

4.4 Discussion of Draft Opinion 21-0003 [Ethics of In-House Counsel: Business Transactions with Clients] and Possible Request to Circulate for Public Comment or Possible Approval for Submission to the Board of Trustees

IN-HOUSE COUNSEL DRAFT OPINION

ISSUE: What conflicts of interest are presented by a stock option agreement between in-house lawyer and the company?

In-house lawyers are often offered employee stock options or grants as part of their compensation package. In a typical attorney-client relationship - - which is inherently imbalanced in favor of the attorney - - taking stock in a client requires compliance with CRPC 1.8.1: the transaction must be fair and reasonable; the lawyer's role in the transaction must be fully and plainly disclosed to the client in writing; and the client is advised in writing to consult with independent counsel about the transaction. The client must then provide written consent to the transaction. This rule applies in the in-house context, even if the lawyer is offered the same general compensation terms as those offered to other employees and indicia of inequality do not exist.

Stock ownership may likewise trigger a material limitation conflict under CRPC 1.7(b) if there is a significant risk that the in-house lawyer's representation will be materially limited by their financial interest in connection with their stock ownership. Such a conflict could arise if the lawyer is asked to advise the company concerning a transaction that affects the character or price of the stock, such as a merger or acquisition. If so, the lawyer must obtain informed written consent from an authorized constituent of the company. If the lawyer does not reasonably believe they can competently represent the company due to the conflict, or if the company refuses to consent to the conflict, the lawyer must refer the matter to nonconflicted in-house counsel or outside counsel.

AUTHORITIES

INTERPRETED: Rules of Professional Conduct 1.0.1, 1.7, 1.8.1, 1.13

STATEMENT OF FACTS

After practicing law for 5 years as in-house legal counsel for a software company ("Old Company"), Lawyer has decided to take a position as General Counsel for a closely-held software company ("Company"), formed by three founders ("Founders"). The Founders make up the Board of Directors ("Board"). Lawyer is expected to head a small team of three lawyers ("Legal Department"). There are approximately 75 salaried employees who own stock and/or stock options.

As part of Lawyer's employment agreement with Company, Lawyer is presented with a stock option agreement that is offered to Company's salaried employees. The agreement states that Lawyer has an option to purchase a certain number of shares of the Company's common stock at an exercise price equal to the fair market value of such shares on the date of the grant, based on the Company's Stock Incentive Plan. The agreement states that the securities will vest at increasing percentages over the course of five years. The agreement also states that in the

CLEAN

event of a merger with or acquisition by another company, the vesting of the Lawyer's option will immediately accelerate and become fully vested.

ISSUE PRESENTED

Does the stock option agreement present Lawyer with any conflicts of interest and if so, how and when should such conflicts of interest be addressed with the Company?

DISCUSSION AND ANALYSIS

I. Overview

"[C]ounsel working for a corporation in-house and private counsel engaged with respect to a specific matter or on retainer" are "bound by the same fiduciary and ethical duties to their clients." *PLCM Group, Inc. v. Drexler* (2000) 22 Cal. 4th 1084, 1094. In-house lawyers have attorney-client relationships with the organizations that employ them. *Gutierrez v. G & M Oil Co., Inc.* (2010) 184 Cal.App.4th 551, 559. Specifically, an organization's legal department is encompassed within the definition of "law firm." California Rules of Professional Conduct (CRPC) 1.0.1(c) ("Firm' or 'law firm' means . . . lawyers employed in a legal services organization or in the legal department, division or office of a corporation, of a government organization, or of another organization."). A lawyer's duties to an organizational client are the same whether they are "employed or retained" by the organization. CRPC 1.13(a). In short, the underlying purposes of a lawyer's fiduciary duties—protecting the public and the integrity of the legal system and promoting the administration of justice and confidence in the legal profession—are not diminished because the lawyer is employed rather than retained by an organizational client.

These principles apply to the in-house lawyer's compensation for legal services. Thus, when an in-house lawyer is presented with a stock option agreement or stock as part of their compensation, that lawyer must analyze whether the proposed arrangement triggers any conflicts of interest. This obligation may be easy to overlook if the lawyer serves a dual role of employee (where the balance of power typically favors the employer-client) and attorney (where the balance of power between attorney and client typically favors the attorney). "For example, in-house lawyers may be seen to owe different duties than independent lawyers, perhaps because they are viewed as employees of the client directly rather than indirectly." *Klein, No Fool for a Client: The Finance and Incentives Behind Stock-Based Compensation for Corporate Attorneys*, 1999 Colum. Bus. L. Rev. 330. Accordingly, "[t]he dual status of in-house counsel—acting as both employee and attorney—and the dual status of the company—acting as both employer and client—can pose some challenging questions about when one role takes precedence over another." *Missakian v. Amusement Industry, Inc.* (2021) 69 Cal.App.5th 630, 652; *see also, General Dynamics Corp. v. Superior Court (Rose)* (1994) 7 Cal.4th 1164 (recognizing this dynamic in the employment law context).

