ETHICAL AND PRACTICAL CONSIDERATIONS FOR SOLO PRACTITIONERS AND SMALL FIRMS REPRESENTING EARLY-STAGE COMPANIES

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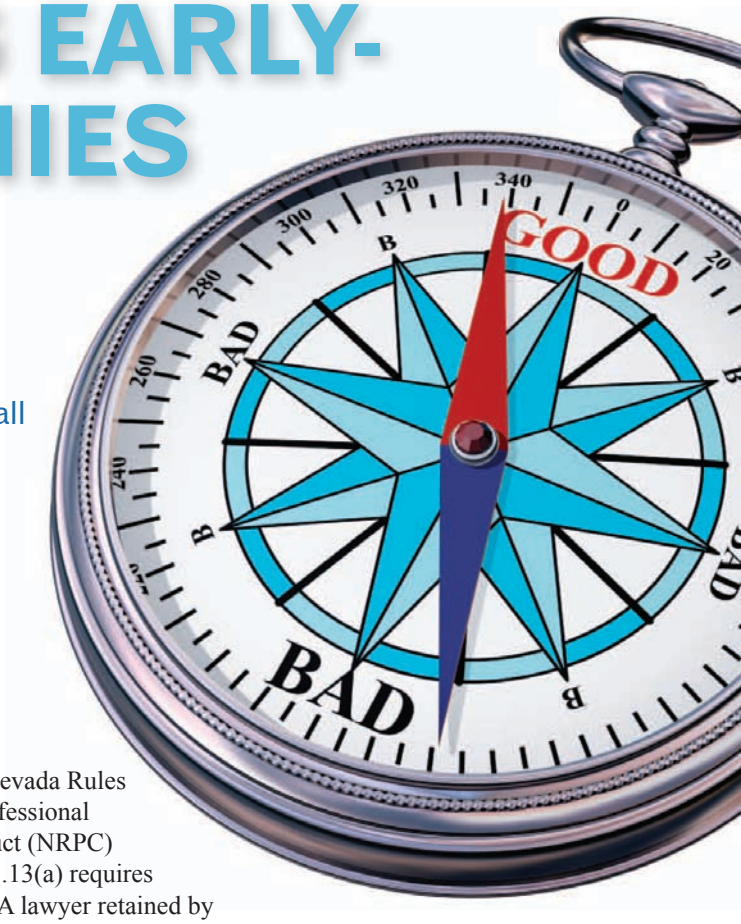

This Great Recession has inadvertently spawned default entrepreneurs seeking job security by building their own businesses, rather then depending upon an employer to control their financial destinies. Solo practitioners and small firm partnerships identify with the self-employed mindset by taking the initiative to build their own law practices. Accordingly, solo practitioners and start-up companies would appear to be an ideal match. However, there are varying issues that all solos or small firms must consider before representing a start-up or early-stage company: most notably client engagement and fee structuring.

As our current economic climate wanes, start-ups (Silicon Valley flavors of the week aside) are commonly insufficiently financed and not in the position to hire in-house counsel or expensive national firms. Conversely, solos can offer competitive rates, personal attention and flexible services, with the ability to better understand and accommodate the demands of start-ups, since solos are essentially start-ups themselves. For these reasons, logic would dictate that solos with experience in finance, corporate and business law market to start-ups and early-stage companies as potential clients.

While this arrangement presents promise and opportunity, there are several ethical and practical considerations to analyze in order to legally and efficiently build a practice with clients that are essentially building an infant or adolescent business.

Client Engagement

The first consideration is: who is your client? Since the autonomy of the start-up company and its founder are at times confusing, a solo must be certain it is engaging with the appropriate entity, that being the organization, and not the individual founder, as the client.

Nevada Rules of Professional Conduct (NRPC) Rule 1.13(a) requires that, "A lawyer retained by an organization represents the organization acting through its duly authorized constituents." Further, NRPC Rule 1.13(f) states, "In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client to the constituent and reasonably attempt to ensure that the constituent realizes that the lawyer's client is the organization rather than the constituent." An equivalent standard governs under the ABA Model Rules for almost all jurisdictions.

Attorneys may find themselves initially representing the best interest of a single founder when structuring the company or negotiating investor participation. This early alignment can become problematic when the once-outside investor becomes a partner, member or shareholder in the company from which they are retained. It must be clear that upon additional shareholders, directors, officers or other members joining the company, the

attorney is representing the rights and interests of the *company* and not any individual founder who may pre-date the investors' participation. Thus, in such an instance, the solo's client never changes, but their duly authorized constituents may.

