ADVISORY ETHICS OPINION 96-08

SYNOPSIS:

A law firm may not create an employee stock ownership plan ("ESOP") using the stock of the law firm. Such a plan would be contrary to the Disciplinary Rules regarding lawyers engaging in the practice of law with non-lawyers. The Disciplinary Rules prohibit the ownership of any interest in a law firm by non-lawyers. In addition, the proposed ESOP would require that a lawyer in the firm act as the trustee of the ESOP. The attorney who was both a member of the firm and the trustee of the ESOP would face an impermissible and unavoidable conflict of interest in attempting to perform the necessary functions of both roles.

FACTS:

A law firm which is organized as a professional corporation desires to create an ESOP for the benefit of its employees. The law firm intends to contribute a class of convertible non-voting preferred stock of the law firm to the ESOP, as described in more detail below.

The firm will appoint one of its member attorneys, who is currently licensed in the State of Vermont, to be the trustee of the ESOP (the "Trustee"). Legal title to the stock will vest in the Trustee, but the beneficial interests in the ESOP will be held by all attorneys and non-attorney employees of the firm who meet the service, age and other requirements as are necessary to participate in the ESOP.

As noted, the stock initially contrtibuted to the ESOP will be non-voting stock. The firm proposes, consistent with the rules governing ESOPs under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the related provisions of the Internal Revenue Code of 1986 as amended (the "IRC"), to create a class of convertible non-voting preferred stock. Although this stock is denominated non-voting, it must carry with it the right to vote on these fundamental corporate events, such as mergers, recapitalization and the dissolution of the firm. Under ERISA and the IRC, when the Trustee is required to vote on these fundamental corporate changes, he or she must solicit the input of the beneficiaries who will direct the Trustee's vote with respect to the shares they beneficially own under the plan. In addition, the stock will include the right, to be exercised by the Trustee to convert the stock into voting stock.

Although the Trustee will have the power to determine whether to convert the stock into the common voting stock of the firm, ERISA imposes strict fiduciary duties on the Trustee's decision-making power. The Trustee must exercise such power in the best interests of the participants in the plan (including non-attorney participants) and the Trustee will be bound by a duty of care and duty of loyalty to the participants in the plan (again including the non-attorney participants).[1]

Certain other provisions of the ESOP are also relevant to the consideration of issues. The ESOP will never actually distribute stock to beneficiaries of the ESOP. Rather, the firm's bylaws and the ESOP provisions will be drafted to require any departing beneficiaries to sell their stock back to the firm. This is permitted under ERISA. This provision is intended to preclude non-attorneys and attorneys leaving the employ of a particular firm from becoming stockholders of the firm, which is not permitted under the laws regulating the professional corporations and the Code of Professional Responsibility.

The ERISA and IRC provisions regulating ESOPs are complex and generally beyond the scope of this opinion; however, some consideration of those rules is necessary to the Committee's determination.

QUESTION:

In order to reach the conclusion expressed in this Opinion, the Committee considered three areas in which the proposed ESOP potentially conflicts with provisions of the Code of Professional Responsibility:

1. Does law firm's formation of the ESOP result in lawyers engaging in the practice of law with non-lawyers in violation of DR 5-107(C)?

2. Would the Trustee be subject to an impermissible conflict of interest between the Trustee's fiduciary duties to the ESOP beneficiaries and the Trustee's duties to the firm and the firm's clients?

[1] *See generally,* 29 U.S.C. §1104.

3. Does law firm's formation of the ESOP result in the impermissible sharing of profits of the firm with non-lawyers under DR 3-102(A)(3)?

DISCUSSION:

Practice with Non-lawyers; Conflict of Interest

The issue raised with respect to whether the proposed ESOP constitutes lawyers and non-lawyers engaged in the practice of law has two components. DR 5-107(C) provides, in relevant part, as follows:

> A lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law for a profit, if:
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> 1. A non-lawyer owns any interest therein, except that a fiduciary representative of the estate of a lawyer may hold the stock or interest of the lawyer for a reasonable time during administration;
>
> 2. A non-lawyer is a corporate director or officer thereof; or,
>
> 3. A non-lawyer has the right to direct or control the professional judgment of a lawyer.

As noted above, the law firm will issue a special class of nonvoting stock to the ESOP. The stock will be convertible into common stock and, moreover, the beneficial holders of the stock will have the right to direct the Trustee's vote on certain fundamental corporate events. This right to vote is required under the IRC provisions relating to ESOPs. *See* IRC Section 409(e). Thus the beneficiaries, including non-attorneys, will have the right to vote on, among other items, whether the firm should merge with another practice and whether the firm ought to dissolve. In the event the Trustee is compelled by his or her fiduciary duty to convert the non-voting stock into the firm's common stock, then the beneficiaries under the ESOP will gain voting rights on additional matters of the firm's business.