78

79

80 **II. Application of CRPC 1.8.1**

81 In the traditional attorney-client relationship, a lawyer’s acceptance of stock or stock options
 82 from a client in lieu of or in addition to fees for legal services is subject to CRPC 1.8.1, which
 83 governs when a lawyer knowingly acquires an ownership or other pecuniary interest adverse to
 84 a client. See CRPC 1.8.1, Comment [5] (“This rule does not apply to the agreement by which the
 85 lawyer is retained by the client, unless the agreement confers on the lawyer an ownership,
 86 possessory, security, or other pecuniary interest adverse to the client.”); ABA Formal Opn. 00-
 87 418 (“[A] lawyer who acquires stock in her client corporation in lieu of or in addition to a cash
 88 fee for her services enters into a business transaction with a client, such that the requirements
 89 of Model Rule 1.8(a) must be satisfied.”). If CRPC 1.8.1 applies, the lawyer must ensure that the
 90 following requirements are met:

91 (a) the transaction or acquisition and its terms are fair and
 92 reasonable to the client and the terms and the lawyer’s role in the
 93 transaction or acquisition are fully disclosed and transmitted in
 94 writing to the client in a manner that should reasonably have
 95 been understood by the client;

96 (b) the client either is represented in the transaction or
 97 acquisition by an independent lawyer of the client’s choice or the
 98 client is advised in writing* to seek the advice of an independent
 99 lawyer of the client’s choice and is given a reasonable opportunity
 100 to seek that advice; and

101 (c) the client thereafter provides informed written consent to the
 102 terms of the transaction or acquisition, and to the lawyer’s role in
 103 it.

104 The purpose of the rule is to address the inherently imbalanced relationship between attorney
 105 and client. *Beery v. State Bar* (1987) 43 Cal.3d 802, 812-813. “The law accordingly takes a
 106 jaundiced view of business transactions between attorneys and their clients.” *Ferguson v.*
 107 *Yaspan* (2014) 233 Cal. App. 4th 676, 685. Indeed, “the law presumes” attorneys engaging in
 108 such transactions “wear” a “black” hat. *Mayhew v. Benninghoff* (1997) 53 Cal. App. 4th 1365,
 109 1369.¹

¹ A lawyer’s failure to satisfy the requirements of rule 1.8.1 subjects a lawyer to discipline. However, a violation of the rule does not by itself give rise to a cause of action for damages caused by a failure to comply with the rule. . Rather, the rule’s “statutory counterpart—Probate Code section 16004—erects a presumption that transactions between an attorney and client ‘by which the [attorney] obtains an advantage’ are a breach of the attorney’s fiduciary duty and are the product of undue influence.” *Ferguson v. Yaspan*, *supra*, at 684-685; see also, *Fair v.*

CLEAN

Some of these concerns may be less pronounced in the in-house context, where the lawyer is offered the same general compensation terms, including stock and stock options, as those offered to other employees. Indeed, the power dynamic may be reversed. “[F]rom an economic standpoint, the dependence of in-house counsel is indistinguishable from that of other corporate managers or senior executives who also owe their livelihoods and career goals and satisfaction to a single organizational employer.” *General Dynamics Corp. v. Superior Court*, *supra*, 7 Cal. 4th at 1172. In addition, the in-house lawyer’s employment agreement may be prepared and/or presented by the General Counsel, employment counsel, or other company counsel.

However, no California court has recognized an exception to, or relaxation of, CRPC 1.8.1 in the in-house context notwithstanding that policies underlying the rule may not be present in the typical in-house context.² The situations in which California courts have considered application of the rule involve the attorney’s status as a business founder, who then provides legal services to the newly-formed entity.³ See, *Fair v. Bakhtiari* (2011) 195 Cal.App.4th 1135, 1169; see also, *Passante v. McWilliam* (1997) 53 Cal.App.4th 1240. However, the rule is prophylactic, requiring compliance whenever the lawyer acquires an ownership interest in a client, which by definition includes a stock grant or option agreement. “[Former rule] 3-300 absolutely prohibits a member from entering into a business transaction with a client or knowingly acquiring a pecuniary interest adverse to a client, unless the transaction is fair *and* the full written disclosure and cosnet requirements of the rule are met.” *Fair v. Bakhtiari*, *supra*, 195 Cal.App.4th 1135, 1162 (emphasis in original). Accordingly, the Committee cannot opine that CRPC 1.8.1 does not apply even if the policy concerns underlying the rule are absent and

Bakhtiari (2011) 195 Cal.App.4th 1135, 1140. “The presumption is rebuttable, and the attorney’s inability to do so renders the transaction voidable at the client’s option.” *Ferguson v. Yaspan*, *supra* at 685.

