

Start-up Companies and Alternative Fee Arrangements: How Can We Help Them?

R. Danny Huntington, Moderator
Fernando Triana Soto, Speaker
JoAnna M. Esty, Speaker

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Introduction



Start-ups are generally big on ideas and lean on cash reserves. Developing and protecting IP before commercial launches can be financially challenging for start-ups.

- Are there ethical/business implications of alternative fee arrangements?
- Are some fee arrangements less risky than others?
- How do you discuss these issues with clients?
- What are the implications of delayed payment terms?

Start-ups: Is There Money to Pay You?

When launching a business venture, it is vitally important to know that there will be enough money to keep it afloat.



- Every business is different and has its own specific cash needs at different stages of development. Some businesses can be started on a shoestring budget, while others may require considerable investment.
- To determine seed money, it is necessary to estimate the costs of doing business for at least the first several months. Some expenses are one-time costs while others will be ongoing costs. **Legal fees can be both.**

Cost Categories for Start Ups



1. Cost of sales: Product inventory, materials, manufacture, shipping, storage.
2. Professional fees: **Setting up the business , trademarks, copyrights, patents, partnership, investment and non-disclosure agreements, attorney fees for ongoing consultation,** retaining an accountant.
3. Technology costs: Computer hardware, and software, development, engineering, communications, labs, websites, security, IT consultants.
4. Administrative costs: Office supplies, licenses, postage, insurance, rent, utilities, office machines and furniture, VAT and other taxes, and miscellaneous items needed to operate.
5. Sales and marketing costs: printing and marketing materials, advertising, public relations, event or trade show attendance or sponsorship, trade association memberships, travel and entertainment.
6. Wages and benefits: Employee salaries, payroll taxes, benefits, workers compensation.

Fee Arrangements

- What are the alternative?
- Why consider the alternatives?
- What are acceptable alternatives for your client, you and your law firm?



Types of Fee Arrangements

1. Hourly
2. Fixed blended or discounted rates
3. Sliding rates
4. Flat fees or fixed fees
 - ◆ Entire projects/portfolios
 - ◆ Per phase
 - ◆ Over time
5. Fee caps
6. Deferred fees
7. Equity
8. Risk sharing fees (Contingency/Success)
9. Outsourcing and subcontracts
10. Mix and match



Hourly, Fixed Blended or Discounted Rates

» The hourly rate billing for lawyers is only 50 years old in the U.S. Before the hourly rate, “eyeball” techniques of legal billing left clients unsure how a lawyer arrived at his gross fee. Hourly billing appealed to clients and lawyers as a more transparent way to value legal services.

» **This type of fee agreement is widely used in the other part of the Americas; it is the easiest to audit.**

» Hourly billing treats legal services as a commodity that can be measured in units of time. Most firms break billable hours into pieces, typically charging clients for each six-minute increment expended by a lawyer or paralegal.

» **Differential fees are also common in Latin America. They usually depend on the level of education of the attorneys, their rank within the firm’s hierarchy, etc.**

» In 1975, the U.S. Supreme Court killed set fee schedules entirely, declaring that they were a “classic illustration of price fixing” that violated federal antitrust laws.

» **Not in the Latin Americas – they are fully accepted and also legal.**

» Fixed blended or discounted rates reduce costs but still rely on billable hours as the sole measure of law firm value delivered.



What's wrong with the billable hour?



“Put most bluntly, the most fundamental misalignment of interests is between clients who are driven to manage expenses, and law firms which are compensated by the hour.”

“Today there is little incentive for law firms to apply risk-reward logic to the amount of legal services provided. And General Counsel know that.”

Mark Chandler (Cisco SVP/GC) “State of Technology in the Law” (2007)

Sliding Rates

Sliding scale legal fees are variable hourly rates based on, for example:

- Ability to pay
- Progress of the matter or length of representation
- Desire to provide representation
- Ability to be competitive (and/or attract clients)
- Retention of clients
- Referrals to others



Example:

SLIDING RATES ...



