ENTREPRENEURSHIP LAW

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ENTREPRENEURSHIP LAW: CASES AND MATERIALS

Second Edition

STEPHEN F. REED

Assistant Director, Donald Pritzker Entrepreneurship Law Center
Clinical Professor of Law
Northwestern Pritzker School of Law

ESTHER S. BARRON

Director, Donald Pritzker Entrepreneurship Law Center
Clinical Professor of Law
Northwestern Pritzker School of Law

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To my beloved dad, the original entrepreneur in my life, my greatest inspiration and the commissioner of all good things. No one could have set the bar higher than you did, and you will always be my model for how to live as an attorney, a professor, an entrepreneur and a human being.

— Esther S. Barron

To Zella and Bennett, who work hard, love to laugh, and make me proud: follow your heart, and if your heart leads you to law school, take Entrepreneurship Law and buy a copy of this book.

— Stephen F. Reed

SUMMARY OF CONTENTS

CONTENTS

CHAPTER V

FINANCING 183

CHAPTER VIII

CHAPTER IX

PREFACE

Entrepreneurship classes have traditionally been reserved for MBA and undergraduate business programs. In past years, law students interested in this area might be lucky enough to enroll in a business school class as an elective to get some insight into this world, but would miss exposure to the underlying legal doctrine. Even as more forward thinking and innovative law schools incorporated entrepreneurship into law school curricula, law professors were forced to use books designed for business students and supplement readings to make the material appropriate for a law school class. This casebook attempts to build a bridge between the study of the entrepreneur and the legal rules that apply to the venture.

In this casebook, we will meet hypothetical entrepreneurs, Andrew Orlando and Olivia Gold, who are based on the hundreds of entrepreneurs we have represented over the past decade. Andrew and Olivia will face many of the legal issues that we have helped our clients tackle. And similar to the real world practice of law, the situations that students will encounter as the entrepreneurs' legal counsel will provide meaningful opportunities to strategize and consider implications of various potential actions and decisions. We have also attempted to weave in aspects of the entrepreneurs' personalities that we have experienced and which add layers of complexity to the representation and relationships involved.

This casebook is designed to provide a solid background in the legal doctrine applicable in entrepreneurship, and a simulated experience of what legal counsel for entrepreneurs manage over the course of representation of a new company from inception through initial growth. We hope you all are counsel to the next Google, but keep in mind that it may be just as exciting and impactful to represent entrepreneurs who achieve their success on a smaller scale. One by one, successful new ventures are strengthening our nation and the globe, changing how we live and interact with one another and delivering opportunity and success to countless entrepreneurs – and the lawyers who work with them.

Esther S. Barron
Stephen F. Reed

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I

INTRODUCTION TO ENTREPRENEURSHIP LAW

Whether an attorney sees entrepreneurship as a philosophically essential aspect of "The American Dream," an important engine in the economy, or simply a good opportunity for client development, the impact of entrepreneurs and entrepreneurial ventures in the United States is undeniable. Occasionally entrepreneurs themselves, lawyers who represent new or small ventures are faced with a unique set of issues not always seen in other areas of practice. While some clients are "social entrepreneurs" — who work with a social purpose through a for-profit or nonprofit venture — and others are traditional business-minded entrepreneurs, all entrepreneurs present lawyers with distinct substantive and interpersonal challenges.

Attorneys who represent entrepreneurs and entrepreneurial ventures need at least a basic comprehension of a myriad of legal disciplines: employment law, intellectual property law, contract law, corporate and agency law, finance law, e-commerce law, and securities law, to name just a few. Throughout this casebook, we introduce the most common doctrinal areas faced by lawyers who represent entrepreneurs. Recognizing that representing entrepreneurial ventures and entrepreneurs is practically different from representing large corporations and their stockholders, we look through the lens of the entrepreneur's lawyer.

Key to understanding the approach lawyers take when representing entrepreneurs is an understanding of some basic characteristics of entrepreneurs as individuals, and the special problems that arise when a person and her business seem to be one and the same being. In this chapter, we introduce some ways of thinking about entrepreneurship and entrepreneurs, including an exploration of a few substantive and ethical aspects of being engaged as counsel to an entrepreneur or an entrepreneurial venture.

A. ENTREPRENEURS AND LAWYERS

On a basic level, we all understand that an entrepreneur is a person who starts a new business. Given the place of entrepreneurs in the economy, the historical and current value of innovation and entrepreneurship in helping the nation and

the world to overcome crises of all types, and the prominence of entrepreneurs in popular culture, we probably also believe entrepreneurship is a pretty big deal. We may even think of entrepreneurs as heroes, or at least celebrities — think of Mark Zuckerberg (of Facebook), or Sergey and Larry (of Google), or the late Steve Jobs (of Apple, NeXT, Pixar, and Apple (again)). We may think of entrepreneurs as brave or foolish, clever or opportunistic, or as possessing any other number of characteristics. As lawyers, however, we need to think about entrepreneurs as clients with goals, and try to help the clients achieve the goals. To be effective at these tasks, a lawyer must understand each client's style and personality so that she can tailor and deliver legal advice in a way that will be constructive.

The first two readings of this chapter will help to frame our conception of the complex meaning of "entrepreneur" and the associated characteristics these clients may possess. In the process, you will learn of a few historical approaches to thinking about entrepreneurs, and also to some current thinking on lawyers as entrepreneurs. As you read, try to think practically about how a client's personality traits can affect a lawyer's approach to practicing law.

WE ARE ALL ENTREPRENEURS NOW

David E. Pozen, 43 Wake Forest L. Rev. 283 (2008)

Everyone, it seems, is an entrepreneur these days. People who tackle civic problems through innovative methods are "social entrepreneurs." Those who promote new forms of legislation or government action are "policy entrepreneurs." Those who seek to change the way society thinks or feels about an issue are "norm entrepreneurs." Those who try to alter the boundaries of altruism or deviance are "moral entrepreneurs." Martin Luther King, Jr., it turns out, was a social, policy, norm, and moral entrepreneur all at the same time. And then, of course, there are the capitalist entrepreneurs, starting for-profit ventures and transforming economic markets as usual. Capitalist entrepreneurship no longer ends at the founding, though: once those ventures become settled concerns, employees may become "intrapreneurs" by pioneering an initiative or subsidiary within the existing corporate structure.

. . .

Theories of entrepreneurship have a long and rich history in Western economic thought. Numerous influential economists have proffered definitions of entrepreneurship as an aspect of their broader positive or normative projects, in which they identify core traits of the entrepreneur and explain his or her role in a market economy. There is a "dis-jointed nature" to this body of work, some have pointed out, because entrepreneurship has been from the start an extremely capacious concept, and commentators have invoked it for a variety of ends. Theories of entrepreneurship abound, but we have no completely satisfying synthetic account of the practice, and we probably never will.

Modern dictionary definitions of entrepreneurship tend to emphasize three interrelated functions. First, the entrepreneur initiates and organizes a business venture, identifying an opportunity and assembling the necessary tools, skills, and personnel to pursue it. Second, the entrepreneur manages the venture, overseeing its efforts to attract customers and generate revenues, at least for an initial period. And third, the entrepreneur assumes the risk of the venture, generally by investing his

or her own capital and reputation and by forsaking a guaranteed income. Implicit in this last function is a tradeoff between the promise of economic gain and the potential for economic loss — a tradeoff that is dramatically exemplified in real life. The majority of new businesses in the United States will fail within their first several years, but some succeed spectacularly, and many of America's wealthiest individuals made their fortunes as entrepreneurs.

Linked to the functional characteristics of the entrepreneur is a set of personal traits that also plays an important role in defining the term. Entrepreneurs, in the American imagination, are leaders, innovators, pioneers, problem solvers, and risk takers; they are diligent, persistent, charismatic, dynamic, imaginative, and resourceful, the bricoleurs of the capitalist marketplace. The term's connotations are not wholly positive, however. Entrepreneurs can be greedy, cunning, opportunistic, and self-interested, possessed of a kind of Nietzschean will to power that may lead to domination and destruction as well as to value creation.[5]

The etymology of "entrepreneur" is tightly bound up with the history of economic theorizing about capitalism. The term derives from the French entreprendre, which translates roughly as to undertake or to embark upon. It came into being in the early fifteenth century and crossed the Channel around 1475 but did not stick. It was not until the mid-1750s, in an essay published posthumously, that the Irish economist Richard Cantillon introduced the term into mainstream economic discourse. Cantillon divided economic actors into two broad camps, those who receive assured incomes and those who do not. The latter, Cantillon explained, are the entrepreneurs, and he gave as an example the merchants who bought goods from country farmers at a fixed price to sell to city dwellers at a price that could not be known in advance. Cantillon's key contribution to the theory of entrepreneurship was to invest it with some substantive economic content and to identify risk bearing as a constitutive element.

