Selling Out

The Dangers of Allowing Nonattorney Investment in Law Firms

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Contents

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Executive Summary

American Bar Association (ABA) Model Rule 5.4 prohibits a law firm from sharing ownership of the firm with nonlawyers and from extending other investment or revenue-sharing opportunities to nonlawyers. Specifically, Rule 5.4 bars a lawyer or law firm from: sharing legal fees with a nonlawyer; forming a partnership with a nonlawyer; or practicing law for profit if a nonlawyer owns any interest in the lawyer's or law firm's practice. These requirements have existed in some form for over a century, and the ABA recently voted overwhelmingly to reaffirm them.

The restrictions are designed to protect clients' rights of confidentiality and loyalty and preserve the exercise of a lawyer's independent professional judgment in service to the client. The rule benefits not only clients, but also the attorneys who represent them, the public at large, and even judges.

Despite the important interests that this rule has served for decades, a persistent movement seeks to end or limit restrictions on nonlawyer ownership of and financial investment in law firms. Some argue that eliminating or modifying Rule 5.4 will increase access to legal representation. But those who stand to gain the most from these potential changes are not potential clients in need of legal services. Instead, changes to Rule 5.4 would unwittingly accommodate the questionable use of third-party litigation funding (TPLF) and benefit the firms that engage in it. TPLF is a rapidly growing business model in which third parties pay money to a litigant or his or her counsel in a lawsuit in exchange for a contingent interest in any proceeds from the litigation. TPLF firms stand ready to expand their operations from investing solely in discrete lawsuits to investment in entire law firms in states that will allow them to do so. Indeed, one TPLF firm touts itself as "the first legal financier to provide capital in exchange for law firm equity."[1] And one observer has warned that "[f]or-profit businesses have been studying moving into the legal field for a while, and the biggest barrier is Rule 5.4."[2]

"The rule benefits not only clients, but also the attorneys who represent them, the public at large, and even judges."

Converting courts into trading floors where people buy and sell lawsuits, and shares in the firms handling those lawsuits, based on their perceived merit cannot possibly expand the availability of legal services to a state's most needy citizens. Allowing nonlawyer ownership would have the unintended consequence of expanding this form of economic speculation in ways that would undermine the inviolable attorney-client relationship. As this paper explains in detail, authorizing nonlawyers to own or invest in law firms threatens to significantly decrease the quality of legal representation by, among other things: inserting questions about who is actually controlling the representation; creating inevitable conflicts of interest among lawyers, clients, and law firm owners or investors; and making the settlement of lawsuits more difficult, inefficient, and expensive (as at least one TPLF executive has admitted).[3]

While law firms certainly operate as businesses in some respects, the practice of law remains a profession. Maintaining the core values of that profession is critical to the profession's continued success and the protection of its welfare-enhancing role in society. For the many reasons explained in detail in this paper, states should not abandon Rule 5.4's prohibition on nonlawyer investment in law firms.

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Chapter

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Introduction

Just as participants in almost every other licensed industry have specific rules governing their conduct, lawyers in America are regulated by the rules adopted and enforced by the relevant authorities—typically, the state supreme court acting in cooperation with the state bar—of the state in which those lawyers practice or are licensed.

By and large, the rules adopted by these state authorities are based on the ABA's Model Rules of Professional Conduct.[4] "[M]ost states in the United States have adopted the Model Rules," although "interpretational differences exist among the jurisdictions, as do differences in the text of some of the rules."[5] The ABA Model Rules thus serve as a widely accepted blueprint for the state-level rules that govern lawyers across the country.

Preserving Loyalty and Confidentiality

The ABA's Model Rules include Rule 5.4, which prohibits a law firm from sharing ownership of the firm with nonlawyers—including TPLF firms, for example—and from extending other investment or revenue-sharing opportunities to nonlawyers.

Rule 5.4: Professional Independence of a Lawyer

Rule 5.4 states that:

(a) A lawyer or law firm shall not share legal fees with a nonlawyer, except that:

(1) an agreement by a lawyer with the lawyer's firm, partner, or associate may provide for the payment of money, over a reasonable period of time after the lawyer's death, to the lawyer's estate or to one or more specified persons;

(2) a lawyer who purchases the practice of a deceased, disabled, or disappeared lawyer may, pursuant to the provisions of Rule 1.17, pay to the estate or other representative of that lawyer the agreed-upon purchase price;

(3) a lawyer or law firm may include nonlawyer employees in a compensation or retirement plan, even though the plan is based in whole or in part on a profit-sharing arrangement; and

(4) a lawyer may share court-awarded legal fees with a nonprofit organization that employed, retained or recommended employment of the lawyer in the matter.