These beneficial rights accorded to non-attorneys create an impermissible combination of lawyers and non-lawyers in a single corporate structure. DR 5-107(C)(1) restricts the non-lawyer from holding ***any*** interest in the firm, except for representatives of the estate of a deceased member. Even before the conversion of the stock, the non-attorney members of the ESOP will have the right to vote on two of the most fundamental decisions a firm can make: whether to merge or dissolve. In the event of a conversion, the beneficiaries in the ESOP would gain the right to vote on more matters, including the influencing of the decision making in the firm by the selection of directors. This Committee has concluded that the prohibition in the Code on the ownership of ***any*** interest in a law firm by a non-lawyer contemplates that no one other than the lawyer members of the firm would have the power to make decisions regarding law firm matters. The Code does not distinguish between major corporate events and others. Accordingly, the ESOP would be impermissible under such provision of the Code because it would necessarily give non-lawyer participants in the ESOP an interest in the firm.

The Philadelphia Bar Association reviewed a related question in connection with a proposed plan by which employees of a firm would be paid a benefit on retirement based on the increase in value of a share of "phantom stock". In that Opinion (80-14), that committee cautioned that the use of the "phantom stock" would raise a question of propriety under the rule stated above, despite the fact the stock was a complete fabrication and had no legal status.

The second element of the issue of lawyers and non-lawyers is the source of greater concern to the Committee. The Trustee of the ESOP is subject to the fiduciary obligations imposed by ERISA. These fiduciary obligations require the Trustee's strict loyalty to the plan participants in all of his or her decisions regarding the ESOP and the Trustee must exercise his or her duty of care in the manner most beneficial to the participants.[2]

That the Trustee of the ESOP will be an attorney and a member of the firm is not relevant. ERISA requires the Trustee to act in the best interest of the participants of the ESOP, some of whom will be non-lawyers, while the Trustee's position as an attorney in the firm requires that he or she be loyal to the firm and its clients. Initially there may be no conflict in these competing roles. However, prior experiences derived from reported case law suggests that the ESOP trustee's obligations may not be coterminous with the attorney's obligation to the firm and the firm's clients.

[2] 29 U.S.C. §1104.

There are circumstances in which the trustee of an ESOP must attempt to dispose of the company stock.[3] The Moench case does not involve a law firm, but it has an excellent description of the potential competing interests where the ESOP Trustee is a director of the company which established the ESOP. With the proposed ESOP, the only legal purchaser of the stock held by the ESOP is the firm, and the trustee, in his capacity as a member of the firm, may find that it is neither convenient or possible for the firm to acquire the stock from the ESOP, when it is time to cash out an employee who is leaving. In addition, the Trustee's obligation to disclose information which the Trustee learns about the firm to the beneficiaries may put the Trustee in conflict with the requirement that the Trustee in his or her capacity as a member of the firm hold certain information about the firm and its clients in confidence. Further, the Trustee as a member of the firm has an inherent and personal interest in maximizing the compensation paid to the lawyers while being under a fiduciary duty to act prudently to see that nothing adversely affect the value of the stock held by the ESOP.

Sharing of Profits

The second area that presents a concern is the potential violation of DR 3-102(A)(3), which provides in part:

> A law firm shall not share legal fees with a non-lawyer, except that: . . .
> (3) A lawyer or a law firm may include non-lawyer employees in a retirement plan, even though the plan is based in whole or in part on a profit sharing arrangement.

The retirement plan exemption to this rule appears to be sufficiently broad to cover the ESOP arrangement because the ESOP is a "retirement plan" and it is based essentially on a profit sharing model. An ESOP is designed primarily to invest in employer securities and to provide participants with an ownership interest in the employer. An employer either contributes stock or cash to purchase employer stock to the ESOP. The goal of the plan is to enable participants to share in the company's growth through their ownership of an interest in the employer. The prohibition on sharing fees contained in the Code is intended to prevent a circumstance in which a non-lawyer who has an expectation of benefit from a fee paid by a particular client seeks to influence a lawyer's judgment in a particular case in order to maximize the share of fees paid to the non-lawyer. The general philosophy of other opinions the Committee reviewed on this point is that the connection between the fees collected by the firm and the payments to non-lawyers must be remote. Payments to non-lawyers derived from fees related to a particular client or matter are prohibited by the rule. Provided the connection between fees collected from a particular client or as a result of a particular case and payments to non-lawyers is remote, which would appear to be true as the intent of an ESOP is to have the value of the stock in the ESOP grow as a result of the growth of the firm, the ESOP would not violate DR 3-102(A)(3).

CONCLUSION:

The formation of an ESOP by a law firm where there will be non-lawyer participation is not possible under the rules of the Code of Professional Responsibility as presently written. The requirements under ESOP and the IRC cannot be reconciled with the Code's prohibition on non-lawyer participating with lawyer in the practice of law. In addition, the role of the trustee of the ESOP and lawyer in the firm results in a potentially irreconcilable conflict of interest for the trustee.

[3] *See generally*, *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995).