The next major thinker to explore entrepreneurship, and the one most often credited with elevating the concept to prominence in economic theory, was the French economist Jean-Baptiste Say. Say went beyond Cantillon's focus on uncertainty of income to develop an account of the entrepreneur who "shifts economic resources out of an area of lower and into an area of higher productivity and greater yield." In his pursuit of profit, according to Say, the entrepreneur figures out how to satisfy a greater number of human needs and wants. Entrepreneurship therefore involves not only the reallocation of existing economic resources but also the generation of new resources; it is a positive-sum, not a zero-sum, game. Being an entrepreneur — or a "master-agent," as Say sometimes described it — "requires a combination of moral qualities, that are not often found together," such as "judgment, perseverance, and a knowledge of the world, as well as of business." Say's work was instrumental in identifying the entrepreneur as both a maker of markets and a creator of economic value, and in painting a picture of the entrepreneur as a rare, exceptionally talented and motivated individual. To this day, Say's basic insights on entrepreneurship continue to frame much of the academic and popular discussion on the subject.

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5. Reflecting these two sides to the entrepreneurial profile, my thesaurus tells me that entrepreneurs are explorers, heroes, knights, organizers, pioneers, producers, romantics, undertakers, venturers, and voyagers; and yet entrepreneurs are also synonymous with charlatans, gamblers, madcaps, mercenaries, opportunists, pirates, rogues, speculators, swashbucklers, and wheeler dealers. . . .

Economic theory, however, has not always assigned a place of prominence to the entrepreneur, and for the most part it still does not. From Adam Smith and David Ricardo on, a venerable line of classical and neoclassical economists have developed market models that assign little to no special significance to the entrepreneur. Entrepreneurs are largely absent from the economic theory of Smith — he never uses the term — who elided the distinction between creators of businesses and owners of businesses and whose depiction of an "invisible hand" leading to market equilibrium drew attention away from the entrepreneur's self-consciously generative role. Neoclassical economists such as Alfred Marshall and A.C. Pigou, writing at the turn of the twentieth century, and Milton Friedman and George Stigler, writing in the mid-to-late twentieth century, have likewise tended to trivialize entrepreneurship in their formal models of a steady-state economy. They have done this, William Baumol observes, partly because innovation is an entirely heterogeneous output that does not lend itself to formal mathematical description and, more basically, because in the neoclassical world of perfect information, perfect competition, negligible transaction costs, and homogeneous goods, entrepreneurs would have nothing to offer; the concept of entrepreneurship would not even make much sense.

The real world is a rather messy place, though, and the absence of entrepreneurship certainly looks like a phenomenological lacuna in the neoclassical view. As neoclassical theory has grown more sophisticated throughout recent decades — spurred by econometric and behavioral evidence to recognize the importance of norms and institutions and the possibilities for imperfect competition, incomplete information, temporary disequilibria, and irrational decision making — there are signs that it has begun to reacquaint itself with the entrepreneur. Still, it remains deeply ironic that the academic discipline most focused on the capitalist process has so marginalized the entrepreneur, while lawyers, sociologists, and political scientists cannot stop talking about her.

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After the early interventions of scholars such as Richard Cantillon and Jean-Baptiste Say, it was the great Austrian economist Joseph Schumpeter who made the most profound contribution to the theory of entrepreneurship and to the public's appreciation of the concept. Schumpeter built on Say in developing the idea of the entrepreneur as innovator, forcing major structural changes across markets and industries in a process of "creative destruction" vital for sustaining a dynamic economy and long-run economic growth. "The function of entrepreneurs," Schumpeter maintained, "is to reform or revolutionize the pattern of production" by exploiting a new technology, developing a new source of supply, reorganizing an industry, or the like. For Schumpeter, the economy did not tend naturally toward stability and growth through the workings of an invisible hand, but rather was propelled forward in sudden leaps by the endogenous innovations of key entrepreneurs. His was a story not of harmonious stasis but of evolution through punctuated equilibria. Yet while Schumpeter wrote with great admiration about "the entrepreneurial type," motivated primarily not by profit but by the "desire to found a private dynasty, the will to conquer in a competitive battle, and the joy of creating," like Weber he recognized that societies often resist the changes that entrepreneurs induce, sometimes violently. . . . As his paradoxical label "creative destruction" captured so sharply, Schumpeter too saw the fundamental public ambivalence that will attach to entrepreneurship on account of its destabilizing power.

Writing around the same time as Schumpeter, the American economist Frank Knight conceptualized the entrepreneur's contribution in very different and nearly as influential terms. Whereas Schumpeter largely excluded the assumption of risk and the duties of ownership from his account of entrepreneurship, Knight drew on Cantillon in emphasizing the entrepreneur's role as a bearer of market uncertainty, as a manager as well as a creator. Knight famously distinguished between risk, which is related to recurring events and is insurable, and uncertainty, which derives from unique events and cannot, Knight claimed, be estimated with any precision. In an economy characterized by changing consumer tastes and purchasing power, Knight argued, adventurous entrepreneurs are needed to create, own, and control business enterprises, guaranteeing wages to their employees in return for the potential of monetary gain. In an economy riven with uncertainty, that is, entrepreneurs must address "the primary problem or function [of] deciding what to do and how to do it." Entrepreneurship, for Knight, was a kind of profession and a public service as well as a disposition and a skill set.

. . .

To sum up: although economic theory has been sporadic in its concern for entrepreneurship, a significant and rapidly growing body of scholarship has interrogated the subject conceptually and empirically. Many have linked entrepreneurship to economic growth and to a characteristic menu of personality traits. Some theorists of the entrepreneur, such as Cantillon and Knight, have emphasized her role in taking on economic risk; others such as Kirzner and Say her role in making and perfecting markets; others such as Baumol and Schumpeter her role in generating innovation and economic value. These theories intersect at many points, clash at others, and do not form a unified whole. . . .

THROUGH THE LENS OF INNOVATION

Mirit Eyal-Cohen, 43 Fla. St. U. L. Rev. 951 (2016)

The American economy is at a critical moment in history. The aftermath of the latest downturn reveals that we have experienced one the deepest recessions in recent times. Yet, our economy has not yet regained its full strength. Now, more than ever, there is a need for economic renewal and mobility. Entrepreneurship is essential for revitalization, economic growth, job creation, and technological renewal. These elements are the driving force behind improvements in well-being and standards of living. Governments have long realized that continuous growth depends upon a vibrant society of entrepreneurs. While the current global pressure to capture entrepreneurship is strong, our competitive edge is being diminished by countries that have developed superior ways to attract intellectual wealth. Accordingly, entrepreneurship warrants distinct legal attention.

Law plays a significantly active role in creating an environment in which entrepreneurs can successfully act. Lawmakers can utilize law to encourage entrepreneurs to create opportunities by reducing transaction and information costs. Law can function as a stabilizing force that allows private actors to contract about future market conditions and reduce their uncertainty. It has the power to increase or reduce the regulatory costs of pursuing entrepreneurship.

Law can also impose rules that obstruct entrepreneurial opportunities. For example, patent laws ensure that entrepreneurs retain control of their discoveries and entrepreneurial gains. They facilitate risk-taking by ensuring that entrepreneurs reap the benefits of successful speculation. Nevertheless, if taken to the extreme, patent laws can hamper entrepreneurship by generating monopoly positions over discoveries and preventing other entrepreneurs from developing and improving them.

Congress has frequently declared that enticing entrepreneurship is a fundamental value in American society. Yet, our laws are not compatible with current economic and technological advances. Recent literature has begun to investigate the ways in which the law can improve production of goods and labor expansion. Legal reform proposals have suggested ways in which the legal system — the contents of specific laws, judicial doctrines, regulations, and legal processes — can be improved to spur production and growth. These proposals have outlined changes in the laws governing immigration, taxation and financial institutions, as well as contracts, torts, patents, education, land use, and other concerns. They have focused on improving the range of property rights and the rule of law. Yet, the question remains: To what degree are they successful in capturing the phenomenon?

All of these reform discussions lack something fundamental: they fail to recognize the contradicting nature of their topics. Legal rules impose duties and establish rights. The practice of law seeks order and authority and the continuity of tradition. Through causal reasoning, it advances an aim and pursues the means to achieve that aim. Using logical deductions lawyers create legal models and doctrinal rules to apply to complex circumstances. Law denotes the existence of norms that deliver sanctions and remedies when certain conditions hold. It enforces rules and creates classifications that aim to direct behavior in a uniform manner.

Entrepreneurship thrives on freedom and creativity. Its essence is making judgments about the unknown. Entrepreneurs make their decisions in a state of uncertainty, without being able to calculate the likelihood or probabilities of an imminent sequence of events. Therefore, entrepreneurship involves the creative reading of the present and the imaginative prediction of the future. It prospers on deviations as opposed to traditional causation, and it involves adapting to disarray. In a state of disequilibrium, the entrepreneur's alertness discovers profitable opportunities to match unmet demand with untapped supply. Therefore, entrepreneurs prefer legal structures that provide them with greater autonomy.

This Article argues that these differences matter. The nature of a legal solution is essentially cognitive and causal; it does not address the effectual aspects of entrepreneurship. The friction between law and entrepreneurship creates significant distortionary effects. Through theoretical discourse, this Article maintains that a new approach is necessary. It contends that a legal culture that wishes to entice greater innovation is one that requires its legal agents to think like entrepreneurs. While some scholars have developed frameworks for crafting laws that facilitate entrepreneurship, they have mostly focused on theories of risk. However, there is more to entrepreneurship than taking risks.