When disputes arise between shareholders and management, a solo or small practice attorney could informally attempt to mediate the conflict as corporate counsel, but should abstain in the event either party pursues more formal legal proceedings, such as arbitration or litigation, remaining continually cognizant of their duty to the organizational client.

Fee Structure

The second consideration is how you will be compensated for your legal services. While focusing a law practice on potentially undercapitalized clients may not be the most prudent choice for a solo or small firm, there are various fee structures that come with their own set of risks and rewards.

NRPC Rule 1.5(b) requires that, "The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing …."

Thus, the terms of your fee agreement must provide for the scope of services included in the representation. The detail describing the scope of services under your fee agreement is incredibly important when proposing alternative fee structures such as flat, subscription or equity-based compensation.

Hourly Billing

While the hourly billable model is the most common, such a structure may not be appropriate for the insufficiently financed start-up company. Many of these companies are seeking your assistance in order to raise capital by drafting the necessary corporate documents and advising on state and federal compliance matters. Under an hourly fee model an attorney can generate billable fees that may exceed the start-up company's ability to pay. This places the solo or small firm in the unsavory position of collecting on its client, which may strain any future working relationship. Moreover, each billable invoice to a solo or small firm is vital to the firms' success, not only endangering the relationship, but putting the firm in a compromising position when the corporate client is unable to pay for services previously rendered. Therefore, a solo or small firm's retainer amount, under the fee agreement, should parallel the amount they anticipate the hourly fees to total for the initial contemplated and budgeted services. This will safeguard the solo or small firm from collecting unnecessarily or carrying the hourly fee balance as a long-term receivable.

Flat Fee

A flat fee compensation model offers a potentially more realistic option for early-stage companies with finite legal service needs, sensitive to continually accruing law firm fees. These flat fee options are offered through unbundled legal services, which specify the scope of representation for a fixed price. This could be as simple as drafting an independent contractor agreement or as complicated as preparing a private placement offering. A flat-fee model, through commoditization of legal services, which clearly defines the scope of representation and services provided at a fixed cost, may be a more practical approach to representing the interests of start-up or early stage companies; this is due to the companies' budgetary constraints and very identifiable service needs. By offering quality, reasonably priced unbundled flat-fee services to start-up entrepreneurs, the solo or small firm begins to build a long-term relationship with a company that may grow into a successful, larger commercial client.

Subscription Fee

A third compensation model is the subscription fee, which requires the client to pay a nonrefundable fixed amount on a recurring basis, typically monthly, for a defined scope of services over the course of a quarter, six-month or year-long term. The monthly subscription fee is calculated by budgeting the estimated cost of legal services for the client's current and anticipated legal needs during the term of engagement. This lowers the price of the legal service by amortizing the legal costs over the course of the term. This method may fare better since many early-stage companies do not have the same ongoing, routine legal needs as more established companies and may require that the legal costs

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be spread over several months based upon their capitalization or revenue. Also, this approach hopefully provides a safeguard for the solo or small firm since the subscription fee is earned upon receipt regardless of whether or not the services are rendered during the term of engagement.

Equity Participation

The compensation model that could prove most profitable to the solo or small firm but presents the most risk, by far, is that of equity participation. Equity compensation can come in varying forms, but typically it is a vested interest of units or stock (or a derivative, such as options or warrants) in the client company, in exchange for a finite amount of law-firm provided legal services. This is similar to the subscription fee model in that the client's current and anticipated legal needs during the term of engagement are defined, and the consideration for those services are an agreed-upon equity interest in the client company.

However, solos and small firms interested in such a compensation option should be aware of NRPC Rule 1.8(a) which states that, "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."

The practical risk to the solo or small firm relies upon the start-up or early stage clients' likelihood of success. The success rate of early stage companies is very low, so the law firm assumes a very high risk when contemplating such compensation for service. Additionally, even successful companies' shares are many times illiquid due to their closely held nature, which can hinder the law firm's ability to turn their equity interest into cash compensation.

Therefore, solos and small firms should assess the risks and rewards before engaging with, and proposing, any particular alternative fee structure to a potential start-up or early stage client. The early stage company cannot afford the massive hourly fees of national law firms, which only highlights the natural synergy between small firms and small client companies. Start-ups and early stage companies can be promising client opportunities, as long as solo and small firm expectations are managed and the client base diversified in order to mitigate the natural risk that comes with representing such entrepreneurs. ■

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