Hourly fees escalate up as the Start-up heads towards initial funding: **(Ideal for start-ups)**

↪ Deep discounts initially

↪ Modest discount until execution of funding commitments

↪ Premium once funding is received



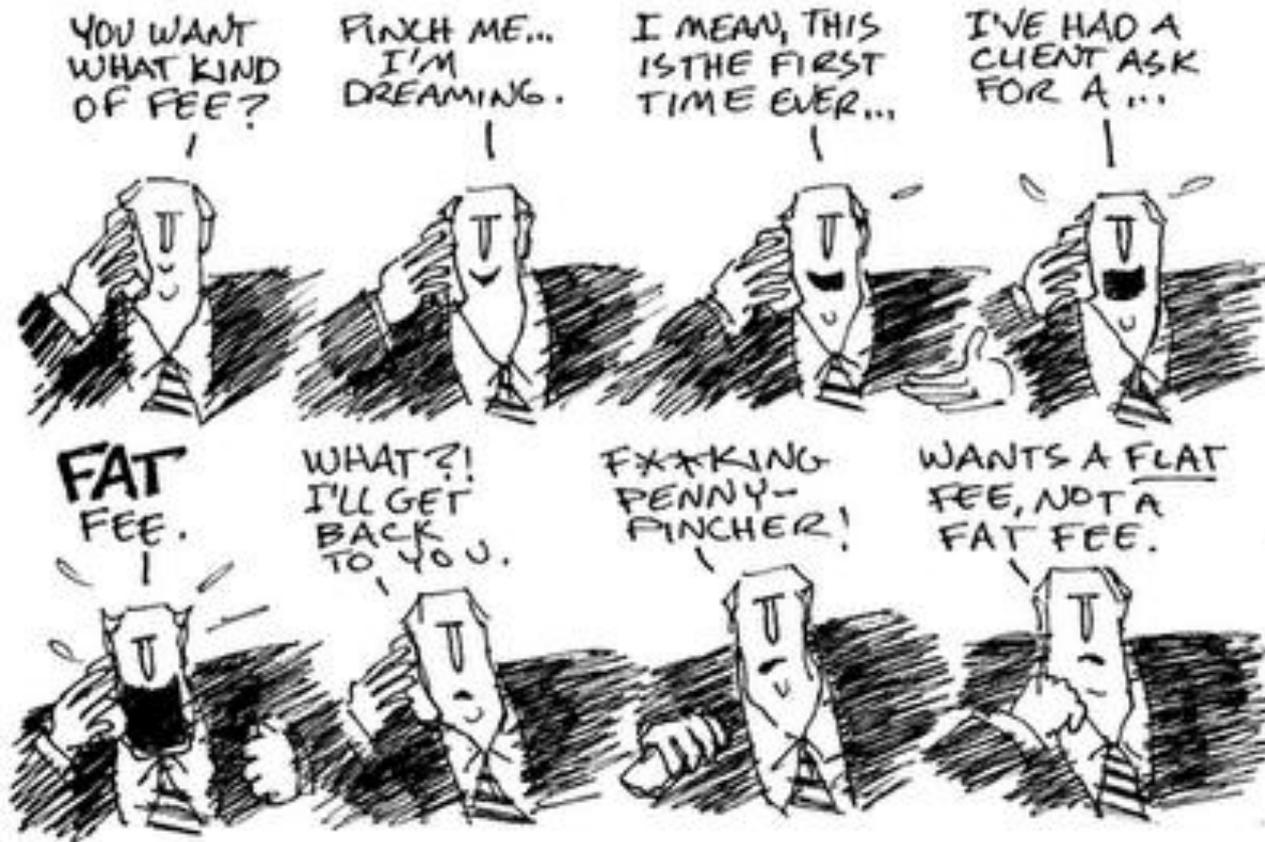
Sliding Rates:

The Type of Work Should ...

- Adjust law firm hourly rate recovery to reflect desired start-up outcome
- Focus on value-added work



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Flat Fee or Fixed Fee

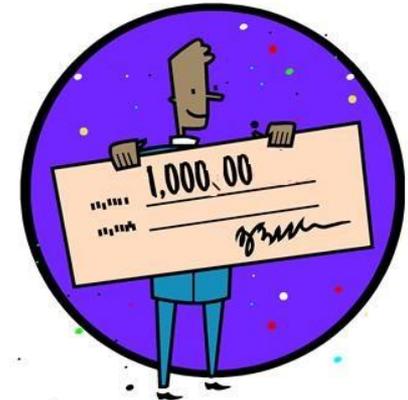
A “flat fee” is a predetermined set amount charged for a particular matter. It is generally used when the matter is simple or routine.