² Washington State and the ABA have addressed this issue. The Washington Supreme Court has recognized that compensation agreements for the in-house lawyer/employee, which may include nonmonetary compensation such as computers, cell phones and health benefits, are more akin to standard employment contracts and should not be governed by Washington’s version of CRPC 1.8.1, because, typically, “‘the lawyer has no advantage in dealing with the client.’” (See, *Chism v. Tri-State Constr., Inc.*, 193 Wn. App. 818, 852; quoting, Wa. RPC 1.8(a), Comment [1]. See also Washington State Bar Association Advisory Opinion 1045 (1986) [concluding that in-house lawyer’s arms-length negotiation concerning compensation in the form of shares in the employer, a publicly traded corporation, did not violate Washington’s version of CRPC 1.8].) The ABA Task Force on the Independent Lawyer [“Task Force”] reached a similar conclusion: “In the usual case, the receipt of equity-based compensation by in-house counsel would not appear to be the type of ‘business transaction with a client’ contemplated by Rule 1.8. Option or restricted stock grants (the usual forms of equity compensation paid to in-house attorneys) are merely a form of compensation and, like cash, are a facet of the general employment relationship rather than part of or related to any particular transaction or undertaking.” (Litigation Section of the American Bar Association, *Lawyers Doing Business with Their Clients: Identifying and Avoiding Legal and Ethical Dangers*, A Report of the Task Force on the Independent Lawyer (2001).)

³ It is irrelevant that the lawyer is not formally designated as “general counsel” or “in-house counsel” for the business entity, or whether the lawyer provides both legal and nonlegal services. “When a member performs both legal and non-legal professional services for a client, the member is subject to the California Rules of Professional Conduct with respect to all of those services.” Cal. Form. Opn. 1999-154.

the in-house lawyer's "employee" role dominates over the "lawyer" role when the lawyer's compensation package is offered.

.

Here, Lawyer was not involved in Company's formation. Lawyer is presented with a stock option agreement that is offered to the Company's employees as part of the Company's Stock Incentive Plan. The securities vest incrementally over time. Thus, stock options are offered as a standard form of compensation in the proposed employment agreement and not in connection with a particular transaction or undertaking. It is an arms-length transaction. Compliance with CRPC 1.8.1 seemingly would be superfluous.

But compliance is still required. Further, Lawyer should consider the relative easy burden of compliance. It is Company's proposal and it undoubtedly views the terms fair and reasonable. The additional step of obtaining Company's express acknowledgement of its right to consult with independent counsel and informed written consent to the arrangement would not be burdensome.

III. Application of CRPC 1.7

Lawyer must separately consider whether the stock option provisions in the employment agreement present a "material limitation" conflict of interest under rule 1.7(b). Specifically, CRPC 1.7(b) prohibits representation of a client if there is a significant risk that the representation "will be materially limited . . . by the lawyer's own interests," without the informed written consent of the client. Further, the lawyer cannot represent the client even with the requisite consent from the client if the lawyer does not "reasonably believe[] that the lawyer will be able to provide competent and diligent representation to each affected client." CRPC 1.7(d)(1). Thus, where the lawyer has a personal interest in the subject matter of the representation, the lawyer must assess whether their independent judgment will be materially impacted to the detriment of the client. See, e.g., ABA Model Rule 1.7, Comment [10]: "For example, if the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. . . . See Rule 1.8 for specific Rules pertaining to a number of personal interest conflicts, including business transactions with clients."

In ABA Formal Opn. 00-418 (2000), the committee opined that although issuance of stock to outside counsel in lieu of or in addition to fees mandated compliance with Model Rule 1.8(a) (the equivalent to CRPC 1.8.1), it "creates no inherent conflict of interest" under the "material limitation" conflict provisions of Model Rule 1.7(b). The committee explained: "Indeed, management's role primarily is to enhance the business's value for the stockholders. Thus, the lawyer's legal services in assisting management usually will be consistent with the lawyer's stock ownership. In some circumstances, such as the merger of one corporation in which the lawyer owns stock into a larger entity, the lawyer's economic incentive to complete the transaction may even be enhanced." (*Id.* at p. 9.)

CLEAN

However, this does not render CRPC 1.7(b) wholly inapplicable to an in-house lawyer who owns stock or stock options. *See also*, Independent Lawyer Report, p. 56 (“To the extent . . . that the receipt of such compensation or the ownership of equity in the employer company might raise a question as to a potential conflict of interest or impairment of the representation, Rule 1.7 would govern.”) Indeed, the committee envisions a number of scenarios where a material limitation conflict could arise, such as advising corporate management on the duty to disclose materially adverse financial information. “[T]he lawyer must evaluate her ability to maintain the requisite professional independence as a lawyer in the corporate client’s best interest by subordinating any economic incentive arising from her stock ownership.” ABA Form. Opn. 00-418 (2000), p. 10. If the lawyer reasonably believes that her representation may be materially limited by her stock ownership she must consult with the client and obtain consent before continuing the representation. *Ibid.* This rule applies with equal force to in-house lawyers regardless of whether the stock option agreement was an arms-length negotiation falling outside the ambit of CRPC 1.8.1, as discussed *supra*.

Here, Company offers Lawyer participation in its Stock Incentive Plan, which includes stock options that vest incrementally over time. These are terms offered to other employees. At the outset of the employment relationship, these provisions by themselves do not present a significant risk that Lawyer’s independent judgment will be materially limited to the detriment of the Company. “Given the relatively limited equity stake of corporate counsel in most cases, the lawyer’s ownership interest usually would not materially limit the representation. Indeed, equity-based compensation grants generally are made in small increments over time and, at the time made, are restricted in ways that give them only contingent, future value.” (Independent Lawyer Report, p. 56.)