(b) A lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law.

(c) A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.

(d) A lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law for a profit, if:

(1) a nonlawyer owns any interest therein, except that a fiduciary representative of the estate of a lawyer may hold the stock or interest of the lawyer for a reasonable time during administration;

(2) a nonlawyer is a corporate director or officer thereof or occupies the position of similar responsibility in any form of association other than a corporation; or

(3) a nonlawyer has the right to direct or control the professional judgment of a lawyer.[6]

Limiting the Influence of Third Parties

Rule 5.4 exists to protect "client rights of confidentiality and loyalty" and to "preserve the exercise of a lawyer's independent professional judgment in service to the client."[7] The promotion of these underlying principles of confidentiality and loyalty has been a "primary purpose of the codes of legal ethics … since their inception in the United States."[8] Numerous other Model Rules further these same ends. For example, Model Rule 1.6 imposes rules on how a lawyer must handle confidential "information relating to representation of a client."[9] And Model Rule 1.7 prohibits certain representations that would create a conflict of interest with respect to multiple clients.[10]

Rule 5.4 promotes these fundamental principles by "limit[ing] the influence of third parties" on any given legal representation.[11] By making law firms beholden only to lawyers—and not to those with a purely financial interest in the firm, like TPLF companies who would seek ownership of law firms in the absence of Rule 5.4—the "regulation attempts to minimize the number of situations in which lawyers will be motivated by economic incentives rather than by their client's best interests."[12] One commentator has observed that if "jurisdictions relax their rules and all law firms admit nonlawyers as partners, the legal profession will risk a substantial loss of its independence."[13]

By making law firms beholden only to lawyers—and not to those with a purely financial interest in the firm, like TPLF companies who would seek ownership of law firms in the absence of Rule 5.4—the "regulation attempts to minimize the number of situations in which lawyers will be motivated by economic incentives rather than by their client's best interests."

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History of Rule 5.4

The restrictions imposed by Rule 5.4 have governed the American legal industry in some form for over a century. As this chapter explains, prohibitions on lawyers partnering with nonlawyers were already recognized in state statutes and case law when the ABA formally recognized these prohibitions in 1928, with amendments to the then-prevailing Canons of Professional Ethics.

The ABA reaffirmed its commitment to these Canons in 1969 when it adopted the Model Code of Professional Responsibility. The organization yet again reinforced these principles when it rejected proposals to discard them in promulgating the Model Rules of Professional Conduct in 1983, which remain in effect and serve as the basis of the lawyer ethics codes of many states across the country. Most recently, in August 2022, the ABA House of Delegates—which is the ABA's policymaking body—issued a resolution again reaffirming these principles.

Recognizing Established Norms

In 1908, the ABA promulgated the Canons of Professional Ethics (the Canons), which served as "a general guide" for the "duties of the lawyer in the varying phases of litigation or in all the relations of professional life."[14] Originally, the Canons included no restrictions similar to those now found in Rule 5.4. But in 1928, the ABA added Canons 33 through 35, which addressed the issue of lawyers partnering with nonlawyers or otherwise sharing legal fees with nonlawyers. Specifically, Canon 33, entitled "Partnerships-Names," provided that:

> Partnerships between lawyers and members of other professions or non-professional persons should not be formed or permitted where any part of the partnership's employment consists of the practice of law.

Canon 34, entitled "Division of Fees," provided that:

> No division of fees for legal services is proper, except with another lawyer, based upon a division of service responsibility.

Finally, Canon 35, entitled "Intermediaries," provided that:

> The professional services of a lawyer should not be controlled or exploited by any lay agency, personal or corporate, which intervenes between client and lawyer. A lawyer's responsibilities and qualifications are individual. He should avoid all relations which direct the performance of his duties by or in the interest of such intermediary. A lawyer's

> relation to his client should be personal, and the responsibility should be direct to the client.

The motivations behind these three "interrelated provisions" adopted in 1928 are best evidenced by an annotated version of the Canons (the 1926 Annotations) that was circulated two years earlier by the ABA Special Committee on Supplementing the Canons of Professional Ethics.[15] The 1926 Annotations quoted extensively from a 1920 report issued by a committee of the Conference of Delegates of Bar Associations (the Delegates Report).[16] The material quoted in the 1926 Annotations from the Delegates Report reveals at least three primary motivations underlying the adoption of Canons 33 through 35.

