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Attorney's Report

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Stock for Legal Fees

Issues in Equity Fee Arrangements

It's a common enough scenario: In lieu of (or as a supplement to) cash payment for legal fees, lawyers make the strategic decision to accept stock in a new corporate client.

For a start-up business with limited resources but promising prospects, offering an equity stake may be the only way to access quality legal representation. Company founders enjoy the security of a "fixed" fee and often have access to the shareholder attorney's business network — including potential investors and business advisors.

For the attorney or law firm, an ownership interest in a promising company represents a potentially fruitful investment. Equity billing arrangements also create the opportunity for attorneys to forge longer-term relationships with clients who will use them for subsequent corporate and transactional work after the initial representation.

Is It Ethical?

Obviously, these stock-for-legal-fees scenarios give rise to a number of thorny ethical issues. Fortunately, the American Bar Association Standing Committee on Ethics and Professional Responsibility has weighed in on the ethical aspects of stock ownership in *Formal Opinion 00-418*.

The ABA holds that a "business transaction" is created when a lawyer acquires equity ownership in a client's business in lieu of — or in addition to — a cash fee for services. As such, the attorney must meet the requirements of Model Rule 1.8(a).

Specifically, "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:

- 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;
- 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
- the client gives informed consent, in 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."

Note that Rule 1.8(a) does *not* apply when an attorney acquires the stock in an open-market purchase or in other circumstances not involving direct intervention by the client.

Putting Policy into Practice

To ensure ethical compliance while fulfilling professional obligations, attorneys and their firms should work through these key areas with a client:

Continued on page 3

2 Attorneys Are in IRS Cross Hairs

3 Managing Stock Transaction Risks

4 Dealing with Vanishing Retainers

Attorneys and the IRS

Are You in the Audit Cross Hairs?

Don't look now, but you may have a target on your back. The legal profession is one of several industries the IRS has singled out for special scrutiny as part of its Examination Specialization Program (formerly known as the Market Segment Specialization Program).

In fact, the feds have released a revised *Attorneys Audit Technique Guide* that specifically identifies the accounting, banking and record-keeping practices used in the profession and highlights issues that revenue agents should focus on in examining a lawyer or law firm.

Who Gets Hit?

According to the guidelines, solo practitioners face the highest potential for an audit. The IRS also considers attorneys who practice in the following areas to have higher potential for noncompliance:

- Criminal law
- Real estate law
- Immigration law

The audit guide identifies the records and documents typically kept by attorneys that IRS agents should request and review — everything from appointment books and client card indexes to disbursement ledgers and time reports. As they sift through these records, agents are advised to look for these common areas of noncompliance:

- Unreported income — Personal bank accounts will be analyzed to determine whether any client fees were deposited directly into a personal account instead of a business account. Particular attention will be paid to withdrawals from client trust accounts.

Agents will also scrutinize attempts by attorneys to defer income. As cash basis taxpayers, attorneys are required to recognize income in the year it is received. So, retainers and prepaid fees must be reported as income in the year received even if the services will not be performed until a later year.

Contingency fee cases also come under scrutiny. When a settlement or judgment is received and deposited into a client trust account, the contingency fee amount is typically includable in income for the year in which it is received (because it is determinable and available as soon as a client's settlement or judgment is received).

- Non-cash income — The *Audit Technique Guide* also directs IRS agents to look for situations in which an attorney receives non-cash payment. Examples include when an attorney performs legal services to pay back a loan, trades legal services for other services or accepts stock in lieu of cash (as discussed in this issue's lead article).

- Employment practices — Agents are also advised to check for employment tax issues, such as treating secretaries, paralegals and clerks as independent contractors when they in fact meet the IRS definition of an employee. See IRS Publication 1779, *Independent Contractor or Employee*, for more details on this important distinction.

- Advanced client costs — The IRS takes the position that advanced client costs should be treated as loans to clients if the attorney expects to later be reimbursed for the costs. A classic example is the attorney in a contingency fee case who covers litigation expenses on behalf of the client with the agreement that the amounts will be recovered out of a future settlement or judgment.

Problems arise when attorneys deduct these costs instead and are later reimbursed. If the costs are never reimbursed, the attorney may deduct the amount as bad debt. To determine whether there is an expectation of reimbursement, IRS agents are advised to look at an attorney's case selection, fee advancement processes and success rate.

Watch Your Back

With the IRS arming agents with specific tools for auditing attorneys and law firms, it is critical to check for potential areas of noncompliance. Make sure your accounting practices and tax filings comply with the Internal Revenue Code and corresponding regulations. ■

Protecting the Attorney-Client Privilege During an Audit

When the IRS comes knocking, it's important to consider that fee arrangements and the identity of clients are generally not considered to be protected communications. However, while the specific fee arrangement is not protected, any portions of an engagement letter, retainer agreement or any other correspondence that reveals the client's motivation for creating the relationship, the nature of legal services provided or the attorney's litigation strategy is protected.