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III. THE ENTREPRENEURSHIP PROCESS

Innovation is a function of economic evolution. Over the last few decades, a vast amount of literature has been developed that establishes the characteristics

of individual entrepreneurs, especially from a psychological perspective. This type of scholarship portrays entrepreneurs as special individuals who tend to exhibit a particular combination of traits that enable them to assume the role of innovators. Such literature has emphasized that entrepreneurs are better able to understand and evaluate certain risks and their returns. Factors such as independence, creativity, confidence, and resilience were found to affect an entrepreneur's decision to take risks and be innovative. Yet to date, there is no agreement on the qualities that are necessary for entrepreneurs to be successful.

It is difficult to isolate human actions that fully capture entrepreneurial elements. Behind every entrepreneurial firm are individuals or groups of people with unique characteristics and entrepreneurial spirits. Regulating the commercialization of entrepreneurial opportunities is mostly administrable at the entity level. Actions, rather than psychological attributes, are what give meaning to the entrepreneurship process. Accordingly, this Part will consider entrepreneurship from the womb to the tomb. It will unfold the entrepreneurship process and frame it in four main stages: discovery, concept development, implementation, and harvesting success or failure.

A. Discovery of Opportunities

The main element that distinguishes the entrepreneurship process from other business undertakings is novelty. Decision making in the business context involves entrepreneurial and non-entrepreneurial actions. The latter usually entails the task of calculation, the deployment of production factors that happen to be unused, or the readjustment of production means. The entrepreneurial aspect of decision making is discovery. Innovative ideas challenge the current body of knowledge and eventually push society forward by destroying old premises. Discovery is a self-determining decision to carry out "new combinations" by introducing new products, new markets, or deploying existing means of production in a unique way.

Kirzner developed the notion of entrepreneurial "alertness" to denote the quest for innovative knowledge. He argued that entrepreneurs are often dissatisfied with the current available knowledge. That dissatisfaction inspires them to be alert to changing conditions and overlooked possibilities. Entrepreneurial discovery ensues when entrepreneurs believe they have revealed possibilities for innovation that actual or potential competitors had hitherto not seen.

Some entrepreneurial discoveries may also generate negative externalities. Creativeness at its peak can also create societal harms or wasteful, inefficient, or destructive outcomes. Nevertheless, when used in a positive manner, entrepreneurship overall improves the efficiency of our lives. The first step in the entrepreneurship process, then, is the search for the discoveries or new combinations that will achieve a constructive effect. This entails observing current opportunities and studying inefficiencies, wasteful processes, or failed projects with the aim of improving them or creating new ones. It could yield either valuable or useless results that will lead to entrepreneurial success or failure.

At this critical stage of discovery, entrepreneurs heavily invest in knowledge procurement, more so than others, in observing their environment, collecting market research data, and determining current and future resources required to develop the opportunities. Next, entrepreneurs conceptualize the idea. This is far from being an easy task. Doubts and uncertainties are inevitable elements of this

process. Entrepreneurs need to overcome the uncertainty hurdle and proceed with developing what they perceive as the future.

B. Resourcing and Concept Development

Following the discovery stage, the entrepreneurship process proceeds to conceptualizing and planning. This stage entails evaluating the discovery, looking at available resources, calculating the return on investment, the real and perceived value of the opportunity, and its risks and rewards. It includes establishing the goals of the project and identifying its uniqueness and competitive advantage over existing rivals. Entrepreneurs do so in the shadow of uncertainty lacking future market information.

The business model and strategy are essentially the entrepreneurs' theory regarding how they will make money from their idea. It involves an assumption of a market need and a hypothesis about how much customers would be willing to pay for the product. Entrepreneurs design for the target consumer market by envisioning the buyers of the new product. At this stage, establishing an organization is a way to gather resources and express their creativity and autonomy. Once a sufficient amount of planning has been conducted, entrepreneurs will choose the organizational form they see as the best fit for their venture and goals.

C. Realization and Implementation

Innovation is distinct from invention. Innovation and "economic leadership" are more relevant to the economy than invention. Inventions are economically insignificant if they are not successfully delivered to the market. The task of the entrepreneur is to carry the invention into practice. The entrepreneurship process takes the previously unnoticed opportunities that entrepreneurs discovered and translates them into profitable exchanges. Production begins and creates new demand in the market that rapidly generates large revenues and sustainable profits by successfully transforming knowledge into economic value.

Entrepreneurs need to carefully and surreptitiously develop their product. They need to navigate their way through this process without losing control over the essence of the entrepreneurial action. They have to create demand that will transport that sought-after, supra-competitive entrepreneurial gain. They need to make decisions while assessing market uncertainties and taking risks. The presence of specialists and departments may restrict entrepreneurs' thought processes and key decisions. At this crucial point, entrepreneurs may realize their interests have separated from that of their organization. The implementation of the entrepreneurial idea can result in a successful process that yields quick but substantial entrepreneurial gains. However, it can also result in failure, as the next Section reveals.

D. Harvesting Entrepreneurial Success or Recognizing Failure

Entrepreneurs create economic value by successfully pulling together a unique package of resources that exploit untapped opportunities. They infuse economic value into the market by creatively securing and allocating the necessary skills

and resources. This economic value is what Schumpeter called "entrepreneurial gains" — the outcome of a successful delivery of the discovery to the market recognized via upsurge in the firm's growth. This reflects the firm's ability to convert valuable knowledge into superior economic performance.

Following the moment when entrepreneurs realize success, they begin to reap "supra-competitive gains." These gains are pure profits emanating from the creation of new market demand and the absence of competitors. What makes entrepreneurial gains uniquely different? Schumpeter distinguished between entrepreneurial gains and ordinary business profits by emphasizing the scope and timing of their onset. Entrepreneurial gains are the portion over and above a normal profit. They follow innovation and do not arise as a response to preexisting demand in the market. The prospect of receiving large rewards and personal gains leads to and maintains alertness to potential economically or socially significant opportunities. Nevertheless, as will be further discussed, entrepreneurial profits are only temporary premiums of successful innovation.

Not all entrepreneurs succeed. The implementation stage can also result in entrepreneurial failure. But entrepreneurial failure is an important part of the entrepreneurship process. Kirzner argued that when there is no room for error, there is no room for opportunities for entrepreneurial discovery. Entrepreneurs often tend to be over-optimistic about the outcomes or the availability of production means. They may also miscalculate the market reaction to their innovation. Making "correct" decisions requires more than reaching an accurate mathematical answer. It involves a detailed assessment of current and future realities and anticipating changes in market conditions in an uncertain environment.

Entrepreneurial failure is economically and culturally valuable. It signals to the market what ideas do not work and provides lessons about new possibilities for improving the process. Entrepreneurial failure is a vital element of the entrepreneurship process and a catalyst for growth. Entrepreneurial failure diffuses knowledge among entrepreneurs and points to other solutions that may lead to entrepreneurial success. Knowledge spillover occurs when failure is followed by entrepreneurial actions of others. Learning from entrepreneurial errors increases the competitiveness of the market. Some entrepreneurs are quick to spot unnoticed opportunities, while others notice only those revealed by the errors of others. Some succeed in pursuing entrepreneurship while others produce waste and fail.

The scope of entrepreneurship, therefore, must include the possibility of discovering errors. Studies on economic growth demonstrate that the benefits of entrepreneurial success outweigh the cost of entrepreneurial failure. Overall, society reaps more benefits from entrepreneurial action. Accordingly, entrepreneurship requires distinct legal considerations. . . .

V. LEGAL CLASSIFICATION FROM THE POINT OF VIEW OF ENTREPRENEURS

The key function of the entrepreneur is to implement innovations effectively. The entrepreneur "is the man who gets things done," and the "enterprise" is the conduit for implementing the entrepreneur's novel ideas and discoveries. Entrepreneurs are people who possess the power to set things into motion. They do not act in a void. Law governs transactions. It administers exchanges between the

entrepreneur and other market players, such as vendors, investors, employees, and the government. Law imposes order and directs the entrepreneurs' ability to execute innovations. It provides entrepreneurs with advantages; it also presents them with hurdles. . . .

Entrepreneurs are heavily invested in the unknown. They constantly make judgments about contingencies, such as cash flow problems, partner breakups, natural disasters, loss of a major customer, new competition, industry change, loss of key personnel, etc. All of these matters require entrepreneurs to make decisions in the shadow of uncertainty. At each stage of the transient entrepreneurship process, the entrepreneur faces ambiguity regarding future market conditions. In the discovery stage, the focus is on trying to predict future market conditions and the market reaction to the newly discovered opportunity. In the resourcing and concept development stage, uncertainty about obtaining funding looms. In the realization stage, the entrepreneur is uncertain about whether the opportunity will lead to a success or a failure. The uncertainty that surrounds the new discovery differs from business risk because it stems from newly created market conditions and it is difficult to identify or measure.