However, the stock option agreement also provides that in the event of a merger with or acquisition by another company, the vesting of the Lawyer’s option will immediately accelerate so as to become fully vested. Given that such a merger is a mere potentiality, and lacking specificity as to any terms and timing, it is unlikely that it presents a significant risk at the outset of Lawyer’s employment that the acceleration provision will materially limit Lawyer’s representation. Lawyer may consider an advance conflict waiver if a reasonably comprehensive explanation of foreseeable scenarios in which Company may be adversely affected by the merger and acceleration of Lawyer’s stock vesting can be provided.. (*See generally*, CRPC 1.7, Comment [9]; *Sheppard, Mullin, Richter & Hampton LLP v. J-M Mfg. Co., Inc.* (2018) 6 Cal.5th 59.) Even if an advance waiver is obtained, in the event of a merger, Lawyer should reassess whether a second “confirming” waiver is required depending on the specificity of the advance waiver and whether it reasonably predicted the materialized conflict. (*See, Visa U.S.A., Inc. v. First Data Corp* (N.D. Cal. 2003) 241 F.Supp.2d 1100; *Western Sugar Coop. v. Archer-Daniels-Midland Co.* (C.D. 2015) 98 F.Supp.3d 1074 (material change may trigger need for new disclosure and informed written consent.) Independent Lawyer Report, p. 43.)

CLEAN

CONCLUSION

The employer-employee relationship inherent in the role of a corporate in-house lawyer presents unique challenges with respect to the application of the conflicts rules that govern the legal profession as a whole. Nevertheless, in-house lawyers are not exempt from compliance with those rules. If their compensation involves the issuance of stock or stock options, they must comply with CRPC 1.8.1. Further, the lawyer has an ongoing obligation to assess whether their stock ownership presents a significant risk that their representation will be materially limited by their financial interests in connection with a particular matter on which the lawyer is asked or expected to provide advice and counsel.

REDLINE

IN-HOUSE COUNSEL DRAFT OPINION

ISSUE: What conflicts of interest are presented by a stock option agreement between in-house lawyer and the company?

In-house lawyers are often offered employee stock options or grants as part of their compensation package. In a typical attorney-client relationship - - which is inherently imbalanced in favor of the attorney - - taking stock in a client requires compliance with CRPC 1.8.1: the transaction must be fair and reasonable; the lawyer's role in the transaction must be fully and plainly disclosed to the client in writing; and the client is advised in writing to consult with independent counsel about the transaction. The client must then provide written consent to the transaction. ~~and the client thereafter provides informed written consent to it. In general, T~~ this rule applies in the in-house context, even if the ~~new~~ lawyer is offered the same general compensation terms as those offered to other employees and indicia of inequality do not exist.

~~However, the Committee is cognizant that some in-house lawyers have not strictly followed CRPC 1.8.1 when acquiring own stock or stock options in the companies where they work. These lawyers, and those contemplating new in-house positions where similar types of incentive-based compensation is offered, should assess the risk of noncompliance. Factors to consider include (1) whether the lawyer was involved in advising on the organization's formation; (2) whether the proposed compensation agreement is drafted and proposed by the organization (or its counsel) or the lawyer; (3) whether the organization has independent counsel concerning the compensation agreement; (4) whether the compensation terms offered to the lawyer are substantively similar to those offered to employees at the same level; and (5) whether the compensation is part of the lawyer's initial employment agreement, or modifications thereto, or related to lawyer's work on a specific transaction. These factors are not exhaustive but are intended as an analytical tool.~~

Stock ownership may likewise trigger a material limitation conflict under CRPC 1.7(b) if there is a significant risk that the in-house lawyer's representation will be materially limited by their financial interest in connection with their stock ownership. Such a conflict could arise if the lawyer is asked to advise the company concerning a transaction that affects the character or price of the stock, such as a merger or acquisition. If so, the lawyer must obtain informed written consent from an authorized constituent of the company. If the lawyer does not reasonably believe they can competently represent the company due to the conflict, or if the company refuses to consent to the conflict, the lawyer must refer the matter to nonconflicted in-house counsel or outside counsel.

AUTHORITIES

INTERPRETED: Rules of Professional Conduct 1.0.1, 1.7, 1.8.1,- 1.13

REDLINE

STATEMENT OF FACTS

After practicing law for 5 years as in-house legal counsel for a software company ("Old Company"), Lawyer has decided to take a position as General Counsel for a closely-held software company ("Company"), formed by three founders ("Founders"). The Founders make up the Board of Directors ("Board"). Lawyer is expected to head a small team of three lawyers ("Legal Department"). There are approximately 75 salaried employees who own stock and/or stock options.

As part of Lawyer's employment agreement with Company, Lawyer is presented with a stock option agreement that is offered to Company's salaried employees. The agreement states that Lawyer has an option to purchase a certain number of shares of the Company's common stock at an exercise price equal to the fair market value of such shares on the date of the grant, based on the Company's Stock Incentive Plan. The agreement states that the securities will vest at increasing percentages over the course of five years. The agreement also states that in the event of a merger with or acquisition by another company, the vesting of the Lawyer's option will immediately accelerate and become fully vested.

ISSUE PRESENTED

Does the stock option agreement present Lawyer with any conflicts of interest and if so, how and when should such conflicts of interest be addressed with the Company?