If an attorney invokes attorney-client privilege and refuses to provide documents, IRS agents are advised that it may be necessary to issue a summons for the documents. The attorney may then challenge the validity of the summons on the basis that the documents requested are protected by privilege. ■

Equity Fee Arrangements

Continued from page 1

• Establishment of a reasonable fee — To ensure that an equity fee arrangement passes muster as "fair and reasonable," the ABA's Ethics Opinion recommends that lawyers first establish a reasonable fee for services following guidance set out in ABA Rule 1.5(a). The attorney should then accept stock with a value that corresponds to the fee at the time of the transaction. Here, the stock should be valued at the same amount investors who are knowledgeable about its value have agreed to pay for their stock during the same period of time.

Of course, the stock of a start-up can swing wildly — from incredibly valuable to essentially worthless. Here, the ABA opinion notes that the risk of failure and the stock's non-marketability should be considered in determining the market value of the stock at the time of the transaction.

In cases where the stock cannot be adequately valued, the ABA suggests that lawyers agree to take a percentage of the overall stock that will be issued. Lawyers should also agree that the value of the stock received will, like a contingent fee, depend upon the success of the undertaking. According to the Ethics Opinion, "the percentage of stock agreed upon should reflect the value, as perceived by the client and the lawyer at the time of the transaction, that the legal services will contribute to the potential success of the enterprise."

• Full disclosure (and discussion) — Once it has been established that a stock transaction and its terms are both fair and reasonable to the client, the lawyer must then fully disclose those terms in writing, as well as clearly explain the transaction and its potential effects on the client-lawyer relationship. For example, if a client's control of the corporation will be somehow limited by the lawyer's stock acquisition (e.g., the transaction creates specific rights for the attorney under corporate bylaws), the possible consequences of such an arrangement must be discussed with the client.

Likewise, the client should be thoroughly advised of any conflicts of interest that could arise out of the stock acquisition. For example, a conflict could arise between the lawyer exercising independent professional judgment on behalf of the corporation and the attorney's desire to protect the value of the acquired stock. The client should know that, as a consequence of such a conflict, the lawyer may need to withdraw as counsel for the corporation or recommend that another lawyer advise the client on the matter.

In the spirit of full disclosure, the attorney should also specify the scope of legal services to be performed, including whether the stock may be retained if the attorney is terminated before all services are performed.

• Independent legal advice — Under Model Rule 1.8(a), the client must have a reasonable opportunity to seek the advice of independent counsel. To fulfill their ethical obligations, attorneys are required to specifically advise their clients to obtain independent legal advice regarding the transaction. However, the ethics rules do not require the client to actually do so.

• Written consent — Finally, the equity transaction must be consented to by the client in writing. Here, the recommendation to obtain independent counsel should be part of the written documentation of the transaction.

Keeping it in Perspective

Ultimately, equity fee arrangements are a vote of confidence in a client's business prospects — and can go a long way toward strengthening the attorney/client relationship. The key is to always structure such arrangements in a manner that satisfies an attorney's obligations under the professional responsibility rules. ■

Our experienced professionals can provide valuable guidance in structuring equity fee arrangements. Contact our office for details.

Managing the Risks of Stock Transactions

The advantages of equity billing arrangements to a law firm can be many, but there are also potential disadvantages, including the financial risk inherent in start-up companies. One bar association ethics committee has recommended that lawyers follow these "good practice" recommendations:

- Develop a policy that addresses the issues raised by ABA Rule 1.8(a) and other related ABA Rules.
- Make certain the client understands that these communications are subject to the attorney-client privilege.
- If stock is being acquired in payment of legal fees, keep track of the time spent performing legal services just as though the client were being billed on an hourly basis.
- Acquire only an insubstantial amount of the issued and outstanding stock.
- If stock is acquired as an investment, it should be an exchange for a cash payment of an amount that, for the lawyer, is non-material. ■

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The Challenge of Vanishing Retainers

Does this sound familiar? *Your firm consistently collects a $5,000 retainer from all clients who are time billed. After the retainer is depleted, you begin invoicing clients monthly for any additional time. The problem is, you are not getting paid (or are receiving partial payment) and are having to write off large amounts of receivables.*

The solution? Require clients to replenish their retainers at a certain point — and do not perform further work until additional funds are received. Of course, you'll need to follow any ethical parameters outlined by your state bar. Here's how it works:

1. Your office manager or bookkeeper reviews clients' unbilled time compared to their unused retainer on a daily or weekly basis. With today's integrated client billing systems, staff should be able to pull up a summary report of work in progress that shows unbilled fees and costs, unpaid receivables and retainer balances in the trust account.

2. When the unbilled time reaches 90 percent of the retainer, the client is invoiced for additional retainer.

3. When 100 percent of the retainer is depleted, work is stopped until additional funds are received.

The key to making this work is to ensure that all timekeepers enter their own time directly and daily. Someone else must be responsible (and held accountable) for monitoring retainer amounts and invoicing additional amounts.

To keep everything upfront and clear, ensure that a clause covering automatic replenishment of retainers (aka "evergreen retainers") in increments a client can afford to pay is included in engagement letters. Then, whenever a retainer minimum balance is reached, bill promptly. ■

Give us a call if you'd like to discuss vanishing retainers in more detail.