Unpredictable, changing circumstances benefit from a stable legal order. Yet, setting strict legal rules can lead to stagnation, among other things, and can restrain entrepreneurs from adjusting the process to meet unanticipated developments. The recent development of sharing economy is one example that highlights the dissonance between law and entrepreneurship. In the past few years, new Internet-based platforms have been shaping a new consumer culture, lowering transaction costs and improving accessibility to shared goods and services on a previously unimaginable scale. Companies such as Uber, Zipcar, Airbnb and TaskRabbit developed new ways to allow greater access to services, accommodation, and transportation. The hotel, taxi, and other industries as well as many state regulators responded by demanding that the new sharing economy comply with existing occupancy, consumer, and taxi regulations, including entry controls and price-fixing.

Likewise, a recent California case required the court to decide whether the sharing economy can fit within labor law's classification of employee or independent contractor. The Northern District of California court applied the California independent contractor test and the "right of control" test, which are descendants of traditional legal doctrines that determine whether the law may hold an employer liable for the tortious conduct of an employee. If indeed drivers ultimately succeed in receiving employee status, the sharing economy model could face a serious challenge.

In this sharing economy example, instead of applying existing classifications from old laws that fail to account for challenges presented by the new sharing economy, the law can be better designed to ensure regulatory objectives of safety and consumer protection. The regulator could create new experimental regulations for sharing economy that will allow more flexibility and further evaluation of the effectiveness of such regulations as more information on these services becomes available. The new sharing economy is one of many examples of the dissonance between law and innovation. Different areas of the law such as intellectual property, telecommunication law, securities law, immigration, taxation, labor laws, etc. consist of similar "friction points" with innovation.

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ENTREPRENEURSHIP AND LAW: ACCESSING THE POWER OF THE CREATIVE IMPULSE

Steven H. Hobbs, 4 Entrepren. Bus. L. J. (2009)

The process of change has shaped the perceptions and realities of how people interact in a world that has become a much smaller place. We find ourselves in an era of global marketplaces that include mega-corporations not bound by national borders or allegiances, as well as the local, small villages where internet access makes it possible for even the smallest business to access the wide world of trade. Entrepreneurship allows us to create new ways of providing innovative services and products to diverse markets and consumers.

Consequently, the creation of entrepreneurial ventures calls for imaginative methods of structuring laws and legal relationships that increase the chance of successfully bringing new services and products to the market. The legal advocate who assists entrepreneurs must become conversant in the theory and application of the entrepreneurial process. This is especially true for lawyers who represent the wide variety of stakeholders in economic, social, educational, and political enterprises, from family businesses, to venture capitalists, to social service providers in nonprofit organizations, to government entities engaged in economic and community development. The skill sets of lawyers must include strategic planning, leadership qualities, and creative problem solving.

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As an initial matter, one should consider the definition of entrepreneurship, especially as it relates to law. . . .

[T]he entrepreneurial process is fundamentally about dynamic change in the manner in which services and products are created and/or re-created. The entrepreneur recognizes possibilities for building a business or organization, seeks the resources necessary for bringing the enterprise into existence, and successfully develops plans for bringing the service or product to market. A broader definition, developed by Jeffrey A. Timmons and James Spinelli, posits a comprehensive method of conceptualizing the process:

> Entrepreneurship is a way of thinking, reasoning, and acting that is opportunity obsessed, holistic in approach, and leadership balanced. Entrepreneurship results in the creation, enhancement, realization, and renewal of value, not just for owners, but for all participants and stakeholders. At the heart of the process is the creation and/or recognition of opportunities, followed by the will to seize these opportunities. It requires a willingness to take risks — both personal and financial — but in a very calculated fashion in order to constantly shift the odds of success, balancing the risk with the potential reward. Typically, entrepreneurs devise ingenious strategies to marshal limited resources.

This definition takes a holistic approach to the process by entailing creativity, strategic planning, the varied participants, risk, and reward. Understanding entrepreneurship as a multi-variant, dynamic process informs the advisors to entrepreneurs of how best to facilitate the enterprise's growth and development.

From a lawyer's perspective, this requires new ways of adapting our legal system to facilitate the entrepreneurial process. For example, one tends to focus on how

the entrepreneurial process is carried out in a start-up business or venture, although entrepreneurial functions can occur in an established firm. The form of the business — sole proprietorship, various partnership forms, various corporate forms, or joint ventures — must be tailored to the nature of the enterprise. Various stakeholders, including employees, managers, and investors, must be accommodated. Other legal issues may arise, demanding creative solutions. For example, the service or product may need protection through licensing and intellectual property law. Due diligence requires a legal analysis of the systems of law which must be accommodated in order for the enterprise to function lawfully. A host of regulatory and tax laws may need to be considered and analyzed from the point-of-view of the new service or product. Thought must also be given to new legal risks and liabilities that may not be readily apparent in the first observation and usage of the service or product.

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[T]he entrepreneurial lawyer will need skill sets that include strategic planning, leadership, and creative problem solving. At the heart of these skills will be a need to foster imagination and innovation in the manner in which we advise entrepreneurs and aid in shaping their enterprises. Just as small businesses are forming strategic alliances with larger businesses to achieve efficiency in bringing services and products to market, so too will lawyers have to conceive of new ways of doing business.

First, an essential, innovative tool and skill for lawyers is to understand the development and use of business plans. They are designed to provide a roadmap for the enterprise, an assessment of the financial, legal and marketing issues, and a resource through which the entrepreneur can attract both human and financial capital. The business plan presents a description of the stakeholders, the needed resources, financial statements, plans for achieving the production of the service or product, and a projection of the business's estimated point of profitability. The plan is designed to take a creative business idea from conception to operational reality. It affords the advisors to the entrepreneur, such as lawyers, venture capitalists, and accountants, a chance to make suggestions and give input on how to maximize the chances of success.

A business plan also tells the story of the entrepreneurial client's enterprise. It offers insight into that client's hopes and dreams. This knowledge allows the entrepreneurial lawyer to tell the client's story to other stakeholders, including potential key employees, financial investors, and government officials who may need to grant regulatory approval. Storytelling, according to Pink, is one of the aptitudes that we will need in this world of rapid change. An entrepreneurial lawyer is an advocate for a client in a crowded marketplace and when time is of the essence, the lawyer must be able to articulately state the client's case and get to the essence of the business proposal. Of course, lawyers have always been known as great storytellers.

Second, the power of the creative impulse is multiplied exponentially when expressed in collaboration with others. Here is where leadership skills will become important when working with a team. Kuratko & Hodgett describe this phenomenon as follows:

> If you wish to become innovative and creative, you need to visualize yourself in complementary relationships to the things and people of the world. You must learn to look at them in terms of how they complement you in your attempts to satisfy your own needs and to complete your projects. You must begin to look at people in nonconventional ways and from a different perspective.

Many minds acting together can solve a problem, improve the efficiency of a service or product, or make a service or product available to more people, cheaply, and with added value. Here is where entrepreneurship, as an expression of the creative impulse, and the law, as a system that facilitates the functioning of enterprises, intersect. New creations and changing market conditions change business and commercial relationships and create heretofore unimaginable risks and dangers. New legal relationships create new legal responsibilities, which in turn create new risk of loss. Here, risk of loss can either be financial (investments of venture capital) or tortious (such as when a new wonder drug later proves to cause unacceptable risks). The lawyer's task is to aid in the identification and structuring of the new relationships and in the minimization and spreading of the risk of loss.

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And finally, the entrepreneurial lawyer must both be imaginative and innovative in crafting creative solutions to legal practice problems. . . .

Our challenge, as lawyers, is both to understand how the creative impulse animates our clients who engage in service or product enterprises, and to tap into the creative impulse in the design and provision of legal services. Lawyers should both assist and serve entrepreneurs animated by a creative impulse and, concurrently, become entrepreneurial in the manner and methods in which we practice law. Daniel Pink notes that information technology has forever changed the way people access legal services and products. There are do-it-yourself websites and internet services where lawyers offer advice in a limited fashion. Pink is certainly correct when observing that new ways of legal practice will be informed by those who can tackle far more complex problems and those who can provide something that databases and software cannot — counseling, mediation, courtroom storytelling, and [other services]. For the entrepreneurial lawyer, this will mean recognizing that being creative will give him or her an edge in the global marketplace for legal services. Furthermore, by paying attention to how we practice, we might just discover, as the lawyers who do collaborative work, that the practice of law can be personally satisfying and rewarding.

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Notes and Questions

1. The stereotypical entrepreneur is a risk-taker, and the stereotypical attorney is risk averse. As one might imagine, these differing approaches to life and business can have an impact on the attorney-client relationship. Suppose a client wants to take a risk that the attorney feels is too great. Who makes the final call? If you are the attorney and a client is making a move you feel introduces too significant a legal risk, should you attempt to end the representation, or assist the client in moving forward? For example (and as we will see in later chapters), clients can ask attorneys to draft contracts that the attorneys know are unlikely to be enforceable. Should attorneys agree to draft unenforceable contracts?

2. Consider the notion, explored by Pozen, that entrepreneurs are

> leaders, innovators, pioneers, problem solvers, and risk takers; they are diligent, persistent, charismatic, dynamic, imaginative, and resourceful, the bricoleurs of the capitalist marketplace. . . . Entrepreneurs can be greedy, cunning, opportunistic, and self-interested, possessed of a kind of Nietzschean will to power that may lead to domination and destruction as well as to value creation.

