

Entrepreneurial Selection and Use of Legal Counsel

Stephen J. Schanz

Entrepreneurs starting new ventures will encounter a host of legal issues requiring consultation with an attorney on an episodic or ongoing basis. It is critical that careful attention be given to the attorney selection process to properly match the needs of the company with the credentials of the attorney. Additionally, options should be explored regarding the billing and payment methodologies the attorney is willing to entertain. The financial resources and cash flow of young companies will likely have a direct impact on the financial agreements entered into with legal counsel. Further, companies desirous of offering the attorney a stake in the company as full or partial payment for legal services need to be mindful of ethical restrictions applicable to the lawyer, as well as exceptions to the lawyer's malpractice coverage arising from his or her role with the company.

Many start-up companies find themselves in need of periodic legal assistance but unable to bear the financial burden of employing an attorney full time. Often their investment or venture capital is dedicated to, and consumed by, other pressing needs of the company. When such an entity decides to locate counsel with whom they can consult on an ongoing basis, several pivotal elements are worthy of examination. The expertise and demeanor of the attorney, his or her rate of compensation, the relevant code of ethics governing the attorney, and limitations of the policy language in the lawyer's malpractice policy can all have a profound effect on the lawyer-client relationship. Such factors can restrict the compensation methodology negotiated between the parties and, in some cases, pose a hindrance to permitting legal counsel to acquire an equity position with the venture.

The Initial Inquiry

During the initial stages of company formation, consultation with qualified legal counsel is essential. Options relative to company structure (i.e., partnership, corporation, limited liability company, etc.), financing, human resources, intellectual property, governance, risk management, and insurance are but a few of the areas in which an experienced counsel can offer valuable advice. Once the time has arrived to consult with an attorney for one or more of the mentioned areas, due diligence should be exercised to ascertain whether the candidate attorney possesses the requisite background, education, and expertise. Though at first blush it might be easy to

designate a specific area of the law as "critical" to your business mission, a thoughtful review of the full continuum of the company's needs is warranted.

For instance, a start-up venture focused on the development of a new software program may indicate a superficial need for an attorney well versed in the various aspects of intellectual property. This may prove to be short-sighted, however, in the event the chosen attorney, while experienced in intellectual property, is not conversant with many of the other concerns the company will undoubtedly have, such as organizational structure, site of incorporation (if any), employment, tax, contractual, financing, and governance matters. While no single attorney is an expert in every field, young companies can frequently link with an attorney competent in several areas of law likely to be encountered and be referred to other counsel in specialized areas on an "as-needed" basis.

Even a straight forward decision such as whether to incorporate carries significant ramifications for a business. Decisions pertaining to stock offerings, classes of stock, composition of the board of directors, duties and authorities of officers, and selection of the jurisdiction in which to incorporate are but some of the choices competent counsel can assist with. The optimum time to consider these options is in the initial start-up phase rather than amending documents after initial decisions have been implemented.

By way of example, there can be dozens of preliminary matters or issues in the formative stage of a new venture which would be valuable, if not essential, for legal counsel to be consulted. These may include:

1. Does the venture have any intellectual property and, if so, is it adequately protected? Patents, trademarks, and copyrights fall into this category.
2. Is the company currently working on ideas that are proprietary in nature but that have not yet been formally protected? Trade secrets and other confidential information fall into this realm. Are there sufficient safeguards applicable to such confidential information, such as password, biometric, or other security measures? If it is necessary to consult with outside third parties, are carefully worded nondisclosure agreements used?
3. When deciding how to organize and structure a new company, tax issues, liability concerns, financing options, the use of employees versus subcontractors, governance options, board of directors structure, voting

rights, and contract matters can all present thorny questions in the early stage of a company's existence which would benefit from legal consultation.

4. When contemplating what financing options may be available, careful evaluation of relevant state and federal security laws is a necessity. Legal counsel can assist in explaining what methods may be used, the requisite forms that must be executed, and the myriad rules with which the company will need to comply.
5. The sovereignty under which the organization is to be created can often involve a discussion and review of various state laws. Certainly the locale of the primary enterprise and its ancillary activities will be a factor but, additionally, pondering the benefits and drawbacks of corporations, limited liability companies and partnerships, the differences in some state laws may be determinative of where to create your business legally.
6. Governance issues are almost universally a key consideration with new ventures. Questions involving what individuals will have day-to-day operating authority, who can sign checks and contracts, what rights investors have, how large a governing board is appropriate, how the board is selected/elected, whether officers and directors can be removed and, if so, for what reason—are all decisions that can best be made with legal counsel after a thorough review of the relevant facts at hand. There is no “one-size-fits-all” template that can guide ventures.

