

**THE STATE BAR OF CALIFORNIA
STANDING COMMITTEE ON
PROFESSIONAL RESPONSIBILITY AND CONDUCT
FORMAL OPINION INTERIM NO. 21-0003**

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

DIGEST: 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 of a client requires compliance with Rule of Professional Conduct 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 rule 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 1.0.1, 1.7, 1.8.1, and 1.13 of the Rules of Professional Conduct of the State Bar of California.

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 offer of employment, Company's CFO sends Lawyer a secure email containing a proposed stock option agreement that is offered to Company's salaried employees. The agreement was prepared by Company's previous General Counsel, who is no longer with Company. The agreement states that Lawyer has an option to purchase a certain number of shares of 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 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 Lawyer's option will immediately accelerate and become fully vested.

Lawyer responds to CFO's email acknowledging receipt of the stock option agreement and advising CFO to consult with independent counsel concerning the stock option terms offered to Lawyer as part of Lawyer's compensation as Company's General Counsel. CFO responds, "Ok, no problem." The following day, Lawyer executes the stock option agreement. CFO then executes the agreement on behalf of Company.

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 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 [95 Cal.Rptr.2d 198].) In-house lawyers have attorney-client relationships with the organizations that employ them. (See *Gutierrez v. G & M Oil Co., Inc.* (2010) 184 Cal.App.4th 551, 559 [108 Cal.Rptr.3d 864].) Specifically, an organization's legal department is encompassed within the definition of "law firm." (Rule 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. (Rule 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) 1999 Colum. Bus. L.Rev. 329.) 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, 651 [285 Cal.Rptr.3d 23]; see also *General Dynamics Corp. v. Superior Court (Rose)* (1994) 7 Cal.4th 1164 [32 Cal.Rptr.2d 1] [recognizing this dynamic in the employment law context].)

II. Application of Rule 1.8.1

In the traditional attorney-client relationship, a lawyer’s acceptance of stock or stock options from a client in lieu of, or in addition to, fees for legal services is subject to rule 1.8.1, which governs when a lawyer knowingly acquires an ownership or other pecuniary interest adverse to a client. (See rule 1.8.1, Cmt. [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.”]; ABA Com. on Prof. Ethics Opn. No. 00-418 (2000) [“[A] lawyer who acquires stock in her client corporation in lieu of or in addition to a cash fee for her services enters into a business transaction with a client, such that the requirements of Model Rule 1.8(a) must be satisfied.”].) If rule 1.8.1 applies, the lawyer must ensure that the following requirements are met:

- (1) The transaction or acquisition and its terms are fair and reasonable to the client and the terms and the lawyer’s role in the transaction or acquisition are fully disclosed and transmitted in writing to the client in a manner that should reasonably have been understood by the client;
- (2) The client either is represented in the transaction or acquisition by an independent lawyer of the client’s choice or the client is advised in writing to seek the advice of an independent lawyer of the client’s choice and is given a reasonable opportunity to seek that advice; and
- (3) 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 [239 Cal.Rptr. 121].) “The law accordingly takes a jaundiced view of business transactions between attorneys and their

clients.” (*Ferguson v. Yaspan* (2014) 233 Cal.App.4th 676, 684 [183 Cal.Rptr.3d 83] citing *Mayhew v. Benninghoff* (1997) 53 Cal.App.4th 1365, 1369 [62 Cal.Rptr.2d 27].) Indeed, “the law presumes” attorneys engaging in such transactions “wear” a “black” hat. (*Mayhew v. Benninghoff, supra*, 53 Cal.App.4th at 1369.)¹

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 (Rose)*, *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, rule 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 [125 Cal.Rptr.3d 765]; see also *Passante v. McWilliam* (1997) 53 Cal.App.4th 1240 [62 Cal.Rptr.2d 298].) 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

¹ The civil legal consequences of violating rule 1.8.1 are beyond the scope of this opinion. (See Cal. Prob. Code Section 16004.)

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 rule 1.8.1, because, typically, “the lawyer has no advantage in dealing with the client.” (*Chism v. Tri-State Constr., Inc.* (2016) 193 Wash.App. 818, 852 [374 P.3d 193]; quoting Wa. Rule 1.8(a), Cmt. [1]; see also Wash. State Bar Assoc. Advisory Opn. No. 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 rule 1.8].) The ABA Task Force on the Independent Lawyer 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) (Independent Lawyer Report).)

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. No. 1999-154.)

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 consent 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 rule 1.8.1 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.

Here, the requirements that the “transaction” and “its terms” are “fair and reasonable,” in writing, and reasonably understood by the client, are met. The stock option agreement is offered to Company’s employees as part of 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. (See *In the Matter of Gillis* (Review Dept. 2002) 4 Cal. State Bar Ct. Rptr. 387, 396 [the “fair and reasonable” question is not determined “in the abstract” but rather based on “the entire transaction” with the client].) Lawyer did not prepare the stock option agreement; it was prepared on behalf of Company by its former General Counsel. The agreement was presented to Lawyer by Company’s CFO. Thus, the terms of the transaction and Lawyer’s role in it was reasonably understood by the client.

The requirement that the client be represented by independent counsel⁴ or advised in writing to seek the advice of independent counsel is satisfied by Lawyer’s email to CFO advising Company to consult with independent counsel concerning the stock option terms offered to Lawyer as part of Lawyer’s compensation as Company’s General Counsel. Company had a reasonable opportunity to do so because it controlled the hiring process and the timing of execution of the stock option agreement. (See, Tuft et al., Cal. Practice Guide: Professional Responsibility & Liability (The Rutter Group 2024) paragraph 4:292 (“What constitutes a reasonable amount of time under CPRC 1.8.1(c) . . . depends on the facts and circumstances of the case – e.g., the nature of the transaction and the client’s sophistication, etc.”).)

Finally, the requirement that the client must consent to the transaction and the lawyer’s role in it was satisfied by CFO’s execution of the stock option agreement on behalf of Company.

III. Application of Rule 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, rule 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

⁴ Often, especially in large public corporations, a company already will be represented by in-house or outside counsel in connection with the hiring of a new lawyer for the company’s legal department. Such representation would satisfy this element. But where, as here, Company is closely-held, looking to *replace* its departed General Counsel, or it is otherwise unclear whether independent counsel is involved, the lawyer must take steps to ensure compliance with this requirement, as Lawyer did here.

to provide competent and diligent representation to each affected client.” (Rule 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 ABA Model Rule 1.7, Cmt. [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 Committee on Professional Ethics Opinion No. 00-418 (2000), the committee opined that although the 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 rule 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 rule 1.7(b) wholly inapplicable to an in-house lawyer who owns stock or stock options. (Independent Lawyer Report, *supra*, 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 Com. on Prof. Ethics, Opn. No. 00-418 (2000), *supra*, p. 10.) If the lawyer reasonably believes that the representation may be materially limited by stock ownership, the lawyer 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 rule 1.8.1. (ABA Com. on Prof. Ethics Opn. No. 00-418 (2000).)

Here, Company offers Lawyer participation in Company’s 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 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, *supra*, 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 Lawyer's option will immediately accelerate so as to become fully vested. Given that such a merger is a mere potentiality and lacks 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 rule 1.7, Cmt. [9]; *Sheppard, Mullin, Richter & Hampton LLP v. J-M Manufacturing Co., Inc.* (2018) 6 Cal.5th 59 [237 Cal.Rptr.3d 424].) 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. (*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.Cal. 2015) 98 F.Supp.3d 1074 [material change may trigger the need for new disclosure and informed written consent]; Independent Lawyer Report, *supra*, p. 43.)

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 conflict 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 rule 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.