DISCUSSION AND ANALYSIS

I. Overview

"[C]ounsel working for a corporation in-house and private counsel engaged with respect to a specific matter or on retainer" are "bound by the same fiduciary and ethical duties to their clients." *PLCM Group, Inc. v. Drexler* (2000) 22 Cal. 4th 1084, 1094. In-house lawyers have attorney-client relationships with the organizations that employ them. *Gutierrez v. G & M Oil Co., Inc.* (2010) 184 Cal.App.4th 551, 559. Specifically, an organization's legal department is encompassed within the definition of "law firm." California Rules of Professional Conduct (CRPC) 1.0.1(c) ("Firm' or 'law firm' means . . . lawyers employed in a legal services organization or in the legal department, division or office of a corporation, of a government organization, or of another organization."). A lawyer's duties to an organizational client are the same whether they are "employed or retained" by the organization. CRPC 1.13(a). In short, the underlying purposes of a lawyer's fiduciary duties—protecting the public and the integrity of the legal system and promoting the administration of justice and confidence in the legal profession—are not diminished ~~simply~~ because the lawyer is employed rather than retained by an organizational client.

These principles ~~similarly~~ apply to the in-house lawyer's compensation for legal services. Thus, when an in-house lawyer is presented with a stock option agreement or stock as part of their

REDLINE

79 compensation, that lawyer must analyze whether the proposed arrangement triggers any
80 conflicts of interest. This obligation may be easy to overlook ~~may be difficult~~ if the lawyer
81 serves a dual role of employee (where the balance of power typically favors the employer-
82 client) and attorney (where the balance of power between attorney and client typically favors
83 the attorney). “For example, in-house lawyers may be seen to owe different duties than
84 independent lawyers, perhaps because they are viewed as employees of the client directly
85 rather than indirectly.” *Klein, No Fool for a Client: The Finance and Incentives Behind Stock-*
86 *Based Compensation for Corporate Attorneys*, 1999 Colum. Bus. L. Rev. 330. Accordingly, “[t]he
87 dual status of in-house counsel—acting as both employee and attorney—and the dual status of
88 the company—acting as both employer and client—can pose some challenging questions about
89 when one role takes precedence over another.” *Missakian v. Amusement Industry, Inc.* (2021)
90 69 Cal.App.5th 630, 652; *see also, General Dynamics Corp. v. Superior Court (Rose)* (1994) 7
91 Cal.4th 1164 (recognizing this dynamic in the employment law context).

92 ~~II. Does the stock option agreement present Lawyer with any conflicts of interest, and if~~
93 ~~so, how and when should such conflicts of interest be addressed with the Company?~~

94

95 ~~A.~~ II. ~~Potential~~ **Application of CRPC 1.8.1**

96 In the traditional attorney-client relationship, a lawyer’s acceptance of stock or stock options
97 from a client in lieu of or in addition to fees for legal services is subject to CRPC 1.8.1, which
98 governs when a lawyer knowingly acquires an ownership or other pecuniary interest adverse to
99 a client. *See* CRPC 1.8.1, Comment [5] (“This rule does not apply to the agreement by which the
100 lawyer is retained by the client, unless the agreement confers on the lawyer an ownership,
101 possessory, security, or other pecuniary interest adverse to the client.”); ABA Formal Opn. 00-
102 418 (“[A] lawyer who acquires stock in her client corporation in lieu of or in addition to a cash
103 fee for her services enters into a business transaction with a client, such that the requirements
104 of Model Rule 1.8(a) must be satisfied.”). If CRPC 1.8.1 applies, the lawyer must ensure that the
105 following requirements are met:

106 (a) the transaction or acquisition and its terms are fair and
107 reasonable to the client and the terms and the lawyer’s role in the
108 transaction or acquisition are fully disclosed and transmitted in
109 writing to the client in a manner that should reasonably have
110 been understood by the client;

111 (b) the client either is represented in the transaction or
112 acquisition by an independent lawyer of the client’s choice or the
113 client is advised in writing* to seek the advice of an independent
114 lawyer of the client’s choice and is given a reasonable opportunity
115 to seek that advice; and

REDLINE

(c) the client thereafter provides informed written consent to the terms of the transaction or acquisition, and to the lawyer's role in it.

The purpose of the rule is to address the inherently imbalanced relationship between attorney and client. *Beery v. State Bar* (1987) 43 Cal.3d 802, 812-813. "The law accordingly takes a jaundiced view of business transactions between attorneys and their clients." *Ferguson v. Yaspan* (2014) 233 Cal. App. 4th 676, 685. Indeed, "the law presumes" attorneys engaging in such transactions "wear" a "black" hat. *Mayhew v. Benninghoff* (1997) 53 Cal. App. 4th 1365, 1369.¹

Some of these concerns may be less pronounced in the in-house context, where the ~~new~~ lawyer is offered the same general compensation terms, including stock and stock options, as those offered to other employees. Indeed, the power dynamic may be reversed. "[F]rom an economic standpoint, the dependence of in-house counsel is indistinguishable from that of other corporate managers or senior executives who also owe their livelihoods and career goals and satisfaction to a single organizational employer." *General Dynamics Corp. v. Superior Court*, *supra*, 7 Cal. 4th at 1172. In addition, the in-house lawyer's employment agreement may be prepared and/or presented by the General Counsel, employment counsel, or other company counsel.