Law as a Profession

First, the practice of law is a profession that requires specialized training and strict requirements for admission. Specifically, the 1926 Annotations, quoting the Delegates Report, noted that "substantially all of the states make requirements for admission to the practice of law"—often including an "educational requirement"—and that most states require lawyers to be people "of good character" who "must take an oath of office" and "conform to the rules of court in respect thereto."[17] Because lawyers have earned the public's trust by complying with these strict standards of admission and ongoing regulation—and, indeed, cannot legally practice law without so complying—the 1926 Annotations reasoned that "a partnership or association of individuals, some of whom are not licensed to practice law and some of whom are so licensed, may not as such association or partnership lawfully and properly practice law or do law business."[18] Allowing nonlawyers to circumvent the requirements of admission to the bar and ongoing regulation simply by partnering with a lawyer would create "a positive injury and menace to society" and would be inappropriate in light of the fact that "the practice of the law is a right or franchise permitted or created by society for its protection and benefit rather than the protection and benefit of the practitioner."[19]

> "Allowing nonlawyers to circumvent the requirements of admission to the bar and ongoing regulation simply by partnering with a lawyer would create 'a positive injury and menace to society' …."

"Natural Persons" and the Right to Practice

Second, the 1926 Annotations noted that the requirements applicable for admission into and ongoing membership in the legal profession were designed to be satisfied by natural persons, not corporate entities like today's TPLF firms. The 1926 Annotations note that "substantially all of the states" require that an "applicant [to the bar] must be a natural person."[20] As the Delegates Report noted, it is "axiomatic" that "a corporation cannot practice law" because "[i]t is not a natural person, it possesses neither learning, good character, nor capacity to take an oath, or to preserve and occupy a personally confidential relation with a client."[21] The "right to practice is fundamentally a permissive franchise which inures only to a natural person possessing the required qualifications for such license, and that it may not and cannot be extended, or granted, to a corporation."[22] Practice of the law "is not a business in the general acceptation of that term, never was, and never can be."[23] Even in 1926, the legal community expressed concern about well-capitalized, profit-seeking corporations supplanting the professional judgment of lawyers acting in the best interest of their clients.

Preserving Public Trust

Third, the 1926 Annotations warned of the lack of public trust in the legal profession that could result from the "commercialization" of the practice of law, which would heat up retail-level competition between corporations pursuing greater market shares of the legal industry to the detriment of the public's trust in the profession. The 1926 Annotations explained that the "sole inducement of the layman to practice law and do law business is," just like the primary motivation of today's TPLF companies, "the fee derived therefrom." [24] The 1926 Annotations further warned that "to secure this" fee, "recourse is had to the ordinary commercial, competitive business methods of solicitation and advertising thereby commercializing the profession of the law and the law business, undermining the ethical and professional standards, and destroying public confidence in the lawyers and the courts with a clamor for recall of judges and decisions."[25] Specifically, the 1926 Annotations were concerned that "[t]he layman, a natural person or corporate, may only compete with the lawyer in the practice of the law and the doing of law business by orally soliciting or advertising to do it more expeditiously, faithfully, intelligently, and at less expense than the lawyer, thereby imputing to the lawyer slothfulness, infidelity, and extortion."[26] In the ABA Special Committee's eyes, this would inevitably lead to "[a] loss of confidence in the courts and lawyers," which was sure to be "a sign of government decline, and a forerunner of disintegration and anarchy."[27]

Importantly, after advancing these arguments about the dangers of lawyers partnering

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with nonlawyers—and characterizing the practice of law as a learned profession carried out only by natural persons governed by strict requirements who partner only with other natural persons governed by the same—the Delegates Report cites several pages of "[a]uthorities fairly sustaining th[is] definition" of what it means to practice law.[28] Thus, while Canons 33 through 35 may not have been formally adopted by the ABA until 1928, these Canons expressed the already-existing "consensus of legislature, bench and bar."[29] These well-established principles, as formally incorporated into the Canons, went on to govern lawyers for decades: during the 40 years that the Canons were in force,

"Ethical Code (EC) 3-1 explained that '[t]he prohibition against the practice of law by a layman is grounded in the need of the public for integrity and competence of those who undertake to render legal services' ...."