If Pozen is right about entrepreneurs, there will be a temptation for attorneys representing (or trying to represent) entrepreneurs to cater to strong entrepreneurial personalities. How might a lawyer giving good or bad news to an entrepreneurial client deliver the message differently than a lawyer giving similar news to in-house counsel at a large corporation? What risks might this style of communication introduce for the lawyer?

3. Eyal-Cohen contrasts entrepreneurship and the law as being quite opposite and potentially incompatible with each other — at least as they exist today. At a minimum, "law" and "entrepreneurship" have processes and approach problem solving in very different ways. What challenges does this present for a lawyer representing entrepreneurs?

4. Hobbs suggests that lawyers can learn from entrepreneurs and harness their own creative impulses. For example, entrepreneurial lawyers can seek to develop innovative solutions to legal problems. Is this kind of risk-taking compatible with your conception of what it is to be an attorney and counselor? How might you expect a sole practitioner's tolerance for risk would compare with a large law firm's tolerance?

5. Think about entrepreneurs you know, either personally or through reading about them in the media. Do they have personality characteristics in common with each other? Do you have traits in common with them? In what ways are you different?

6. Hobbs stresses the importance of business plans. Recently, venture capitalists and other sophisticated investors have made light of overly complex and lengthy business plans as a waste of time, and seem to be more impressed by prototypes and other more tangible evidence of potential success. In addition, investors can lose respect for entrepreneurs that seem to believe there is certainty and predictability that can be neatly laid out in a business plan. Instead, they prefer nimble entrepreneurs who are willing to adapt and "pivot" in response to customer preferences and market changes. Why do you think there is a trend away from lengthy business plans and toward "investor decks" among certain sophisticated outside investors?

B. STRUCTURING THE ATTORNEY-CLIENT RELATIONSHIP

If we accept that stereotypical attorneys and stereotypical entrepreneurs are different in outlook and approach when it comes to taking risks and addressing problems, we can imagine how this culture clash will permeate the lawyer-entrepreneur relationship. For both attorney and client, structuring the relationship properly from the beginning is helpful in reducing later misunderstandings. The attorney will prepare a written engagement letter, discussed at the end of the chapter, in which the terms of the business and legal relationship between the attorney and the client are explained. Prior to the engagement letter stage, however, the lawyer and entrepreneur must first clearly communicate as to who the client will be: the entrepreneur as an individual, or the new venture. Lawyers must then separate, in their minds and in their counsel, the individuals from the entity. All parties need to understand the dynamic and structure of this relationship and continue to respect it appropriately throughout the engagement. This issue can become complicated

and misunderstandings regarding the relationship can be the source for liability and litigation between attorney and client.

In the next readings, you will first read one perspective on the ever-present question "who is the client?" Next, we have included selected rules and official comments from the Model Rules of Professional Conduct addressing the potential conflicts of interest when representing multiple clients. As you read both the article and the Model Rules, try to make the abstract practical by imagining yourself in the shoes of the attorney described in the first paragraph of the Ibrahim piece. At the end of the chapter, we introduce two additional ethical issues: competence — an ever-present issue for the attorney representing an entrepreneurial venture in all its complexity; and conflicts of interest between attorney and client — an issue with direct impact on the ways entrepreneurs can pay for legal services.

SOLVING THE EVERYDAY PROBLEM OF CLIENT IDENTITY IN THE CONTEXT OF CLOSELY HELD BUSINESSES

Darian M. Ibrahim, 56 Ala. L. Rev. 181 (2004)

Consider a seemingly simple dilemma that virtually all practicing lawyers face at some point in their careers and that many practitioners face daily. The lawyer receives an all-too-familiar visit from two friends who together ask the lawyer to form a legal entity for their new business. (Assume, for the purposes of this hypothetical, that the business form chosen is a corporation.) In this initial meeting, the friends ask the lawyer to prepare the necessary organizational documents. This task, which lawyers engage in daily, sounds simple enough, and there would be near universal agreement that the lawyer may undertake this representation. But numerous conflicts of interest are certain to arise between the friends, if not during formation then during the operation of the corporation, and these are often ignored or deemed unimportant by the lawyer. Indeed, . . . even if the lawyer appreciates these conflicts, she has no — or conflicting — guidance in resolving them.

For example, consider some common questions that arise during formation. To issue stock to the friends, the lawyer must know whether they will be equal owners or majority-minority owners. If the latter, does the lawyer have a duty to advise the minority shareholder that, without contractual protections, he could be outvoted on all matters? Without legal guidance, an unsophisticated minority shareholder would not know that his appointments as an initial officer and director of the corporation are subject to the majority shareholder choosing not to remove him from these positions.

The lawyer's dilemma, in its most-stripped-down form, is this: Who is the lawyer's client? Simply the corporation as an entity? Both shareholders? One shareholder to the exclusion of the other? Or some combination of the foregoing? Lawyers have faced potential civil liability and disciplinary actions for failing to appreciate the entity-owner distinction, and clients are usually even more confused.

Assume the client is the corporation as an entity. This would provide no guidance for the lawyer when determining whether to advise the minority shareholder of the possible perils of this status. It would be impossible for the lawyer to know at the time of incorporation whether it would be better for the corporation if the majority shareholder could effectively eliminate the minority shareholder's management

rights. Maybe the majority shareholder is more business-savvy, or perhaps the majority shareholder will prove too impetuous in his decision-making and the minority shareholder's veto power on important decisions will keep him in check. In short, the lawyer will most likely be unable to predict which shareholder will be the better decision-maker at the outset. Moreover, even if the lawyer could hazard a guess, it is unadvisable to put the lawyer in the position of having to make subjective decisions that involve business, rather than legal, judgment.

Assume the client is only the majority shareholder. If the lawyer advises the minority shareholder to prospectively guard against oppressive conduct, the majority shareholder may have a cause of action against the lawyer. Now assume the client is only the minority shareholder. If the lawyer did not advise the minority shareholder of the dangers of this status, the lawyer could be liable to the shareholder for inadequate representation. If both shareholders are deemed the lawyer's clients, the lawyer will face ethical conflicts of interest problems.

To complicate matters, a lawyer forming a closely held corporation is usually asked to prepare a shareholders agreement to govern internal matters between the shareholders. The shareholders agreement should provide, at the very least, a restriction on the transferability of shares. Such a provision prevents one shareholder from selling his shares to a third party without first giving the remaining shareholder the right to buy them (commonly referred to as a "right of first refusal" provision). This gives shareholders the right to choose with whom they do business.

Often shareholders will instruct the lawyer to "prepare your standard shareholders agreement." The lawyer should respond that "there is no standard shareholders agreement" because each business and each set of shareholder relationships is unique. Moreover, almost every drafting choice the lawyer makes will favor one shareholder over the other. This is easy to see when considering the majority-minority ownership situation. For instance, shareholders agreements commonly divide decisions into those that can be made by a mere majority and those that require the unanimous approval of the shareholders. Lawyers representing majority shareholders prefer that no decisions require unanimous consent — that way, their clients ultimately make all decisions. Conversely, lawyers representing minority shareholders would prefer that a broad range of decisions require unanimous consent, thus giving their clients more of a voice in the operation and affairs of the corporation. It is difficult to see how the lawyer who represents only the corporation, or both shareholders, or who does not appreciate the subtleties of client identity, can adequately draft a shareholders agreement. Yet lawyers do it daily.

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The foregoing discussion may lead the reader to conclude that these problematic drafting choices only present themselves in the majority-minority situation, and that representation of the nebulous "corporation," or even co-representation of the shareholders, is a harmless fiction in the equal ownership situation. Although client identity may be less of a concern in the equal ownership situation, important drafting choices benefiting one shareholder over another still exist. How the lawyer drafts the corporation's internal documents again depends on who is classified as the lawyer's client. The foregoing discussion focuses on potential conflicts during the corporation's initial stages, but lawyers will continue to encounter these ethically gray issues once the corporation is up and running.

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SELECTIONS FROM MODEL RULES OF PROFESSIONAL CONDUCT AND OFFICIAL COMMENTS

American Bar Association (2012)

Rule 1.7 Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

Comment

General Principles

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[2] Resolution of a conflict of interest problem under this Rule requires the lawyer to: 1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentible; and 4) if so, consult with the clients affected under paragraph (a) and obtain their informed consent, confirmed in writing. The clients affected under paragraph (a) include both of the clients referred to in paragraph (a)(1) and the one or more clients whose representation might be materially limited under paragraph (a)(2).

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[4] If a conflict arises after representation has been undertaken, the lawyer ordinarily must withdraw from the representation, unless the lawyer has obtained the informed consent of the client under the conditions of paragraph (b). . . .

[5] Unforeseeable developments, such as changes in corporate and other organizational affiliations or the addition or realignment of parties in litigation, might create conflicts in the midst of a representation, as when a company sued by the lawyer on behalf of one client is bought by another client represented by the lawyer in an unrelated matter. Depending on the circumstances, the lawyer may have the option to withdraw from one of the representations in order to avoid the conflict. . . .