However, no California court has recognized an exception to, or relaxation of, CRPC 1.8.1 in the in-house context notwithstanding that policies underlying the rule may not be present in the typical in-house context. ² ~~No California court has addressed whether CRPC 1.8.1 applies to~~

¹ A lawyer's failure to satisfy the requirements of rule 1.8.1 subjects a lawyer to discipline. However, a violation of the rule does not by itself give rise to a cause of action for damages caused by a failure to comply with the rule. . Rather, the rule's "statutory counterpart—Probate Code section 16004—erects a presumption that transactions between an attorney and client 'by which the [attorney] obtains an advantage' are a breach of the attorney's fiduciary duty and are the product of undue influence." *Ferguson v. Yaspan*, *supra*, at 684-685; *see also*, *Fair v. Bakhtiari* (2011) 195 Cal.App.4th 1135, 1140. "The presumption is rebuttable, and the attorney's inability to do so renders the transaction voidable at the client's option." *Ferguson v. Yaspan*, *supra* at 685.

² Washington State and the ABA have addressed this issue. The Washington Supreme Court has recognized that compensation agreements for the in-house lawyer/employee, which may include nonmonetary compensation such as computers, cell phones and health benefits, are more akin to standard employment contracts and should not be governed by Washington's version of CRPC 1.8.1, because, typically, "the lawyer has no advantage in dealing with the client." (See, *Chism v. Tri-State Constr., Inc.*, 193 Wn. App. 818, 852; quoting, Wa. RPC 1.8(a), Comment [1]. See also Washington State Bar Association Advisory Opinion 1045 (1986) [concluding that in-house lawyer's arms-length negotiation concerning compensation in the form of shares in the employer, a publicly traded corporation, did not violate Washington's version of CRPC 1.8].) The ABA Task Force on the Independent Lawyer ["Task Force"] reached a similar conclusion: "In the usual case, the receipt of equity-based compensation by in-house counsel would not appear to be the type of 'business transaction with a client' contemplated by Rule 1.8. Option or restricted stock grants (the usual forms of equity compensation paid to in-house attorneys) are merely a form of compensation and, like cash, are a facet of the general employment relationship rather than part of or related to any particular transaction or undertaking." (Litigation Section of the American Bar Association, *Lawyers Doing Business with Their Clients: Identifying and Avoiding Legal and Ethical Dangers, A Report of the Task Force on the Independent Lawyer* (2001).)

REDLINE

~~stock or stock option agreements between in-house counsel and their employer.~~ The situations in which California courts have considered application of the rule involve the attorney's status as a business founder, who then provides legal services to the newly-formed entity.³ See, *Fair v. Bakhtiari* (2011) 195 Cal.App.4th 1135, 1169; see also, *Passante v. McWilliam* (1997) 53 Cal.App.4th 1240. However, the rule is prophylactic, requiring compliance whenever the lawyer acquires an ownership interest in a client, which by definition includes a stock grant or option agreement. "[Former rule] 3-300 absolutely prohibits a member from entering into a business transaction with a client or knowingly acquiring a pecuniary interest adverse to a client, unless the transaction is fair *and* the full written disclosure and cosnet requirements of the rule are met." *Fair v. Bakhtiari*, supra, 195 Cal.App.4th 1135, 1162 (emphasis in original). Accordingly, ~~in the absence of such authority,~~ the Committee cannot opine that CRPC 1.8.1 ~~it~~ does not apply even if the policy concerns underlying the rule are absent and the in-house lawyer's "employee" role dominates over the "lawyer" role when the lawyer's compensation package is offered. ~~At the same time, the Committee is cognizant of the practical reality that many in-house lawyers own stock or stock options in the companies for which they work despite that they have not fully complied with CRPC 1.8.1.~~

~~Out of state authority and the ABA provide some guidance on this issue. The Washington Supreme Court has recognized that compensation agreements for the in-house lawyer/employee, which may include nonmonetary compensation such as computers, cell phones and health benefits, are more akin to standard employment contracts and should not be governed by Washington's version of CRPC 1.8.1, because, typically, "the lawyer has no advantage in dealing with the client." (See, *Chism v. Tri State Constr., Inc.*, 193 Wn. App. 818, 852; quoting, Wa. RPC 1.8(a), Comment [1]. See also Washington State Bar Association Advisory Opinion 1045 (1986) [concluding that in-house lawyer's arms-length negotiation concerning compensation in the form of shares in the employer, a publicly traded corporation, did not violate Washington's version of CRPC 1.8].)-⁴~~

³ It is irrelevant that the lawyer is not formally designated as "general counsel" or "in-house counsel" for the business entity, or whether the lawyer provides both legal and nonlegal services. "When a member performs both legal and non-legal professional services for a client, the member is subject to the California Rules of Professional Conduct with respect to all of those services." Cal. Form. Opn. 1999-154.

