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Externship Spring 2010 Final Paper

Analysis of the Deferred Payment Legal Services Model

Even before the current recession, there has been a slow but steady movement away from the traditional billable hour model employed by many law firms. One possible alternative to this model, particularly applicable to startup corporate work and intellectual property ("IP"), is a deferred payment model. Such a model involves providing legal services for payment at a later date. This makes it possible to provide early stage companies with much-needed legal work at the time that they are least able to pay.

Advantages to this model include growing a grass roots client for the attorney, increasing innovation and creating jobs in a particular region, and hopefully, creating a profitable relationship. A deferred payment model involves additional risk, but this risk may translate into a lucrative working relationship, and at the same time aid in the development of new ideas and entrepreneurial ventures.

1. Different Deferred Payment Model Structures

a. Payments

There are a number of possible ways to structure the deferred payment. One model involves charging standard but deferred fees that do not require repayment until a "liquidity event" occurs. Such a liquidity event may be a buyout, IPO, or large financing round. The deferred payment could also be achieved by taking a certain percentage of revenues until the fees are repaid. Another model involves providing services in exchange for equity in the early stage client company.

The liquidity event model is effective for growth companies that require substantial amounts of financing. This model partially follows a traditional hourly billing scheme, in that hours are recorded for later billing. When these companies have a successful financing round, they are able to use the newly acquired cash to pay all or part of the legal fees.

A revenue percentage model is effective for companies that may not require substantial amounts of financing. An example of such a company would be a “Web 2.0” venture in which costs are limited to the developer’s computers and costs of living. A royalty model may involve a percentage of revenues being taken until the legal fees are paid.

Useful for both types of companies is an equity model. Such a model may involve receiving a fixed ownership stake in the corporation in exchange for the legal services. This structure involves higher risk, but also has the opportunity to be very lucrative. However, attorneys taking equity in a client company must be aware of the Rules of Professional Responsibility, Securities law, and potential client relation issues, which will be discussed in detail below.

b. Client Creation

Community based venture patenting is a model similar to a deferred payment model, in that it serves to generate clients. This model first involves a patent attorney approaching a large group of people, be it a town, a large company, hospital, or other group. The attorney would educate the group about the patent system, and then encourage group members to be creative and submit their ideas for review. Such a program preferably would be ongoing and would evaluate ideas as they come in. In the event that one of the members has a genuinely good and patentable idea, it could be patented and commercialized. Such a program serves to both create a client for an attorney, and to harness the creativity of a large group of people. This type of clientgeneration could then be tied in with the above mentioned payment models. Community based venture patenting is a further way to generate new and valuable clients that would not be accessible by a traditional billable hour firm. Refer to Section 6 b for an example of how this model could work with the workers at a hospital.

2. Why Deferred Payment is a Useful Model

Put simply, a deferred payment model opens a new market to a firm. Instead of being limited to clients who can afford to pay a billable hour rate, the deferred payment model allows law firms to access a wider array of clients. By reaching out to early startup companies who will not be able to pay fees for some time, attorneys can develop a relationship with them, and keep them once they become successful. Additionally, by taking a risk on an early stage venture, it is possible to receive lucrative returns as compensation.

For example, a traditional billable firm would have to offer its lowest possible billing rates to even come close to accessing early stage companies, which results in minimal profit. Deferring the payment makes it reasonable for attorneys to take equity positions, receive a royalty payment, or defer payment at a higher billing rate, thereby achieving a greater profit in return for the risk taken. Moreover, even if payment were deferred at a low billing rate, the deferment creates a loyal client who can pay more in the future as they grow.

In addition to the economic benefits, deferred payment models can help attorneys further social good. Providing legal services to early stage companies aids in their growth. In turn, this growth can create jobs, and bring money and growth to the region of the growing company. Ideally, this growth will build on itself to create more ventures, thereby creating more jobs and prosperity. In this way, an attorney can have a direct positive impact on a region, bringing about positive social growth.