Though the factors mentioned above frequently arise in the formative stages of a venture, each can also become critical later in the entity's life span as conditions change. Perhaps there is a challenge to the company's intellectual property or it appears someone is infringing on the venture's intellectual property, a new round of financing may be desired which involves the creation of another class of stock with differing rights, the issuance of stock options may be contemplated, or carefully drafted employment contracts are needed. Each event may trigger a beneficial consultation with an attorney.

One benefit of using a law firm instead of an individual practitioner is the breadth and scope of expertise available within the firm. While this can be a significant asset, the client company should clearly investigate during its initial discussions the billing rates for other attorneys it may need to consult. Young and start-up ventures often find budgetary surprises that can drain cash flow and impact its economic stability, so exploring all potential legal costs for using counsel can result in a more accurate financial projection.

In similar fashion, interviews with various attorneys should be conducted to reveal not only their areas of knowledge, but also their personalities and offer some insight as to whether their demeanors would integrate sufficiently with

those of the company principals with whom they would be working. Clear, concise, and effective communication between legal counsel and company representatives is indispensable to getting the most out of the attorney-client relationship. Personalities and perspectives that seem to clash at the outset are unlikely to improve with time or get better under pressure situations.

A practical aspect of selecting legal counsel is to research which attorneys or firms in the geographical area are accustomed to representing start-ups and presumably are knowledgeable about the uncertainties and timing of venture capital and resultant cash flow. Word of mouth, recommendations from other companies, scanning profiles in legal databases, and advertisements in phone directories are but a few of the ways to search out such firms. Attorneys who have dealt with several new ventures are likely to be more familiar with billing options that are more favorable to the client. Reduced hourly or project rates, delayed billing, “blended rate billing,” “value billing,” or modified retainer arrangements might offer an emerging business a greater degree of financial latitude to enhance its chances for success.

Once firms with this experience are identified, reference checks and informal inquiries can be conducted to ascertain the strengths and weaknesses others may have experienced with the lawyers. This information can better assist the company in selecting counsel most suitable to their enterprise.

Costs

Once an attorney or law firm appears to have the necessary skills and credentials, young companies are prudent to explore the compensation rate the attorney charges thoroughly. This can vary widely depending on geographic location (i.e., urban v. rural), size (solo practitioner v. law firm), type of unit billing (per hour, per diem, daily, retainer, etc.), and terms of the retention agreement (client billed monthly, quarterly, etc.). All options have the potential to affect the company, its operations, and cash flow.

Recently, some law firms have recognized the unique needs of entrepreneur driven start-ups and have begun offering a fixed annual fee in exchange for a mutually agreed upon range of legal services, much like an “outsourcing” of the legal counsel role (Edelstein 2006). In this way, some firms facilitate access to any of their member attorneys, as needed, so long as the utilization does not exceed the parameters established in the contract with the start-up company. One potential drawback is that either party may not want to renew the contract upon its expiration, and this would require a new search for legal counsel.

Other creative billing arrangements include “blended billing” and “value billing.” Most law firms that have more than one attorney performing services for a client have partners, associates, and legal assistants working on a client file with

each charging a separate rate. When taking on a new emerging client, the firm might be persuaded to undertake a blended rate in which the estimated hours necessitating a partner and the hours expected of an associate(s) or legal assistant have their respective rates “blended” to arrive at a more moderate per hour charge to the client. Law firms agreeing to this format undertake a certain degree of risk if they seriously miscalculate (and hence underestimate) the number of hours or tasks that can be satisfactorily performed by an associate at a rate lower than the partner. This arrangement, however, can soften the financial burden on the new company by moderating what would otherwise likely be a much higher legal bill.

In “value billing,” the company client and law firm thoroughly review the client’s legal needs, the tasks needed to be performed, the results the parties expect to receive, and the timeframe within which the services and results should occur. By mutual agreement, the parties reach a consensus on what the value of the legal services will be if the desired benchmarks are met. If performance falls below expectations, the client and law firm can consider a discount or reduction in fees to reflect the difference. (McMenamin 2007).

While start-ups can be lawyer-intensive in the formative stages, requiring advice in many organizational areas and in policy development, successful growth and expansion is also likely to increase demands for counsel as licensing, contracts, intellectual property, human resource, and other dimensions expand. Adequate flexibility should be built into budgets in hopes of remaining capable of securing services in a timely matter as needs arise.

Offering Equity in Exchange for Fees

In some situations, young start-ups find the idea of offering an equity position in the company as “compensation” for a predetermined amount of legal services attractive. While at first this can appear viable, it is not without significant repercussions worthy of extended analysis.