Flat fees are typically used by start-ups for organizational documents, and for patent prosecution, patent searches, opinions, and copyright and trademark registrations (and often do not cover additional expenses).

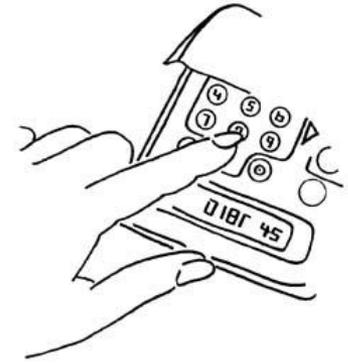
Flat fees are also common in Latin America. (They demand a huge reckoning effort from the law firm since often a flat fee is set that, in hindsight, is lower than it should have been.)

Flat Fee/Fixed Fee: *Benefit or Not?*



- Flat fees are easier for a Start-up to manage.
- Flat fees allow clients to control costs by budgeting for legal services with higher accuracy.
- With flat fees, there may be greater incentive for the client to assist in the process (*e.g.*, make another round of edits, call with any questions, etc.).
- Flat fees are problematic when clients believe that they are applicable to any new matter they entrust to the Firm. Setting boundaries is urgent for this type of agreement.

Flat Fee or Fixed Fee: Calculations Entire Projects/Portfolios/Phase



Calculate fees by:

- Evaluate the complexity of each task within the project/ portfolio/phase, and estimate the amount of time it will take to complete the matter
 - Set a fixed price using average cost
 - Exclude outliers in calculating averages
 - Consider and establish upside and downside protections or otherwise how to align interests
 - Consider pre-set adjustments in price to align incentives
 - Consider multiple projects, which may be used to “balance” amounts charged per project



Flat Fee: Over Time



A flat fee over time is a pre-set amount that is charged to the client each month for a term, regardless of the legal work that is performed.

- It is typically used to cap initial fees for the organizational documents and IP-related matters – which may be significant, and otherwise unaffordable.
- Start-ups pay a pre-set amount each month for a defined term, covering the expected heavier legal load in the beginning, and making up the deficit over time.
- If the work load is significantly different, the parties can make adjustments.
- Like flat fees, it allows the client to control costs by budgeting for legal services with higher accuracy.

Flat Fees: Latin America

Types of typical flat fee agreements:

- Retainer: The parties agree on a monthly amount of hours of legal assistance. It entails compensation of those months in which the legal assistance was more required with those in which it was less required.
- Deferred: The flat fee must be paid in quotas at certain stages of the proceeding.
- Combined: Modular plus a success bonus.

NOTE: In IP matters, the most recent change relates to oppositions to trademark registration. In the past, they were usually charged on an hourly basis (exceptional in IP matters) but they are recently being charged as a flat fee.



Example:



Fixed Fee for a U.S.-Based Law Firm

What does the fixed fee start-up package include?

With the law firm's start-up package, the services last from inception until the start-up receives its first financing, or for 6 months, whichever is shorter. If financing is not obtained within 6 months, an extension for another 6 months is available.

Included services are:

- incorporation or formation of an LLC;
- university patent license option or license;
- stock option plan (with forms, procedures re option grants and tax treatment);
- standard form contracts (no customization, such as NDAs, employee offer letters;
- up to 6 hours of additional attorney work and access to a library of legal forms.

Services that are not included are: out-of-pocket costs, such as filing fees; patent applications; litigation; maintenance of stock/minute book and individual option grants; services requiring referral to outside counsel.

Fee Cap



A "fee cap" is a maximum amount that patent attorney or patent agent will charge for a matter.

- It's typically utilized to cap fees for drafting and filing patent applications.
- It removes some of the client's risk because the client knows the maximum amount to be charged for the matter.
- Like flat fees, if the fees exceed the fee cap, the overage is absorbed by the law firm.
- Unlike flat fees, if the fees are below the fee cap (the matter takes less time than expected), the client is not charged.

Deferred Fee

Legal counsel may defer some or all fees in exchange for 1) the promise to pay the fees at a later time, and 2) typically some additional incentive to compensate for the risk that the start up may never pay.

★ Additional incentives can include higher rates, equity in the company, collateral (security interests in the IP).



★ Deferred fee arrangements are a great value to a start up if: 1) it raises a lot of money or produces exponential returns, or 2) the business fails (provided there is no personal guarantee or collateralization).