Identifying Conflicts of Interest: Directly Adverse

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[7] Directly adverse conflicts can . . . arise in transactional matters. For example, if a lawyer is asked to represent the seller of a business in negotiations with a buyer represented by the lawyer, not in the same transaction but in another, unrelated matter, the lawyer could not undertake the representation without the informed consent of each client.

Identifying Conflicts of Interest: Material Limitation

[8] Even where there is no direct adverseness, a conflict of interest exists if there is a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests. For example, a lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer's ability to recommend or advocate all possible positions that each might take because of the lawyer's duty of loyalty to the others. The conflict in effect forecloses alternatives that would otherwise be available to the client. The mere possibility of subsequent harm does not itself require disclosure and consent. The critical questions are the likelihood that a difference in interests will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.

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Personal Interest Conflicts

[10] The lawyer's own interests should not be permitted to have an adverse effect on representation of a client. . . . [A] lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed financial interest. . . .

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Nonlitigation Conflicts

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[28] Whether a conflict is consentable depends on the circumstances. For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them. Thus, a lawyer may seek to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest or arranging a property distribution in settlement of an estate. The lawyer seeks to resolve potentially adverse interests by developing the parties' mutual interests. Otherwise, each party might have to obtain separate representation, with the possibility of incurring additional cost, complication or even litigation. Given these and other relevant factors, the clients may prefer that the lawyer act for all of them.

Special Considerations in Common Representation

[29] In considering whether to represent multiple clients in the same matter, a lawyer should be mindful that if the common representation fails because

the potentially adverse interests cannot be reconciled, the result can be additional cost, embarrassment and recrimination. Ordinarily, the lawyer will be forced to withdraw from representing all of the clients if the common representation fails. In some situations, the risk of failure is so great that multiple representation is plainly impossible. For example, a lawyer cannot undertake common representation of clients where contentious litigation or negotiations between them are imminent or contemplated. Moreover, because the lawyer is required to be impartial between commonly represented clients, representation of multiple clients is improper when it is unlikely that impartiality can be maintained. Generally, if the relationship between the parties has already assumed antagonism, the possibility that the clients' interests can be adequately served by common representation is not very good. Other relevant factors are whether the lawyer subsequently will represent both parties on a continuing basis and whether the situation involves creating or terminating a relationship between the parties.

[30] A particularly important factor in determining the appropriateness of common representation is the effect on client-lawyer confidentiality and the attorney-client privilege. With regard to the attorney-client privilege, the prevailing rule is that, as between commonly represented clients, the privilege does not attach. Hence, it must be assumed that if litigation eventuates between the clients, the privilege will not protect any such communications, and the clients should be so advised.

[31] As to the duty of confidentiality, continued common representation will almost certainly be inadequate if one client asks the lawyer not to disclose to the other client information relevant to the common representation. This is so because the lawyer has an equal duty of loyalty to each client, and each client has the right to be informed of anything bearing on the representation that might affect that client's interests and the right to expect that the lawyer will use that information to that client's benefit. See Rule 1.4 ["Communications"]. The lawyer should, at the outset of the common representation and as part of the process of obtaining each client's informed consent, advise each client that information will be shared and that the lawyer will have to withdraw if one client decides that some matter material to the representation should be kept from the other. In limited circumstances, it may be appropriate for the lawyer to proceed with the representation when the clients have agreed, after being properly informed, that the lawyer will keep certain information confidential. For example, the lawyer may reasonably conclude that failure to disclose one client's trade secrets to another client will not adversely affect representation involving a joint venture between the clients and agree to keep that information confidential with the informed consent of both clients.

[32] When seeking to establish or adjust a relationship between clients, the lawyer should make clear that the lawyer's role is not that of partisanship normally expected in other circumstances and, thus, that the clients may be required to assume greater responsibility for decisions than when each client is separately represented. Any limitations on the scope of the representation made necessary as a result of the common representation should be fully explained to the clients at the outset of the representation. See Rule 1.2(c).

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Organizational Clients

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[35] A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect

of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at board meetings while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.

Rule 1.13 Organization As Client

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if

(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization,

then the lawyer may reveal information relating to the representation whether or not Rule 1.6 ["Confidentiality of Information"] permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

(f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7 ["Conflict of Interest: Current Clients"]. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

Comment

The Entity as the Client

[1] An organizational client is a legal entity, but it cannot act except through its officers, directors, employees, shareholders and other constituents. Officers, directors, employees and shareholders are the constituents of the corporate organizational client. The duties defined in this Comment apply equally to unincorporated associations. "Other constituents" as used in this Comment means the positions equivalent to officers, directors, employees and shareholders held by persons acting for organizational clients that are not corporations.

[2] When one of the constituents of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is protected by Rule 1.6. Thus, by way of example, if an organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client's employees or other constituents are covered by Rule 1.6. This does not mean, however, that constituents of an organizational client are the clients of the lawyer. The lawyer may not disclose to such constituents information relating to the representation except for disclosures explicitly or impliedly authorized by the organizational client in order to carry out the representation or as otherwise permitted by Rule 1.6.

[3] When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. Paragraph (b) makes clear, however, that when the lawyer knows that the organization is likely to be substantially injured by action of an officer or other constituent that violates a legal obligation to the organization or is in violation of law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. As defined in Rule 1.0(f), knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious.

. . .

Clarifying the Lawyer's Role

[10] There are times when the organization's interest may be or become adverse to those of one or more of its constituents. In such circumstances the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussions between the lawyer for the organization and the individual may not be privileged.

[11] Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case.

Dual Representation

[12] Paragraph (g) recognizes that a lawyer for an organization may also represent a principal officer or major shareholder.

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Notes and Questions

1. Prof. Ibrahim describes a very common situation encountered by lawyers who represent entrepreneurs. In a situation with multiple founders with potentially divergent interests, is it better for the attorney to choose one entrepreneur as a client or to represent the new venture being created? Does your analysis change if the lawyer has a preexisting professional relationship with one of the founders?

2. Model Rule 1.7(b) seems to suggest that a conflict between clients can be acceptable if certain requirements are met. Is it likely that two co-founders could both be represented by the attorney under the exception described in the Rule? Does the exception change your response to Question 1? How does Model Rule 1.13 complicate this relationship?

3. Even if a lawyer and entrepreneur agree that the lawyer will represent the new business and not the individual founder, the entrepreneur will often refer to — and think of — the attorney as "my lawyer" rather than "the organization's lawyer." Does a lawyer need to do anything to work against this kind of perception by the entrepreneur and third parties? What are the consequences, positive and negative, of taking any such actions?

4. Model Rule 1.13 says a lawyer working for an entity "represents the organization acting through its duly authorized constituents." The official comment sheds further light on what the Rule means, making the (perhaps) obvious point that lawyers who represent entities take direction from the officers, directors, and owners of their client. Put another way, the way a lawyer knows what his entity client wants him to do is to ask the officers, directors, and owners of the client.

Some lawyers and scholars worry that by representing an entity, rather than its founders, the attorney may face a conflict where he needs to tell his human "client" that the instruction is counter to the best interest of his entity client. Subpart (b) of Rule 1.13 and the associated official comment address what to do in this situation. If the client is a small entrepreneurial venture with one shareholder who is also the sole director and officer, can a situation ever arise in which the human "client" gives an instruction that is counter to the desires of the entity client? What if the lawyer concludes the instruction from the human client is very likely to destroy the business? Furthermore, what if the human client admits that the instruction is intended to destroy the business? To the extent you feel there is a potential conflict, would it be appropriate to raise this issue with your client, or would it fall into the category of "theoretically interesting but not practical or relevant"?

5. Imagine two entrepreneurs arrive at an attorney's door with a business plan and a prototype. They say they are just two people with a great idea who are looking to start a business but haven't yet formed a company. Assume a search of relevant databases reveals that they have not filed any paperwork with the secretary of state of any state to form a legal entity. Do they have a legal entity now? Who owns the intellectual property they have created? Is there any person other than the two individual entrepreneurs or the "entity yet-to-be-formed" who the attorney can represent in this context?

SELECTIONS FROM MODEL RULES OF PROFESSIONAL CONDUCT

American Bar Association (2020)

Rule 1.1 Competence

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

Comment

Legal Knowledge and Skill

[1] In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances.

[2] A lawyer need not necessarily have special training or prior experience to handle legal problems of a type with which the lawyer is unfamiliar. A newly admitted lawyer can be as competent as a practitioner with long experience. Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems. Perhaps the most fundamental legal skill consists of determining what kind of legal problems a situation may involve, a skill that necessarily transcends any particular specialized knowledge. A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can also be provided through the association of a lawyer of established competence in the field in question.

[3] In an emergency a lawyer may give advice or assistance in a matter in which the lawyer does not have the skill ordinarily required where referral to or consultation or association with another lawyer would be impractical. Even in an emergency, however, assistance should be limited to that reasonably necessary in the circumstances, for ill-considered action under emergency conditions can jeopardize the client's interest.

[4] A lawyer may accept representation where the requisite level of competence can be achieved by reasonable preparation. This applies as well to a lawyer who is appointed as counsel for an unrepresented person. See also Rule 6.2 ["Accepting Appointments"].