An attorney wishing to accept a company’s offer of equity for legal services rendered must ensure he or she does so in compliance with the code of ethics applicable in that state. Every jurisdiction has a code of ethics governing attorney conduct and most have provisions that apply when a lawyer obtains an interest in the client. Specific language from state to state differs, but the common theme is that a lawyer must advise the client (i.e., company) of a potential conflict of interest, obtain the client’s consent, and secure written documentation of such consent. Depending on the circumstances, a conflict of interest could arise in a number of ways. An entrepreneur launching a new company may be in immediate need of legal services and offer a sought-after attorney shares in the company as a way of reducing compa-

ny expenditures. This can usually be done, albeit with certain safeguards in place.

The Canons of Ethics applicable in various forms in most states prohibit a conflict of interest between lawyer and client. Consider, as an example, a relevant provision of the North Carolina State Bar Rules of Professional Conduct (North Carolina State Bar 2006):

Conflict of Interest: Current Clients: Specific Rules

- (a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest directly adverse to a client unless:
 - (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 in a manner that can be reasonably understood by the client;
 - (2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and
 - (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer’s role in the transaction, including whether the lawyer is representing the client in the transaction.

In many instances the position of the lawyer holding an equity interest will be identical to the interest of the company as a whole. The possibility exists, however, for their two interests to conflict. Suppose the attorney holds voting shares of stock as his equitable “payment” and management proposes one course of action for shareholder approval and the lawyer disagrees and votes contrary to the company’s proposal. In such a scenario the interest of the two parties would not be consistent. Complicating this alternative even more is the nearly impossible task of predicting future events the company may encounter that could generate a conflict of interest. Though its language is not identical, the State Bar of Michigan has similar rules governing its licensees (State Bar of Michigan 2006).

California, in its Rules of Professional Conduct, specifically targets a lawyer’s financial interest with clients for cautionary review. In relevant part, its rules (California State Bar, Rules of Professional Conduct 2007) state:

- (B) A member shall not accept or continue representation of a client without providing written disclosure to the client where:
 - (1) The member has a legal, business, financial, professional, or personal relationship with a party or

- witness in the same matter; or
- (2) The member knows or reasonably should know that:
 - (a) the member previously had a legal, business, financial, professional, or personal relationship with a party or witness in the same matter; and
 - (b) the previous relationship would substantially affect the member's representation; or
 - (3) The member has or had a legal, business, financial, professional, or personal relationship with another person or entity the member knows or reasonably should know would be affected substantially by resolution of the matter; or
 - (4) The member has or had a legal, business, financial, or professional interest in the subject matter of the representation.

These factors strongly suggest that the more balanced and “arms-length” approach would be to negotiate compensation for attorney services on a per hour, per diem, per project, or retainer contract basis. At a minimum, a start-up venture and an attorney seeking to enter into an equity relationship need to give serious evaluation to the applicable ethical rules governing the attorney’s participation. While sanctions for violations might be imposed on the attorney and not the client company, it is important the lawyer-client relationship be formed in a legitimate fashion serving the best interests of both parties.

The Insurance Dilemma

Even if the company successfully negotiates with an attorney for an equitable stake in their company and satisfies the ethical mandates required, the attorney may still be confronted with another risk deserving careful analysis.

The majority of practicing attorneys carry legal malpractice insurance to cover errors or omissions they might make in the rendition of professional services, much as a physician carries medical malpractice insurance. As with every contract of insurance, the actual terms, conditions, and limitations of the specific policy govern what is insured. Sometimes the policy language can exclude coverage for lawyers acting on behalf of a company in an official capacity, such as an officer, director, etc. Consider the following coverage exclusion in a North Carolina liability carrier’s policy (Lawyers Mutual 2006):

EXCLUSIONS

- (g) any claim, or any theory of liability asserted in a suit, based in whole or in any part upon any insured’s act(s) or omission(s) occurring in whole or in part, while such Insured is, in any way, or to any extent, acting in his or her capacity as an owner, officer, manag-

er, director, shareholder, member, partner, trustee, employee, or fiduciary (other than as covered by the provisions of II. Coverage- Fiduciary) of a business enterprise, regardless of whether for profit, or of a not-for-profit or charitable organization, or of a pension, welfare, profit-sharing, mutual or investment fund or trust;

...