★ Deferred fees can also wind up as a large debt that the start-up must disclose to potential investors and ultimately pay off.

Deferred Fee: *Downside for the Start-up*



Since the start-up is not paying the fees right now, it doesn't hurt much, and the start-up may not ask for the discounts it otherwise might.

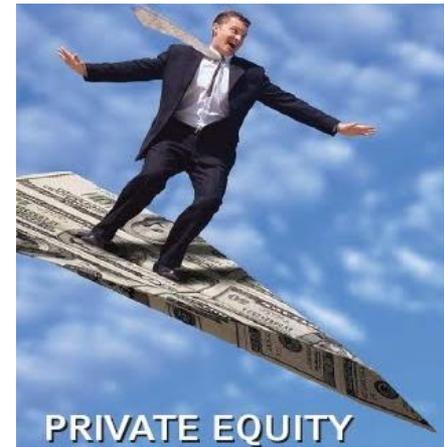
Work may be performed that is not necessary due to significant changes required by investors.

In the early stages of any company, organizational structures and solid procedures to determine the legal work necessary have not been established.

Start-Up

Equity in start-ups

What about taking stock in a startup in exchange for legal services?



It helps thinly capitalized start-ups because they avoid having to spend precious operating capital on legal fees.

But...

1. It's asking attorneys to invest in the start-up.
2. It's taking the risk that the start-up may not succeed.
3. It may affect the ability of an attorney to give unbiased advice.
4. It may violate rules of professional conduct of the state bar and/or the U.S.P.T.O.



Equity:

Owning A Piece Of The Company

- For start-up “stock for fees” representation, a conflict of interest waiver is necessary. It should state that the start-up was advised and had the opportunity to seek counsel from an independent lawyer about the arrangement (along with other stock for fees conflict language boilerplate).
- The most common stock for fees legal work include organizational and related launch issues, financings, and intellectual property issues.
- Such arrangements usually involve an agreed to amount of legal work (*e.g.*, “\$10,000 of legal fees billed at \$400 hourly”) in exchange for an equity percentage of the start-up.
- Entertainment companies typically offer law firms this kind of agreement. For instance, the law firm may become a co-producer of a film. It is absolutely necessary for the law firm to be able to conduct a due diligence investigation of the company and the project, so as to be as positive as possible about its true chances of success.

Ethical Issues With Taking Stock



Latin America

Ethical Issues with Taking Stock

- » Codes of Ethics of ASIPI, Chile, Venezuela, Colombia and Costa Rica do not forbid taking equity from a client.
- » Does lawyer become the client? Yes.
- » Is there a conflict of interest when the lawyer is the client at the same time? No. (Why?)
- » A conflict of interest involves contrary interests. Here, the interests of the lawyer and the client are the same.



ABA Formal Opinion 00-418

Acquiring Ownership in a Client in Connection with Performing Legal Services (July 7, 2000)



The Model Rules of Professional Conduct do not prohibit taking equity in a client provided the following Model Rules are satisfied:

- (1) Rule 1.5(a) (the reasonableness of the fee);
- (2) Rule 1.7(b) (conflicts between the client and the lawyer's own interest);
- (3) Rule 1.8(a) (business transactions with a client); and
- (4) Rule 2.1 (lawyer's duty to exercise independent professional judgment and render candid advice).



Rule 1.8(a) of Professional Conduct

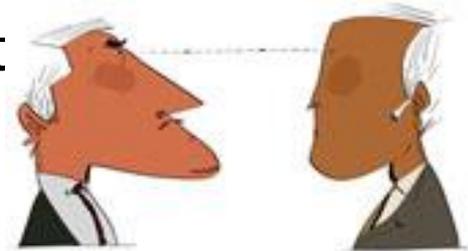
Rule 1.8(a) of the ABA Model Rules of Professional Conduct provides that a lawyer may not enter into a transaction with a client unless:

- (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 to the client in a manner which can be reasonably understood by the client;
- (2) The client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
- (3) The client consents in writing thereto.

Emphasis of the Opinion

Attorneys considering investments in clients should read this opinion carefully. (Note, the U.S.P.T.O. rules of conduct usually follow the ABA model rules.) The opinion covers taking equity for fees *and* equity investments in clients.