3. Types of Services Provided

Early stage companies are typically in great need of general business setup and planning services, along with intellectual property protection. Good business structure is very important for early stage companies so that managers know where they stand. This provides direction and protects the company in case something goes wrong. Additionally, IP protection is critical at the early stage, and it lends itself particularly well to deferred payment models because the IP generally should be protected before it is commercialized. Other early stage work may include financing, securities and tax services.

It is important for companies to be formed using the appropriate business association. Typically, entrepreneurs who try to handle formation on their own make mistakes that they must later pay to have fixed by an attorney. Corporate financing is another area that requires legal expertise. Founders who attempt to set up their own financing almost inevitably cross the unpredictable and counterintuitive lines set by the SEC. For any company, particularly in an early-stage, violating securities law is a dangerous proposition that can result in serious consequences.

Providing competent IP counsel is also vital for an early stage company. Typically new ventures are based on a new idea or concept that is protectable by some sort of IP. It is important to protect this to ensure future growth, and to increase investor and consumer confidence. A "patent pending" on an item increases buyer confidence and investor security and is therefore extremely valuable. The key for early ventures is to provide them with *competent* IP counsel. Often innovators are not experienced in the full array of IP protection strategies, and can end up hurting themselves if they try to file a patent on their own. Moreover, patents may not be the best way to protect a business' idea. For example, in some cases, trade secrets can provide superior protection.

Strong IP protection for an early stage company is additionally advantageous because of the enhanced business opportunities that it creates. IP rights can be licensed or sold, creating additional streams of revenue for the company. Moreover, IP rights can be valuable as bargaining chips in negotiations, and for providing added security for investors. Because it is often difficult to raise the initial capital needed to invest in IP protection, these advantages can be difficult to achieve for early stage companies, delaying and possibly preventing growth.

4) Potential Conduct Issues and Securities Law Conflicts Involved with Equity Payment

Taking an equity stake in a company in exchange for legal services can raise conduct issues regarding fees and can cause a conflict of interest. These issues can be resolved, and should not be problematic as long as the attorneys involved are open with the clients, act reasonably, and with restraint. To be clear, it is acceptable to take equity in a company and collect the profits that may result from growth so long as the equity provided at the time it is granted is reasonable. For example the firm of Wilson, Sonsini, Goodrich & Rosati received equity as compensation in the company VA Linux. When that company went public, the firm's shares were valued at $24.5 million after the first day of trading. Tanya Patterson, HEIGHTENED SECURITIES LIABILITY FOR LAWYERS WHO INVEST IN THEIR CLIENTS: WORTH THE RISK? 80 Tex. L. Rev. 639, 643 (2002). The ABA Standing Committee on Ethics and Professional Responsibility has specifically addressed the issue in its Formal Opinion 00-418. This opinion will be summarized below.

a. Business Transactions With a Client: Model Rule of Professional Conduct ("Model Rule") 1.8(a)

The ABA Committee has determined that a lawyer who acquires stock in a client corporation in return for services enters into a business transaction with that client. Therefore, Model Rule 1.8(a) must be satisfied. Rule 1.8(a) requires:

> A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest 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.

Regarding part 1, the ABA suggests that the guidelines of Model Rule 1.5(a) regarding reasonable fees must be followed. Important to note however, is that the reasonableness of a fee is to be ascertained *at the time of the transaction*. A reasonableness determination at the time of the transaction provides the ability for investments to become quite large without a lawyer facing a conduct issue. In other words: if the equity compensation is reasonable for the amount of legal work done, its growth as the company grows is not particularly relevant.

The reasonableness noted in part 1 requires an evaluation of all information available at the time of the fee agreement. Among the factors considered are those listed in Rule 1.5(a), and also the risk in taking equity, and the liquidity of the investment. This often involves the difficult task of evaluating the value of the stock at the time of the transaction, because the value of early stage companies is anybody's best guess.

The most reasonable approach when taking equity as payment is for the attorney to establish a reasonable fee for the work, and take that value in exchange for an amount of stock that the attorney and client can agree on. If all this is properly recorded and the client is correctly informed, there should be no conduct issue.

Part 2 of Rule 1.8(a) simply requires that the attorney advise and allow the client to seek independent legal counsel. This is very important and an attorney should be careful to implore the client to take advantage of this. Further this advice should be fully documented in writing.