- (i) any claim or any theory of liability asserted in a suit, based in whole or in any part upon the liability of any Insured to a member of the family of such Insured, or to any other Insured, or to the testamentary or trust estate of any such person, or any liability of the Insured to any business enterprise (regardless of whether for-profit or a not-for-profit or charitable organization), or the owners thereof, not designated in this Declarations of this policy, which at the time of the act(s) or omission(s) of any Insured upon which liability is based, in whole or in any part, was a business enterprise in which any Insured, or a member of the family of any Insured, or of different Insureds, or the testamentary or trust estates of any such person or persons, together or individually, owned as much as a 15 percent interest (whether legal, equitable or in combination), and which liability is based in whole or in any part, or to the extent, upon the conduct of such business (including, but not limited to, the ownership, maintenance, use or care of any personal or real property);

Depending upon the specifics of the contractual arrangement, a lawyer holding an equitable interest in a start-up company, either while serving as its lawyer on a fee-for-service basis or receiving an interest in the company as payment for his or her services, may find that his professional liability coverage would not extend to acts or omissions involving that particular client (Graebe 2003). Though certainly posing a risk to the individual lawyer or lawyers involved, this could also present a peril to the company in the event the attorney made a serious mistake causing damage to the company and insurance coverage was not applicable.

A more perplexing and ambiguous dilemma may arise in situations offering the attorney stock options at a strike price in the future. By its nature, an option could be exercised at a future date or be allowed to lapse without execution. In the former, the analysis would likely focus on the time at which legal advice was rendered and whether, at that time, the options had been exercised. In the latter, the insured attorney would have a strong argument that he or she at no time had an equitable interest in the company inasmuch as the option represented only a future possibility that never materialized. For insurance purposes, the argument would continue that

the attorney was not in a conflict of interest that triggered the exclusion of malpractice coverage. Additionally, such an ambiguity could place the burden of legal construction on the insurer that presumptively was the drafter of the contract. The long established doctrine of “contra proferentem” calls for such language to be construed against the party that drafted it (*Black’s Law Dictionary* 1968).

Though the use of options may offer some value in navigating around particular malpractice insurance coverage exclusions, it must simultaneously be viewed from a potential investor’s vantage point. Those seeking to invest are likely to be swayed one way or another by the company’s balance sheet and financial statements. An attorney vested with shares of a company in exchange for services may be viewed less favorably than one holding options exercisable in the future. As with most components of new ventures, such decisions should not be considered in a vacuum, but rather viewed from the perspective of all stakeholders.

Another concern arises when the company would like the attorney to serve as an officer or director of the venture itself. While the traditional malpractice policy typically covers acts arising from legal representation, many exclude coverage for acts performed as an officer or director of a company as these are seen as different and distinct from acts while acting solely as an attorney. Many companies obtain directors

and officers liability coverage, often termed “D&O insurance,” to insure against errors and omissions made by company officials. Should the company have such a policy, the company’s attorney would likely be included among its insureds for acts arising in his or her capacity as an officer, while the lawyer’s malpractice policy would respond for acts of negligence in legal representation. An attorney serving both as legal counsel and an officer or director should have both types of coverages.

Summary

In the process of determining the type of compensation arrangement the company wants to have with its legal counsel, a multitude of factors should be weighed. Financial resources, cash flow projections, attorney billing rates, frequency of billing, lawyer education and expertise, the designation of the attorney as legal counsel or officer, director or other capacity, and the best interest of the company as an entity should be carefully evaluated. In terms of the potential for conflicts of interest, both the company and the lawyer need to individually scrutinize their positions for incursions of relevant rules of ethical conduct, insurance gaps, and competing interest. A “problem” for the lawyer is also tantamount to a “problem” for the company and vice versa. The optimal relationship should form a solid, firm foundation for both parties.

References

Black’s Law Dictionary 4th rev. ed. 1968.

California State Bar, Rules of Professional Conduct, Rule 3-310, Avoiding The Representation of Adverse Interest.

http://www.calbar.ca.gov/state/calbar/calbar_home.jsp. Accessed May 16, 2007.

Edelstein, S., of Counsel, Squire Sanders & Dempsey, LLP. Phone interview, March 19, 2006.

Graebe, W. 2003. Serving on the board of directors. *LML Today* (January).

McMenamin, J., Partner, McGuire Woods LLP. Phone interview, April 25, 2007.

Lawyers Mutual Liability Insurance Company of North Carolina, Insuring Agreement, Exclusions, subparagraphs (g) and (i). 2006.

North Carolina State Bar, Rules of Professional Conduct, Rule 1.8: Conflict of Interest: Current Clients: Specific Rules. 2006.

State Bar of Michigan, Michigan Rules of Professional Conduct, Rule 1.8 Conflict of Interest: Prohibited Transactions. 2006.



About the Author



STEPHEN J. SCHANZ (Stephen_Schanz@ncsu.edu) is a teaching assistant professor in the Department of Management, Innovation and Entrepreneurship in the College of Management at North Carolina State University. He received his J.D. from Pepperdine University School of Law and an LL.M from Loyola University School of Law-Chicago. He is licensed to practice law in North Carolina and Michigan. He has taught business and law-related courses at both the graduate and undergraduate levels for several years and counseled many young, start-up ventures while in private practice.