's Code of Prof. Resp. Anno.*, DR 5-104(A), Commentary at 310 (West 2000). Compare Ass'n of the Bar of the City of New York, Formal Opinion 2000-3, "*The Acceptance of Securities in a Client Company in Exchange for Legal Service To Be Performed*." (such advice to client prudent)

[12] The Court refused enforcement of a fee arrangement for a 1/3 interest in clients' inventions in exchange for prosecuting patent applications, licensing and "providing other assistance and advice as became necessary," which became a 1/3 stock interest in the clients' corporation, on the grounds that "neither the initial arrangement nor its subsequent incarnations were entered into upon adequate disclosure to defendants of other possible fee arrangements and potential conflicts of interest, or with the aid of independent counsel retained for the purpose of safeguarding defendants' interests. Rescission of the parties' arrangements *ab initio*, with payment to plaintiff in quantum meruit for his services, is an equitable result." This despite the fact that the trial court found that the lawyer "worked diligently" for 13 years and the clients profited from his "extraordinary efforts." From the trial court and First Department decisions, respectively, in *Rhodes v. Buechel*, NYLJ March 18, 1998 (Sup. Ct. N.Y. Co.), *aff'd*, 258 A.D.2d 274, 685 N.Y.S.2d 65 (1st Dep't 1999), *app. den.*, 93 N.Y.2d 806, 689 N.Y.S.2d 708 (1999). *Accord Schlanger v. Flaton*, 218 A.D.2d 597, 601, 631 N.Y.S.2d 293, 297 (1st Dep't 1995) as to need to advise client to get other counsel.

has opined that the corresponding Model Rule (§1.8(a)) applies to all cases where a lawyer acquires stock in a client as a fee.[13]

Moreover, not every prospective client who wants to hire a lawyer for something other than cash is impecunious. For example, this issue can arise where there is a preexisting lawyer-client relationship and a new transaction presents an opportunity for the client to pay with a share of the deal or for the lawyer to get a share of a deal with a greater upside than cash payment.[14] So suggesting that the client get a second lawyer to negotiate the first lawyer's fee agreement is, in reality, not as funny as it seems, and not funny at all in the courts. Despite the uncertainty in whether taking an interest in client's business requires you to suggest that client should consult other counsel, it is prudent to do this routinely, even where it may be obviously impractical for the client.[15]

What have the courts actually done with these kinds of fee arrangements and in other cases where the lawyer simply invested in or with the client?

In *Schlanger v. Flaton*, 218 A.D.2d 597, 631 N.Y.S.2d 293 (1st Dep't 1995), the lawyer became part owner of a corporation owning real estate where client had a business in exchange for legal services. The lawyer acted as counsel in the real estate acquisition. The lawyer failed to recommend that client get other counsel and did not recommend that he and his client enter into a shareholders' agreement to anticipate and avoid possible disputes between them. Eventually, the lawyer wanted to increase the client's rent for space used by client's business in the jointly-owned building to a market rent, resulting in a dispute.

The Court cited *Matter of Cooperman*, 83 N.Y.2d 465, 472, 611 N.Y.S.2d 465 (1994), for a trustee-like standard when a lawyer deals with a client: "The attorney's obligations, therefore, transcend those prevailing in the commercial market place …" Thus, deals with client are treated like a trustee dealing with a trust beneficiary – a form of self-dealing:

> Even in the absence of any indication of fraud or undue influence on the part of the attorney, the agreement may still be invalid "unless he can show that the client was fully aware of the consequences and that there was no exploitation of the client's confidence in the attorney" [cit. om.]

218 A.D.2d at 602, 631 N.Y.S.2d at 296. The Court noted that the lawyer had failed to disclose risks of differing interests or to recommend that client get other counsel and stated that (unspecified) details of real estate transactions had been arranged to the lawyer's advantage. The possible conflicts that should have been warned of or handled by a shareholder's agreement in advance were:

---

[13] See ABA Formal Opinion 00-418 (2000), at 3 n. 7.

[14] *See DiLuglio v. Providence Auto Body, Inc.*, 755 A.2d 757 (2000); *Matter of Strutz*, 652 N.E.2d 41 (Ind. 1995).