Part 3 of Rule 1.8(a) requires that the terms of the transaction and the lawyer's role be recorded in a writing that can be easily understood by the client, in the form of informed consent. The lawyer must be sure to explain the scope of services, all of the points of the transaction and how it will influence the lawyer-client relationship. This explanation must be clear enough for the client to understand, and preferably should be in writing. Some important client discussion topics will include the potential limitation in control of the client's business, potential attorney conflicts, and corresponding consequences.

In summarizing Rule 1.8(a) issues, the ABA formal opinion notes:

> The best way to comply with the requirements of Rule 1.8(a) is to set forth the salient terms of the transaction in a document written in language that the client can understand and, after the client has had an opportunity to consult with independent counsel, to have the document signed by both the client and the lawyer.

b. Conflict Concerns- Model Rule 1.7

Generally, a lawyer holding equity in a company does not create conflicts of interest under Model Rule 1.7. This is because the lawyer's role of furthering the client's comports with the interests of the lawyer as a stockholder. However, in some circumstances, this may not be the case. Rule 1.7(b) requires that to represent a client, any time representation "may be materially limited… by a personal interest of the lawyer" the lawyer must reasonably believe the representation will not be adversely affected, and the client must consent. Examples may include litigation, and disclosure issues when negotiating venture deals. In these situations it is imperative that the layer evaluate his ability to maintain his role as a lawyer to serve the company's best interests, and if his ownership position will raise objectivity questions. If the answer is yes, then the lawyer cannot represent the client. If the answer is no, the lawyer must obtain informed consent of the client, in writing.

c. Securities Law Concerns

SEC Rule 701 permits employers to issue securities as compensation without the costly and difficult process of registration with the SEC. However, the Rule specifically prohibits securities compensation to advisors such as lawyers for work that is: "in connection with the offer or sale of securities in a capital-raising transaction." SEC Rule 701(c)(1)(iii). A SEC No Action Letter made this prohibition abundantly clear, stating that:

> Securities issued in full or partial compensation to… attorneys for services rendered in connection with the offer and sale of securities in a capital-raising transaction would not come within the purview of…Rule 701… and thus would be ineligible for exemption under that rule.
> Hopper, Kanouff, Smith, Peryam & Terry Letter 1988 WL 234888 (June 16, 1988).

Therefore, any equity compensation for legal services must specifically exclude services regarding corporate financing that involves the sale of securities. Instead, this capital-raising work should be structured either with deferred payment, or direct payment if possible. Taking equity in a client in exchange for this type of services can seriously injure both the company: through SEC discipline; and the lawyer: through the malpractice lawsuit he would be inevitably be subject to.

5) Advantages and Disadvantages to a Deferred Payment Model

A deferred payment model, like anything, has advantages and disadvantages. However, with the right structure, the disadvantages can be greatly minimized. Moreover, the deferred payment structure, unlike a typical investment has inherent risk-minimizing features that minimize disadvantages.

A deferred payment model has the obvious disadvantage that the lawyer might not get paid if the company fails. Another downfall is the limitation to use with clients that are early stage emerging companies. It would be difficult to transfer this model into other types of law practice except as a contingent fee, which is already commonly done. Finally, the biggest disadvantage of deferred payment models is the potential to upset clients, particularly models that involve equity compensation with an increased payout. In one particular situation, a firm structured a program that would earn three times the legal fees at a “liquidity event” such as a financing round. This substantial payback for the firm enraged many of the firm’s corporate clients, and soured the local market against this type of deferred payment model.

The advantages to a deferred payment model are far more numerous than the disadvantages. Deferred payment models create new clients that are grateful for their attorneys, it helps new ideas come to market- creating new jobs and stimulating the local economy, and is a great marketing tool. In addition, the nature of a deferred fee program inherently provides risk padding features. These advantages, coupled with smart management and a responsible structure allow a deferred payment model to thrive.

Deferred payment models open the market for firms, allowing them to get new clients and in some situations, create a client almost from the ground up. By deferring payments, clients that would not normally be able to afford the services of a top tier law firm (or any firm) are now accessible. Moreover, by the firm showing its faith in the company by offering deferred payments, the clients become grateful to have the firm on their side. This helps create a positive and lasting relationship between the firm and client.