⁴ Wa. RPC 1.8(a), Comment [1] states that "[RPC 1.8(a)] does not apply to ordinary fee arrangements between client and lawyer, which are governed by Rule 1.5, although its requirements must be met when the lawyer accepts an interest in the client's business or other nonmonetary property as payment of all or part of a fee. In addition, the Rule does not apply to standard commercial transactions between the lawyer and the client for products or services that the client generally markets to others, for example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has no advantage in dealing with the client, and the restrictions in paragraph (a) are unnecessary and impracticable." The comments to CRPC 1.8.1 are substantially similar. See CRPC 1.8.1, Comment [5]: "This rule does not apply to the agreement by which the lawyer is retained by the client, unless the agreement confers on the lawyer an ownership, possessory, security, or other pecuniary interest adverse to the client." See also, CRPC 1.8.1, Comment [6] "This rule does not apply . . . to standard commercial transactions for products or services that

The ABA Task Force on the Independent Lawyer [“Task Force”] reached a similar conclusion:

~~In the usual case, the receipt of equity-based compensation by in-house counsel would not appear to be the type of ‘business transaction with a client’ contemplated by Rule 1.8. Option or restricted stock grants (the usual forms of equity compensation paid to in-house attorneys) are merely a form of compensation and, like cash, are a facet of the general employment relationship rather than part of or related to any particular transaction or undertaking.~~

~~(Litigation Section of the American Bar Association, *Lawyers Doing Business with Their Clients: Identifying and Avoiding Legal and Ethical Dangers, A Report of the Task Force on the Independent Lawyer* (2001) [hereafter “Independent Lawyer Report”]).~~

~~The Task Force noted that the “timing, size and conditions” placed on stock grants are typically the result of unilateral decisions by the corporate employer, in consultation with outside advisors and counsel. In short, the Task Force concluded, such stock grants, under normal circumstances, should not create interests that are “adverse” to the company’s interests. In other words, this type of compensation arrangement would be similar to a “standard commercial transactions for products or services that a lawyer acquires from a client on the same terms that the client generally markets them to others, where the lawyer has no advantage in dealing with the client.” CRPC 1.8.1, Comment [6].~~

~~However, a distinction must be made between “normal circumstances,” i.e., an employment agreement offered by an established company that contains stock grants or options as a general form of employment compensation, and other types of business transactions in which there is an inherent imbalance of power between attorney and client. For example, CRPC 1.8.1 applies to situations where the attorney and an existing or new client form a business together as founders or shareholders, and the attorney provides legal services to the newly formed business entity.⁵ See, *Fair v. Bakhtiari* (2011) 195 Cal.App.4th 1135, 1169; see also, *Passante v. McWilliam* (1997) 53 Cal.App.4th 1240.~~

~~Thus, to determine whether the arrangement falls within “normal circumstances,” the in-house lawyer should analyze whether the equity-based compensation arrangement is a “standard” contract that does not involve an imbalance of bargaining power in favor of the lawyer. Factors~~

a lawyer acquires from a client on the same terms that the client generally markets them to others, where the lawyer has no advantage in dealing with the client.”

⁵ It is irrelevant that the lawyer is not formally designated as “general counsel” or “in-house counsel” for the business entity, or whether the lawyer provides both legal and nonlegal services. “When a member performs both legal and non-legal professional services for a client, the member is subject to the California Rules of Professional Conduct with respect to all of those services.” Cal. Form. Opn. 1999-154.

REDLINE

~~to consider include (1) whether the lawyer was involved in advising on the organization's formation; (2) whether the proposed compensation agreement is drafted and proposed by the organization (or its counsel) or the lawyer; (3) whether the organization has independent counsel concerning the compensation agreement; (4) whether the compensation terms offered to the lawyer are substantively similar to those offered to employees at the same level; (5) whether the compensation is part of Lawyer's initial employment agreement, or modifications thereto, or related to Lawyer's work on a specific transaction.~~

~~Again, the Committee cautions that even if these factors weigh against application of CRPC 1.8.1, it only lessens the risk of a violation of the rule.~~

Here, Lawyer was not involved in Company's formation. Lawyer is presented with a stock option agreement that is offered to the Company's employees as part of the Company's Stock Incentive Plan. The securities vest incrementally over time. Thus, stock options are offered as a standard form of compensation in the proposed employment agreement and not in connection with a particular transaction or undertaking. It is an arms-length transaction. Compliance with CRPC 1.8.1 seemingly would be superfluous. ~~(?) [exhausting form over substance?]~~.

But compliance is still required. Further, ~~However,~~ Lawyer should ~~also~~ consider the relatively easy burden of compliance. It is Company's proposal and it undoubtedly views the terms fair and reasonable. The additional step of obtaining Company's express acknowledgement of its right to consult with independent counsel and informed written consent to the arrangement would not be burdensome.