[15] Ass'n of the Bar of the City of New York, Formal Opinion 2000-3, "*The Acceptance of Securities in a Client Company in Exchange for Legal Service To Be Performed.*"

- Payment of rent by client's business
- Apportionment of cost of the real estate between the parties
- Alteration or improvement of the premises
- Dispute resolution
- Deadlock voting

218 A.D.2d at 602, 631 N.Y.S.2d at 297. (Courts find lots of potential conflicts in retrospect – it is doubtful that a lawyer could anticipate them all.) The Court described the lawyer's accepting the real estate interest without paying for it (instead paying for it out of future legal services) as a form of borrowing, another form of doing non-legal business with a client. The Court rejected the defense that the client was a sophisticated businessman and held that the lawyer's duty to warn of possible differing interests applied regardless of client's sophistication.

The lawyer's conduct was found to be a violation of DR 5-104(A) and of a lawyer's fiduciary obligations. The client's motion for summary judgment was granted and the lawyer lost his interest in the real estate corporation.

In *Passante v. McWilliam*, 53 Cal. App. 4th 1240, 62 Cal. Rptr. 298 (Ct. App. 1997), the lawyer had located a loan for a start-up he represented, which promised him 3% of its stock if he found financing. The loan was made, but the stock was never delivered. Five years later, the client had become wildly successful, and the lawyer pressed the company for his stock. It was conceded that the loan saved the company from going out of business. Nevertheless, the Court held that lawyer couldn't collect the stock as a legal fee because he had had to advise the company that it might want to consult other counsel before making the deal and did not advise the company of possible complications arising from his holding 3% of its stock. 53 Cal. App. 4th at 1242, 62 Cal. Rptr. at 299. The promise was held otherwise to be an unenforceable promise to make a gift, and the Court overturned a $33 million jury verdict for the lawyer.

By contrast, in *DiLuglio v. Providence Auto Body, Inc.*, 755 A.2d 757 (2000), the lawyer invested $25,000 in a company he represented and represented it in a transaction using the money to buy real estate. The client asserted that the investment was a loan, the lawyer claiming it to be an equity investment. The Court held that it was an equity investment. Consequently, said the Court, the lawyer owed client the duties prescribed by ABA Model Rule §1.8(a): (1) the terms had to be fair and reasonable and in writing (2) client had to be "given a reasonable opportunity to seek the advice" of other counsel and (3) client had to consent in writing. 755 A.2d at 769. Here, the lawyer failed in his procedural duties, but the Court found that the lawyer acted in good faith and did not take unfair advantage of the client. 755 A.2d at 770. Such transactions were stated to be voidable if client acts within a reasonable time, but here, considering the client's sophistication as a businessman and his repeated reaffirmations of the lawyer's stock interest, the client was estopped from voiding the shareholding. 755 A.2d at 772. By the way, the lawyer was the former lieutenant governor of Rhode Island.

In *Simms v. Exeter Arch. Prod., Inc.*, 868 F. Supp. 668 (M.D. Pa. 1994), the lawyer for a close corporation (and his law firm), were disqualified from representing the corporation in a stockholder's derivative action because the lawyer owned stock in the company and because plaintiff stockholder claimed that he thought the lawyer had been acting for him personally as well. Also, the lawyer's ownership of stock in company and his resultant direct benefit from the defendant's success if plaintiff's stock ownership in the company is eliminated was considered. Also relevant were the facts that the lawyer drafted the shareholders' agreement, although it was not clear whom he represented there, and that he would be a witness in the case.

In summary, the main points to remember are: (1) Due to the problems with which such agreements are fraught, taking an interest in a client's business is "not advisable"[16]; (2) the process of making such agreement requires strict obedience to the procedural rules established in New York Code DR 5-104(A) (or, in other states, ABA Model Code §1.8(a)); and (3) The substantive terms of the agreement must be "fair and reasonable" to the client (in the judgment of a court enjoying the power of hindsight) and therefore, the lawyer must not treat the negotiation as an arms' length one, but rather as if the lawyer were a fiduciary dealing with a beneficiary.

[16] *Greene v. Greene*, 56 N.Y.2d 86, 451 N.Y.S.2d 46 (1982).