Thoroughness and Preparation

[5] Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners. It also includes adequate preparation. The required attention and preparation are determined in part by what is at stake; major litigation and complex transactions ordinarily require more extensive treatment than matters of lesser complexity and consequence. An agreement between the lawyer and the client regarding the scope of the representation may limit the matters for which the lawyer is responsible. See Rule 1.2(c)

[stating "A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent"].

. . .

Maintaining Competence

[8] To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject.

Rule 1.8 Conflict Of Interest: Current Clients: Specific Rules

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to 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 in a manner that can be reasonably understood by the client;

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

. . .

(k) While lawyers are associated in a firm, a prohibition in the foregoing paragraphs (a) through (i) that applies to any one of them shall apply to all of them.

Comment

Business Transactions Between Client and Lawyer

[1] A lawyer's legal skill and training, together with the relationship of trust and confidence between lawyer and client, create the possibility of overreaching when the lawyer participates in a business, property or financial transaction with a client, for example, a loan or sales transaction or a lawyer investment on behalf of a client. The requirements of paragraph (a) must be met even when the transaction is not closely related to the subject matter of the representation, as when a lawyer drafting a will for a client learns that the client needs money for unrelated expenses and offers to make a loan to the client. The Rule applies to lawyers engaged in the sale of goods or services related to the practice of law, for example, the sale of title insurance or investment services to existing clients of the lawyer's legal practice. See Rule 5.7 ["Responsibilities Regarding Law-related Services"]. It also applies to lawyers purchasing property from estates they represent. It 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.

[2] Paragraph (a)(1) requires that the transaction itself be fair to the client and that its essential terms be communicated to the client, in writing, in a manner that can be reasonably understood. Paragraph (a)(2) requires that the client also be advised, in writing, of the desirability of seeking the advice of independent legal counsel. It also requires that the client be given a reasonable opportunity to obtain such advice. Paragraph (a)(3) requires that the lawyer obtain the client's informed consent, in a writing signed by the client, both to the essential terms of the transaction and to the lawyer's role. When necessary, the lawyer should discuss both the material risks of the proposed transaction, including any risk presented by the lawyer's involvement, and the existence of reasonably available alternatives and should explain why the advice of independent legal counsel is desirable. See Rule 1.0(e) (definition of informed consent).

[3] The risk to a client is greatest when the client expects the lawyer to represent the client in the transaction itself or when the lawyer's financial interest otherwise poses a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's financial interest in the transaction. Here the lawyer's role requires that the lawyer must comply, not only with the requirements of paragraph (a), but also with the requirements of Rule 1.7. Under that Rule, the lawyer must disclose the risks associated with the lawyer's dual role as both legal adviser and participant in the transaction, such as the risk that the lawyer will structure the transaction or give legal advice in a way that favors the lawyer's interests at the expense of the client. Moreover, the lawyer must obtain the client's informed consent. In some cases, the lawyer's interest may be such that Rule 1.7 will preclude the lawyer from seeking the client's consent to the transaction.

[4] If the client is independently represented in the transaction, paragraph (a)(2) of this Rule is inapplicable, and the paragraph (a)(1) requirement for full disclosure is satisfied either by a written disclosure by the lawyer involved in the transaction or by the client's independent counsel. The fact that the client was independently represented in the transaction is relevant in determining whether the agreement was fair and reasonable to the client as paragraph (a)(1) further requires.

. . .

Notes and Questions

1. As you will see throughout this casebook, effective representation of entrepreneurs requires competence in a large number of legal areas. Start-ups need assistance in employment law, intellectual property law, business organization law, dispute resolution, contract law, product liability law, e-commerce law, the Uniform Commercial Code, securities law, tax law, and many other areas. How can an attorney effectively represent an entrepreneur in light of Rule 1.1? When a client has a specific and specialized legal need, such as the desire to prosecute a patent, and the attorney does not have the relevant expertise, what should the attorney do (i) from a legal ethics perspective, (ii) from a business development perspective, and (iii) from a client relations perspective?

2. Entrepreneurial clients often lack cash to pay service providers, including their lawyers. Imagine an entrepreneur offers you an ownership stake in the new business in exchange for your legal services. In light of Rule 1.8, can you accept? Should you accept? What benefits, in financial and non-financial terms, might an attorney receive in this situation? What risks? If you accept that lawyers are risk adverse, can you imagine what reaction large law firms have to this kind of offer?

Can you imagine what reaction they had to this kind of offer during the internet boom of the late 1990s or the tech entrepreneurship resurgence in the 2010s?

INTRODUCTION TO HYPOTHETICAL CLIENTS

Dr. Olivia M. Gold, a research scientist, has developed an innovative new method of analyzing and detecting bacteria growth in food. The new technology is faster, more accurate, and less expensive than previous technology in this area. Olivia developed the process in her free time, and not during the hours she was supposed to be working her regular job in the "Gene Lab" of Kramer BioGenetics, Inc. Olivia has not discussed her discovery with any of her supervisors or co-workers at Kramer.

Andrew Orlando is an old college buddy of Olivia's. Andrew is a brand manager at a health care company, Life Line, Inc. He works on the brand "Clean Machine," which is primarily comprised of a line of antibacterial kitchen soaps. He recently convinced Olivia that they should form a new, jointly owned business to exploit Olivia's discovery.

Andrew and Olivia believe that they can use Olivia's technology to create a food testing probe that will be able to analyze the bacteria level in food and indicate on a small LCD display whether the food is safe to eat. Rather than trying to sell Olivia's technology to an established medical or other health care company, they intend to design the product themselves, and then their new business will market the product directly to consumers as well as to stores such as Wal-Mart. Although Olivia has some questions about Andrew's judgment and maturity, she knows that Andrew's marketing expertise, outgoing personality, and connections in the health care world will be essential to the success of the new business. They have not yet had a discussion about how much of the company they will each own, or how they will ultimately make decisions. In fact, they already have had one significant disagreement: Andrew would like to call the product "General Germ," whereas Olivia prefers the name "Germ Genie."

Olivia and Andrew are each prepared to invest $125,000 to get the new business going, but they realize they will need a lot more than $250,000 to make it through the research and development phases of their business before they have a product ready to launch. If they can raise sufficient capital, their projections show that their business will be "cash-flow positive" within 18 months of the product launch.

Olivia and Andrew have come to you looking for help with their new venture. We will be considering various issues faced by the intrepid entrepreneurs in problems at the end of every chapter of this book.

PROBLEM

You work for attorney Jessica Leigh, a partner in the successful Wildcat Firm. Jessica is a rainmaker, and her newest catch is the venture to be started by Olivia Gold and Andrew Orlando. Prior to commencing the representation, Jessica had the clients sign the engagement letter below.

September 5, 2020

Germ Genie
Attn: Olivia M. Gold and Andrew Orlando
4101 N. Western Ave, Unit 5B
Chicago, Illinois 60622

Dear Dr. Gold and Mr. Orlando:

We are pleased that you have asked the Wildcat Firm to act as legal counsel for the company you intend to form, Germ Genie (the "Company"), in connection with the Company's formation, the protection of its trademarks and patents, the preparation of customer and vendor contracts, and any other matter that you and we may specifically agree to be subject to such representation. The purpose of this letter is to set forth the terms and conditions of our relationship.

Our fees will be determined in accordance with our normal billing practices, taking into account the various factors we normally consider in determining our fees, and will be billed on a monthly basis.

Our normal billing practice is to determine fees by multiplying the number of hours spent working on a matter by our regular and customary billing rates for similar services performed by the firm. The minimum billing increment is ordinarily 1/10 hour. As we discussed, my current billing rate is $400. Hourly rates for attorneys currently range from $100 to $700. These rates may be changed by the firm in the future, in which case new rates will apply to all work performed thereafter.

In addition to our fees described above, you will be responsible for all out-of-pocket expenses incurred. Statements for out-of-pocket expenses will be submitted monthly or at other appropriate intervals. These will be paid promptly unless other arrangements are made. Large expenditures like government filing fees, taxes, and the like will be discussed with the Company before they are incurred. In circumstances where a third party provider or government agency is involved, we may ask that you pay these expenses directly.

It must be understood that we represent the Company only, and not either of you as individuals or as owners or employees of the Company. Accordingly, our representation of the Company does not create any fiduciary relationship between the Wildcat Firm and either of you. You should consider retaining separate counsel to advise you on issues affecting you as individuals. Additionally, it should be understood that we have the right to discuss with both of you any information provided to us by one of you.

Periodically, we distribute materials that include listings of representative clients and a basic description of the legal services performed for each client. We may refer in those materials to our representation of the Company and the work we have performed for the Company.

It is the Company's right as a client to terminate this engagement at any time on reasonable notice and upon the payment of all expenses incurred to the date of termination. Upon the termination of our engagement or completion of the matters set forth above, the Wildcat Firm will have no obligation to provide further legal assistance or advice or to

inform the Company of changes in the law that could affect it. All files will be turned over to the Company on its written request except internal documents and drafts of documents, which we may retain.