~~At the same time, the Committee is cognizant of the practical reality that many in house lawyers own stock or stock options in the companies for which they work despite that they have not fully complied with CRPC 1.8.1.~~

~~B.~~ III. ~~Potential~~ Application of CRPC 1.7

Lawyer must separately consider whether the stock option provisions in the employment agreement present a "material limitation" conflict of interest under rule 1.7(b). Specifically, CRPC 1.7(b) prohibits representation of a client if there is a significant risk that the representation "will be materially limited . . . by the lawyer's own interests," without the informed written consent of the client. Further, the lawyer cannot represent the client even with the requisite consent from the client if the lawyer does not "reasonably believe[] that the lawyer will be able to provide competent and diligent representation to each affected client." CRPC 1.7(d)(1). Thus, where the lawyer has a personal interest in the subject matter of the representation, the lawyer must assess whether their independent judgment will be materially impacted to the detriment of the client. See, e.g., ABA Model Rule 1.7, Comment [10]: "For example, if the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. . . . See Rule 1.8 for specific Rules pertaining to a number of personal interest conflicts, including business transactions with clients."

REDLINE

In ABA Formal Opn. 00-418 (2000), the committee opined that although issuance of stock to outside counsel in lieu of or in addition to fees mandated compliance with Model Rule 1.8(a) (the equivalent to CRPC 1.8.1), it “creates no inherent conflict of interest” under the “material limitation” conflict provisions of Model Rule 1.7(b). The committee explained: “Indeed, management’s role primarily is to enhance the business’s value for the stockholders. Thus, the lawyer’s legal services in assisting management usually will be consistent with the lawyer’s stock ownership. In some circumstances, such as the merger of one corporation in which the lawyer owns stock into a larger entity, the lawyer’s economic incentive to complete the transaction may even be enhanced.” (*Id.* at p. 9.)

However, this does not render CRPC 1.7(b) wholly inapplicable to an in-house lawyer who owns stock or stock options. *See also*, Independent Lawyer Report, p. 56 (“To the extent . . . that the receipt of such compensation or the ownership of equity in the employer company might raise a question as to a potential conflict of interest or impairment of the representation, Rule 1.7 would govern.”) Indeed, the committee envisions a number of scenarios where a material limitation conflict could arise, such as advising corporate management on the duty to disclose materially adverse financial information. “[T]he lawyer must evaluate her ability to maintain the requisite professional independence as a lawyer in the corporate client’s best interest by subordinating any economic incentive arising from her stock ownership.” ABA Form. Opn. 00-418 (2000), p. 10. If the lawyer reasonably believes that her representation may be materially limited by her stock ownership she must consult with the client and obtain consent before continuing the representation. *Ibid.* This rule applies with equal force to in-house lawyers regardless of whether the stock option agreement was an arms-length negotiation falling outside the ambit of CRPC 1.8.1, as discussed *supra*.

Here, Company offers Lawyer participation in its Stock Incentive Plan, which includes stock options that vest incrementally over time. These are terms offered to other employees. At the outset of the employment relationship, these provisions by themselves do not present a significant risk that Lawyer’s independent judgment will be materially limited to the detriment of the Company. “Given the relatively limited equity stake of corporate counsel in most cases, the lawyer’s ownership interest usually would not materially limit the representation. Indeed, equity-based compensation grants generally are made in small increments over time and, at the time made, are restricted in ways that give them only contingent, future value.” (Independent Lawyer Report, p. 56.)

However, the stock option agreement also provides that in the event of a merger with or acquisition by another company, the vesting of the Lawyer’s option will immediately accelerate so as to become fully vested. Given that such a merger is a mere potentiality, and lacking specificity as to any terms and timing, it is unlikely that it presents a significant risk at the outset of Lawyer’s employment that the acceleration provision will materially limit Lawyer’s representation. Lawyer may consider an advance conflict waiver if a reasonably comprehensive

REDLINE

273 explanation of foreseeable scenarios in which Company may be adversely affected by the
274 merger and acceleration of Lawyer's stock vesting can be provided.. (See generally, CRPC 1.7,
275 Comment [9]; *Sheppard, Mullin, Richter & Hampton LLP v. J-M Mfg. Co., Inc.* (2018) 6 Cal.5th 59.)
276 Even if an advance waiver is obtained, in the event of a merger, Lawyer should reassess
277 whether a second "confirming" waiver is required depending on the specificity of the advance
278 waiver and whether it reasonably predicted the materialized conflict. (See, *Visa U.S.A., Inc. v.*
279 *First Data Corp* (N.D. Cal. 2003) 241 F.Supp.2d 1100; *Western Sugar Coop. v. Archer-Daniels-*
280 *Midland Co.* (C.D. 2015) 98 F.Supp.3d 1074 (material change may trigger need for new
281 disclosure and informed written consent.) Independent Lawyer Report, p. 43.)
282

CONCLUSION

285 The employer-employee relationship inherent in the role of a corporate in-house lawyer
286 presents unique challenges with respect to the application of the conflicts rules that govern the
287 legal profession as a whole. Nevertheless, in-house lawyers are not exempt from compliance
288 with those rules. If their compensation involves the issuance of stock or stock options, they
289 must comply with CRPC 1.8.1, ~~or otherwise assess the risk of noncompliance. Even if the~~
290 ~~assumes the risk of noncompliance, the~~ Further, the lawyer has an ongoing obligation to assess
291 whether their stock ownership presents a significant risk that their representation will be
292 materially limited by their financial interests in connection with a particular matter on which
293 the lawyer is asked or expected to provide advice and counsel.
294
295