Deferred payment models also allow new ideas to reach the commercial stage that may have floundered in a traditional payment structure. Deferring payments to protect ideas with intellectual property protection can lead an entrepreneur to start a business. Deferring the legal costs to structuring this business allows the business to grow. This growth can create jobs and in turn create prosperity in the region.

From a marketing standpoint, a deferred payment program is advantageous. A firm can use this type of program to position itself as a community leader. Additionally, by promoting itself as a supporter of early stage companies, the firm can encourage their creation, further stimulating regional growth and allowing the deferred payment program to grow. Those that may be intimidated to start a company likely will feel more secure if they know someone can provide guidance and assistance.

Inherent in the legal work required by a growing company are risk padding features which lower the risk that a company will not pay. For example, a company that is not growing will only require initial legal services such as corporate structuring work, and initial intellectual property protection, which is relatively inexpensive. On the other hand, a growing company will need corporate structure work, along with financing, third party agreements, and further intellectual property protection. These services are far more costly, but because the company is growing, it is gaining a greater ability to pay, either through revenue, financing rounds, or both. The companies that do not grow do not need these expensive services, and so there are not as many deferred fees that could be lost.

Further lowering risk is the fact that many firms already take on clients who must defer payments because they cannot afford to pay. This is normally done on an ad hoc basis. Without a structured program or client evaluation this becomes a risky venture. Alternatively, a structured deferred payment program can evaluate a client to determine the risk. Further, a structured program adds more prestige and is a more marketable tool, decreasing risk to the firm and at the same time attracting positive attention.

6) Case Studies

a. Eaton Peabody Innovative Enterprise Program

One particular deferred payment model that I have firsthand experience with is the Eaton Peabody's Innovative Enterprise Program ("IEP"). This program is a purely deferred compensation model that has met with promising success in generating new clients who are growing fast. The program was specifically designed not to take equity in the clients because of the high risk and the potential damage it can do to a client. Instead, deferred payment was chosen because it allows the client to flourish, involves less risk, and develops a grateful client. Moreover, at the time the program began there was a general trend among entrepreneurs against giving equity to attorneys based on previous bad experiences. The IEP started as a way to address a local market of emerging companies that needed legal aid, and also as a way to develop new clients. In practice, results have been much better than expected

Initially, it was expected that the IEP would have results similar to a standard venture model: 1/3 of investments fail, 1/3 break even and do not grow, and 1/3 grow and succeed. In reality however, it turned out that the requirement of legal services increases only with growth, thus creating an inherent risk buffer as discussed above.

Further, a structured program such as the IEP provides a filter to evaluate and select good clients. The benefit to this is twofold: first, clients that do not have a strong outlook are rejected, and second, the selection process increases competition and adds prestige to the program. This both limits the risk to the law firm and increases entrepreneurship competition in the region. Moreover, at Eaton Peabody, as in many firms, attorneys would pick up early stage corporate clients on an ad hoc basis. These clients as a whole create a larger risk than the deferred payment program because they were not evaluated in a structured manner.

Eaton Peabody considered the different options noted when structuring their IEP deferred payment model. A straightforward deferred fees model was chosen over equity or other deferred payment models because it has a lower risk and is most beneficial to the client. Instead of seeking a huge payout through an equity position in a company, Eaton Peabody plans to make their money be developing a base of successful, loyal and happy clients.

The deferred fees as structured in the IEP provide less risk than an equity position because the fees are repaid at a "liquidity event," which is far more frequent than the type of event (buyout or IPO) that must occur for repayment with an equity position. Liquidity events are events such as an additional round of financing, the receipt of a grant, a buyout or IPO, among others. Since grants and financing rounds occur before buyout or IPOs, repayment of the deferred fees are more reliable. This risk is further mitigated by the IEP clients typically being required to pay a minimum monthly fee, and setting a re-negotiable "drop dead date", typically 18 months, when the fees become due regardless of a liquidity event. As noted however the drop dead date is re-negotiable and will generally be extended except for extenuating circumstances.

