



ETHICS OPINION 1062

New York State Bar Association
Committee on Professional Ethics

Opinion 1062 (6/29/15)

Topic: Financing a law practice; crowdfunding websites.

Digest: A law firm may engage in certain types of crowdfunding but not others. Any form of fundraising that gives the investor an interest in a law firm or a share of its revenue would be prohibited. However, in some circumstances a law firm may give the funding source some kind of reward. For example, a law firm may send a funder non-confidential memoranda discussing legal issues (provided the law firm complies with any applicable advertising rules), or may agree that the law firm will provide pro bono legal services to certain charitable organizations, provided that the lawyer complies with Rule 1.1 regarding competence and the representation does not involve conflicts in violation of Rule 1.7 or Rule 1.9.

Rules: 1.1(b), 1.7, 1.9, 5.4(a) & (d), 7.1.

FACTS

1. The inquiring lawyers, who are recent law school graduates, plan to start a small firm. They need to raise capital to fund the start-up expenses of the new firm for the first few months of operations, such as rent, website development, professional liability insurance, and office supplies.
2. The inquiring lawyers have accumulated substantial student loan debt and aim to avoid further borrowing. They ask whether they may ethically raise start-up funds via internet websites through a method known generally as “crowdfunding.”
3. “Crowdfunding” is defined generally as funding a project or venture by raising small amounts of money from a large number of people. It is often used in product development to test a market and refine a product. Philanthropic organizations also use crowdfunding to raise funds. We are aware of five basic approaches to crowdfunding: (1) Donation, (2) Reward, (3) Lending, (4) Equity, and (5) Royalty. In each of the models, the user uses the funding website of a crowdfunding “platform,” which charges fees based on the amount of money raised. The platforms have varying focuses, models and fee structures. See generally Crowds Unite, What is Crowd Funding?, available at <http://crowdsunite.com/what-is-crowdfunding>.
4. The first of the five approaches to fundraising -- the lending model -- is close to the traditional working capital loan.

5. The second approach, the equity model, is often used for new ventures and provides the funding source an ownership interest in the venture.
6. Similarly, the third approach, the royalty model, which often is used for specific product development and rollout, rewards the investor with a percentage of the sales proceeds from that particular product.
7. The donation model is used most often for philanthropic causes where there is no material or financial return to the contributor.
8. The reward model typically provides the funder with a sample of the product or service being supported by the fundraising effort. It is often used by private ventures to pre-sell product or create a large following for the product.

QUESTION

9. What are the ethical limitations on using internet-based crowdfunding to raise working capital for a law firm?

OPINION

10. This Committee expresses no opinion on the business merits of any of the five crowdfunding methods or whether any might succeed in reaching the law firm's fundraising goals. But we comment briefly on each model.
11. The lending model would only increase debt and therefore would not meet the law firm's goal.
12. The donation model may be unattractive to potential donors (since they receive nothing in return and may not wish to support an enterprise designed to make a profit). The donation model might also be unattractive to the law firm, since friends and relatives of the lawyers might be inclined to donate directly to the law firm even if the lawyers were not using crowdfunding, whereas under the donation model their contributions will be diminished by the platform's fees. But we see no ethical issues with the donation model, as long as the lawyers make clear that donors will receive nothing in return and that the law firm is designed to be a profit-making enterprise.
13. Two of the models – the royalty model and the equity model – would clearly violate the Rules of Professional Conduct. The royalty model contemplates the investor receiving a percentage of revenues, and would therefore violate Rule 5.4(a) ("A lawyer shall not share legal fees with a nonlawyer"). Similarly, the equity model violates Rule 5.4(d) (lawyer shall not practice law in a for-profit entity if a non-lawyer owns any interest therein.).
14. The remaining model, the reward model, might fit the law firm's business needs, and the inquiring lawyers have suggested several examples of rewards, including (i) informational pamphlets, (ii) reports on the progress of the firm and (iii) the lawyers' performance of pro bono work for a third-party non-profit legal organization. Whether these rewards would be attractive enough to raise capital requires a judgment that is beyond the jurisdiction of this Committee, but we can comment on the ethical implications of the suggested rewards.

15. Informational pamphlets and progress reports. Informational pamphlets, whitepapers or reports on the firm's progress may be governed by Rule 7.1 ("Advertising"). Materials may not be considered advertising as defined in Rule 1.0(a) if they are "topical newsletters, client alerts, or blogs intended to educate recipients about new developments in the law...." Rule 7.1, Cmt. [7]; N.Y. State 967 (2013) (blog written by an attorney is not an "advertisement" if the primary purpose of the blog is not retention of the attorney). However, the lawyers should take care that their writings on legal topics do not give individual legal advice. See Rule 7.1(r) (without affecting the right to accept employment, lawyer may write for publication on legal topics "so long as the lawyer does not undertake to give individual advice").

16. Pro bono hours. The proposal to offer pro bono hours to a third-party non-profit legal organization raises several issues. In N.Y. State 971 (2013), a lawyer proposed to donate legal services to a charitable organization for auction as a fund-raising device. We discussed the requirement of Rule 1.1(b) that a lawyer accept employment only if the lawyer is, or intends to become, competent to handle the matter. Opinion 971 also discussed the prohibition on undertaking a matter that would involve an impermissible conflict of interest under Rule 1.7 or Rule 1.9. We therefore concluded that the firm's offer of pro bono services must be conditioned on the firm's ability to comply with these ethical constraints. We stressed, however, that the fact these limitations apply does not mean that the lawyer cannot participate. See also N.Y. State 897 (2011) (lawyer may market legal services on a "deal" of the day" or "group coupon" website provided that the advertising is not misleading or deceptive and makes clear that no lawyer-client relationship will be formed until the lawyer can check for conflicts and assess competence to provide the services). The same principles apply to the reward model that the inquiring lawyers are considering here.

CONCLUSION

17. A law firm may engage in certain types of crowdfunding but not others. Any form of fundraising that gives the investor an interest in a law firm or a share of its revenue would be prohibited. However, in some circumstances a law firm may give the funding source some kind of reward. For example, a law firm may send a funder non-confidential memoranda discussing legal issues (provided the law firm complies with any applicable advertising rules), or may agree that the law firm will provide pro bono legal services to certain charitable organizations, provided that the lawyer complies with Rule 1.1 regarding competence and the representation does not involve conflicts in violation of Rule 1.7 or Rule 1.9.

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