We know of no engagements for other clients of the Wildcat Firm that would prevent us from representing the Company. However, if a situation should arise in which it becomes appropriate to take a position adverse to one of our other clients, we reserve the right to withdraw from this engagement.

Please sign and return a copy of this letter to confirm that the Company agrees with the terms and conditions of our engagement. We look forward to working with you.

Very truly yours,
Jessica Leigh

Agreed and accepted:
Germ Genie
By: _____
Olivia M. Gold
And: _____
Andrew Orlando

1. Suppose that the client asks you to assist with preparing documents for the investment in the Company by an unrelated angel investor. Can you do so under the terms of the existing engagement letter? What steps might you take to ensure that the new project is covered by the same terms as the other projects you have agreed to complete?

2. Over drinks one night, you tell a friend of yours that you now are working on the "Germ Genie" client, and that you are excited because "they have a neat new technology that could revolutionize food safety." You do not say anything specific about the projects you are working on for the client, nor do you name the individual founders. Unbeknownst to you, Olivia and Andrew are two tables away and hear everything you have said, which they angrily tell Jessica the next day. Have you violated your ethical duties or breached your engagement letter? What strategy will you use in discussing the issue with Jessica? With the client?

3. Imagine that on a Monday you call the client to discuss an issue. The client does not answer the call and you leave a voicemail. On Tuesday, you try again and have a four-minute conversation with the receptionist who answers the phone. On Wednesday, you send an email to the client requesting a return phone call and you briefly explain the issue in the message. Finally, on Thursday, you hear back from the client and speak for exactly one hour. What is the maximum amount of time you would feel justified in billing the client? What is the minimum amount of time you would need to charge to be fair to the Wildcat Firm? What amount of time would you charge?

4. Suppose a prominent venture capitalist in town is a longstanding client of the Wildcat Firm. Jessica introduces the venture capitalist to Olivia and Andrew, and the venture capitalist wants to invest in Germ Genie.

(a) Would Jessica overstep her place, or violate any ethical rules, by introducing the venture capitalist to Germ Genie?

(b) Assume the clients have negotiated the salient business terms on their own without legal representation. Can the Wildcat Firm draft the documents, and if so, who will be the client?

(c) Assume the venture capitalist wants the Wildcat Firm to represent her in a contentious negotiation over the terms of her investment in Germ Genie. Must the Wildcat Firm withdraw from representing Germ Genie?

5. Imagine that only Andrew signs the engagement letter. The client relationship, including billing and collections, proceeds normally, and Andrew is your primary point of contact. Six months into the engagement, you get a call from Andrew, telling you that Olivia has agreed to sell her interest in Germ Genie to Andrew for a nominal amount, and he asks you to prepare the necessary paperwork. What responsibilities do you have to Olivia, to Andrew, and to Germ Genie? Can you just complete the work Andrew requested and send it to him without contacting anyone else?

6. Assume that, as with the Model Rules of Professional Conduct, your state code of ethics does not require engagement letters between attorneys and clients. Do you think that Jessica made a good or bad choice in having the client sign an engagement letter? Are there circumstances you can imagine that would make an engagement letter more advisable with an entrepreneurial client than with a large established company? Less advisable?

II

THE TRANSITION FROM EMPLOYEE TO ENTREPRENEUR

This chapter explores the issues that arise when an entrepreneur conceives and decides to begin pursuing an idea for a new business while still an employee of another organization. The entrepreneur must be aware that the planning and launching of a new venture may be subject to legal restrictions. These restrictions can apply to the entrepreneur's activities both while still employed and after the employment relationship terminates. Under state law, the entrepreneur owes an employer fiduciary duties — chiefly a duty of loyalty — notwithstanding the desire to launch a new venture. The duty to be loyal to the employer can prevent the entrepreneur from launching a competing business while still employed, and from usurping a corporate opportunity in the process of starting a business. At the same time, the entrepreneur may have entered into an employment contract that could severely limit the ability to commence a competing business even after the employment relationship and the related fiduciary duties have terminated. Intellectual property concerns are also at play: the entrepreneur may also find she does not own the innovation, invention, or other intellectual property necessary to start the business, even if she invented it on her own time. In addition, the entrepreneur needs to be wary of violating Federal and state trade secrets statutes when founding and building a business.

A. CONCERNS ARISING SEPARATELY FROM ANY CONTRACTUAL RELATIONSHIP

In Section B of this chapter, we explore the duties that can arise between a worker and her employer because of a written contract. In this Section A, we explore legal obligations that exist whether or not there is a written contract between the worker and the existing employer. These concerns are in three primary categories: fiduciary duty concerns, unfair competition concerns, and trade secret concerns.

1. Fiduciary Duties

Broadly put, a fiduciary relationship is a relationship in which parties place trust and confidence in each other. A "fiduciary duty" is an embodiment of that relationship in a legal or ethical rule the parties are expected to follow in their course of conduct. While students who have taken a Business Associations or Corporations course have been exposed to fiduciary duties in the context of a director or officer of a corporation, or a partner in a partnership, fiduciary duties extend some distance down into the hierarchy of a business organization. An employee who is categorized as a "key" or "skilled" employee will owe duties of loyalty and care similar to the duties owed by a director of the same organization.

When it comes to a client looking to leave her current employer to start a new business, duty of loyalty issues are paramount. The lawyer must help to determine whether the employee is the type that owes a duty of loyalty — understanding that a key employee like a high-ranking vice president likely will owe such a duty, a skilled employee like a technical designer will likely owe such a duty, but a rank-and-file employee like a mailroom worker likely will not owe such a duty. As a public policy matter, our laws reflect an interest in providing lower-level employees (who have less responsibility and receive less compensation) with more latitude to change jobs.

Having determined whether the client owes a duty to the current employer, the lawyer then must explore whether the client has done — or intends to do — anything that violates the duty of loyalty. Directly competing while still an employee is disloyal; directly competing after termination of employment (which terminates the fiduciary relationship) is permissible since no duty of loyalty is owed after the termination of the fiduciary relationship. Sharing or use of confidential information learned while the fiduciary relationship existed is disloyal, even if the sharing or use occurs after the termination of the fiduciary relationship. Preparation for competition is not in and of itself disloyal when conducted while the employment relationship exists, suggesting an employee can work on a business plan for a competing business or even explore renting office space, provided such efforts do not interfere with the employee's job responsibilities. The moment the employee begins to offer a competing product or service, however, the employee is competing and the duty of loyalty has been breached.

2. Trade Secrets

Federal and state trade secret statutes apply to workers with access to trade secrets. A trade secret is any information of value to the company (often stated as information that gives the company a competitive advantage), which the company has taken steps to keep confidential. If an entrepreneur takes confidential information — such as a password-protected customer list, an internal business strategy document, or private marketing data — from his current employer and uses it for his new venture, the entrepreneur has likely violated the state trade secret law. (Note that this is in addition to any duty of loyalty violation that may occur from using the information.) In addition to the civil penalties that the entrepreneur may face under trade secret statutes, these statutes typically give rise to criminal liability. A lawyer representing an entrepreneur must counsel the client to avoid taking

any sensitive information from the current employer. Trade secrets are discussed in greater detail in Chapter 4.

3. Unfair Competition

The tort of unfair competition — which is born largely out of state common law — addresses economic harm resulting from unfair business practices. An employee can commit this tort easily by violating the fiduciary duty of loyalty, or infringing a trademark, or misappropriating confidential information (including misappropriation of information that violates trade secret statutes). In short, anything dishonest or unjust is a possible claim under an unfair competition theory. Employers typically include unfair competition claims in actions against former employees, and when advising entrepreneurs the lawyer must look out for anything that "smells bad" and warn the client of this possible tort.

The following cases involve employees who have taken a variety of actions that potentially implicate the duty of loyalty, trade secret law, and the tort of unfair competition. As you read them, keep the basic premises summarized above in mind, and notice the ways in which the court expresses the legal rules and applies them to the specific, nuanced facts of the cases.

REHABILITATION SPECIALISTS, INC. v. KOERING
Court of Appeals of Minnesota 404 N.W.2d 301 (1987)

Rehabilitation Specialists, Inc. ("RSI") appeals from a summary judgment for Nancy Koering, an ex-employee who started a competing business, on its suit for breach of her duty of loyalty, as well as unfair competition and misappropriation of confidential business information. We reverse and remand for trial.

FACTS

RSI provides physical therapy, occupational therapy and related therapy services to health care facilities in Minnesota and several other states. In 1982, RSI hired Koering as its director of occupational therapy. In January, 1984, Koering was promoted to assistant administrator, and in November, 1984, she was promoted to administrator. Koering's responsibilities included soliciting business and negotiating contracts for RSI.

In May, 1985, Koering considered starting her own therapy business. On June 13, 1985, she told this to Robert Schuchman, vice-president of operations for Beverly Enterprises ("Beverly"), a company which owns and operates over 1200 long-term care facilities nationally. Beverly is one of RSI's major customers. Schuchman dealt almost exclusively with Koering while she was at RSI.

Koering described her June 13 meeting with Schuchman in an answer to an interrogatory, as follows:

> Nancy informed Mr. Schuchman that she was thinking about beginning her own business and inquired about possible opportunities for contracting for new business.