The deferred fees as structured in the IEP are advantageous to clients because they do not interfere with the structure and ownership of the company. As noted above, there can be many difficulties that arise when taking equity in a client. Moreover, regardless of these issues, it is best for emerging companies to keep close control of the company so that its direction is not interfered with. Finally, deferred fees were chosen because of the potential downside of equity compensation. If a client feels like they were ripped off, or that a lawyer tricked them into giving up more than they should have, the will not be with that lawyer for very long. One bad incident could rapidly spread among the entrepreneur community, turning the whole market against a lawyer or firm. In the small legal world of Maine, that could have an extremely devastating effect on a law firm's corporate practice.

Currently the IEP has four clients. All of these clients are showing promising growth, and two have made partial repayments from liquidity events. These four clients have been selected from a large pool of applicants, indicating that the program is viewed as prestigious, and well known. Other clients that get turned away either continue development and re-apply, or pay the firm in a traditional billing method.

b. Venture Patent Model Involving Hospital Workers

The type of venture patenting noted earlier, intended to grow a client from the ground up, can be envisioned to work in a hospital setting. Hospitals employ a wide variety of workers including doctors, nurses, support staff, management, janitors, and maintenance workers. A lawyer could help a hospital or other similar organization to set up a program that encourages this diverse group of workers to submit their ideas or solutions to problems. These solutions could yield a broad array of novel ideas. Encouraging workers to submit their ideas allows the hospital or other entity to work as a "think tank" of sorts. Hopefully, out of many ideas submitted, one or two may be marketable.

After this point, the hospital will require the services of the lawyer who initially set the program into action. The lawyer will be utilized to assist in the protection and commercialization of the newly created intellectual property. The hospital could then invest resources into developing and commercializing the new invention. Possibly transferring the technology to a spinout company, or generating revenues through licensing. By initiating this process, a lawyer can successfully develop a client from scratch, and at the same time aid in community growth.

7) Applicability to a Larger Scale – Can a Deferred Payment Model Work at a Large Law Firm?

The question of applicability of a deferred payment model's widespread applicability inevitably yields the typical lawyer response: it depends. As noted, deferred payment models are limited to early stage growth companies, so that is one drawback. Another limitation is that there are limited geographic regions that could support a large enough client base for the model to work. A third limitation is that for an entire income stream to be based on deferred payments involves a lot of risk, and could only be handled by a financially secure lawyer or firm.

Likely the biggest determinant of success of a deferred payment model is the region in which the work is done. In an area such as Silicon Valley, the Greater Boston area or Research Triangle N.C., where startup companies are commonplace, a deferred payment model likely will be a great way to generate business. Alternatively, in a more rural and less industrial regions, it would be much more difficult because startup companies may be few and far between.

If the attorney or attorneys involved were dedicated to working with startup companies, were financially secure enough to take the risks, and in the right region, it is likely that a deferred payment model could yield successful results if used firm-wide. Moreover, it would be an effective way for attorneys to access clients that may not be accessible by other firms. These clients would hopefully become loyal to the firm, creating permanent clients who hopefully would attract more startup companies, allowing the law practice to grow.

8) Conclusion

A deferred payment model is a very effective method to open new markets for firms. The model is limited to intellectual property and corporate law, however, within these structures it can be highly effective. Whether the model is structured as deferred fees, equity payment, or a combination of the two may be a difficult decision. The decision on structure will depend on willingness to take on risk, the attitude of the entrepreneurs in the region, and careful consideration of the pros and cons involved with each model, including ethical, securities, and client relation issues. Based on case studies, both models may yield tremendous results. The risky, equity payment model may result in ownership in a company that goes public, allowing the law firm to realize a tremendous payout. Likewise, the deferred fee style may help to develop a group of loyal and successful clients who, with growth, are able to pay top tier legal fees and bring in new clients. This deferred payment model provides a viable alternative to the billable hour model among the startup company market, providing them with legal services when they are least able to pay, and developing a new, grass-roots client base.

References:

I would like to thank Dennis R. Haszko and Jeffery W. Spaulding of Eaton Peabody for their time spent discussing this issue in personal conversations on April 1, 2010 and April 5, 2010, respectively.