The opinion emphasizes the necessity of full and fair disclosure in a manner “that can be reasonably understood” by the client.



It requires the law firm to remain continually vigilant for conflicts of interest that may later arise due to the lawyer’s equity interest, thereby requiring withdrawal from representation.

Risk Sharing Fees (Contingency)



Contingency Fee. The law firm receives a fixed or scaled percentage of any recoveries in a lawsuit/claim brought on behalf of the client/plaintiff. Typically, the client pays litigation expenses.

They are used in many plaintiff cases seeking monetary or monetizable damages. They are often appropriate when the client is an individual, start-up, or corporation with limited resources to finance its litigation.

Partial Contingency Fee. The law firm receives a portion of its hourly rate plus a smaller percentage of any recoveries in the lawsuit/claim. The law firm has a fee floor, and the litigation costs are still somewhat reduced to the client.

Partial contingency fees are most common in plaintiff cases seeking monetary or monetizable damages, however, they are not limited to such matters. Defense cases can also be structured as partial contingency fees with success contingent on agreed upon results or milestones being achieved.

Risk Sharing Fees (Success)



Holdback/Success Fee. A holdback/success fee arrangement is similar to that for a partial contingency fee. The law firm is paid a portion of its fees up front, but has a portion withheld contingent upon its success. If the matter concludes successfully, the law firm receives a multiple of the holdback or an agreed upon success fee.

It is typically used in defense cases or when the result sought in the matter is not monetary. For start-ups, it is used in corporate transactions where success is the completion of an acquisition, sale or other transaction.

It is also used in patent cases where the outcome sought is a finding of validity/invalidity, or in litigation defense cases where the result sought is summary judgment or limit damages.

Risk Sharing Fees

Considerations:



Do they really reward efficiency and outcome (rather than hours worked)?

Do they benefit both the client and the attorney?

Do they increase the likelihood of success?



Outsourcing and subcontracts

The principle of outsourcing is fundamental:

Do what you do best and let others do what they do best, most efficiently and at least cost to both you and the client. (It makes sense to focus on core capabilities.)



It 's not a new principle for law firms: many firms for years have outsourced, *e.g.*, mailroom services and records storage. Outsourcing today can go in any number of directions, with direct impact on firm costs and client value. Economies of scale and experience benefit clients. A high-volume specialist can often perform it at a lower cost and at a quality at least equivalent to an in-house team.

NOTE: This is not the practice of law. It is providing high quality, low cost legal support products for licensed attorneys. The work is delivered electronically and should be produced under the firm 's supervision; it is transparent to the client.

For start-ups, regular review of the balance between externally and internally sourced work is critical to secure value for the money.

Service Outsourcing . . .

This is a most dramatic and high profile development; high speed Internet technology connects U.S. law firms to the growing pool of highly educated talent in developing countries where the use of English is widespread (with India being the prime example). Such offshore legal service providers can reduce, by up to 80%, the cost of:

- ◆ Transcription of voice files from depositions, trials and hearings
- ◆ Accounting support in the preparation of timesheets and billing materials
- ◆ Paralegal and clerk support for research and file management
- ◆ Data entry for marketing, conflicts and contact management
- ◆ Litigation support, including electronic discovery
- ◆ Legal research, including case citation summaries
- ◆ Review, and due diligence of business documents
- ◆ Patent review, searches, drafting and drawings





Mix and match . . .

Recent Examples



- A mid-size Silicon Valley law firm began offering flat fees to certain clients for the first time this year.
- Two large international law firms now offer both fixed fees and deferred payment plans to clients likely to get funding.
- A large U.S. law firm began a “Venture Services” program in July in which “good bet” clients can defer half of their fees for a year, subject to a cap. The amount owed is excused if the client doesn’t get funding.
- An International law firm has a division called “Venture Pipeline” to introduce promising start-ups to investors. (In one year, the firm introduced 125 companies, and 44 percent obtained funding.)



Risks

- Low or no realization
- Inability to recover advanced costs
- Failure to meet client expectations
- Conflicts
- Ethics violations

Discussing/Deciding



Are some fee arrangements more risky than others?

Yes, they are.

How do you discuss alternative fee arrangements?

Early, thorough discussions of available options.

Thank you.

Questions?

Note: The views and opinions expressed herein are those of the speakers only and should not be attributed to the speakers' past or present employers or their clients.