"they were interpreted consistently by the ABA Committee on Professional Ethics and Grievances to prohibit nearly any form of business association between lawyers and nonlawyers that offered legal services to the public."[30]

New Model Code Reaffirms Prohibition on Nonlawyer Ownership

In 1969, the ABA replaced the Canons with a Model Code of Professional Responsibility (the Model Code).[31] The format and organization of the Canons changed significantly when updated to create the Model Code.[32] But much of the substance stayed the same, including the regulations previously reflected in Canons 33 through 35. Disciplinary Rule (DR) 3-103(A) provided that "[a] lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law." DR 3-102(A) provided that "[a] lawyer or law firm shall not share legal fees with a nonlawyer" except in limited circumstances. And Canon 35's restrictions on a nonlawyer's control of a lawyer's services were reflected in various sections of the Model Code.[33]

The Model Code also formally set forth rationales justifying these and other restrictions, and many of them echo the reasoning that guided the original adoption of Canons 33 through 35. Ethical Code (EC) 3-1 explained that "[t]he prohibition against the practice of law by a layman is grounded in the need of the public for integrity and competence of those who undertake to render legal services" and observed that "the public can better be assured of the requisite responsibility and competence if the practice of law is confined to those who are subject to the requirements and regulations imposed upon members of the legal profession." EC-2 similarly noted that because the "sensitive variations in the considerations that bear on legal determinations often make it difficult even for a lawyer to exercise appropriate professional judgment, … it is therefore essential that the personal nature of the relationship of client and lawyer be preserved," uninfluenced by commercial interests, like those driving today's TPLF companies, or considerations other than the best interest of the client.

Strictly Limited Exceptions

In adopting the Model Code, there "seems to have been no significant debate as to the propriety of continuing the business prohibitions contained in the prior Canons."[34] To the extent that the 1969 Model Code loosened the ability of nonlawyers to share in legal fees or law-firm ownership, the Model Code did so only on a hyper-limited basis that the U.S. Supreme Court determined was constitutionally required. Decisions by the U.S. Supreme Court in the 1960s and 1970s recognized the Constitutional right of nonprofit organizations like labor unions and political organizations to provide members and beneficiaries with legal services.[35] The Model Code "grudgingly" recognized these decisions and went no further, as DR 2-103(D) permitted lawyers to be involved in those organizations "only in those instances and to the extent that controlling constitutional interpretation at the time of the rendition of the services requires the allowance of such legal service activities."[36]

During the 1969 discussions on the Model Code, the ABA House of Delegates rejected a more lenient version of the rule prohibiting nonattorney ownership of law firms. This alternative proposal would have allowed even "profit-making institutions to furnish legal services to members or beneficiaries," so long as the "organization did not derive any profit from the legal services."[37] The Chairman of the ABA Section of General Practice—"who claimed to have surveyed more than 9,000 members on the subject"—warned that, if this version was adopted, "the laymen will run the practice, and not the lawyers."[38] He warned that "[a]ll the evils that you can imagine will result from allowing laymen to run the law practice and not the lawyers: loss of the independence of the bar, loss of the traditional client/lawyer relationship, the encroachment of advertising, solicitation and the morals of the marketplace, a reduction in the quality of legal services."[39]

Six years later, however, the Model Code was amended to allow the provision of legal services by for-profit entities so long as the entity did not derive any profit from the legal services.[40] Even this modest relaxation of the rules, however, was based on the recognition that because the for-profit entity would not be able to derive profit from the legal services, it would therefore be unlikely to "interfere with the exercise of the lawyer's professional judgment."[41]

"Radical" Revision Movement

Unlike the adoption of the Model Code in 1969, the ABA's promulgation of the Model Rules of Professional Conduct in 1983 involved much more than just formatting changes and reorganization. Before proposing what would become the Model Rules, the ABA Commission on Evaluation of Professional Standards, known as the "Kutak Commission," spent "five years reviewing and reformulating the prior Model Code of Professional Responsibility."[42] The Kutak Commission initially proposed a "radical" overhaul of the Model Code's rules on lawyers partnering with nonlawyers.[43] Under this proposal, Rule 5.4 would have provided that:

> A lawyer may be employed by an organization in which a financial interest is held or managerial authority is exercised by a nonlawyer, or by a lawyer acting in a capacity other than that of representing clients, such as a business corporation, insurance company, legal services organization or government agency, but only if:
>
> (a) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship;
>
> (b) information relating to representation of a client is protected as required by Rule 1.6;
>
> (c) the organization does not engage in advertising or personal contact with prospective clients if a lawyer employed by the organization would be prohibited from doing so by Rule 7.2 or Rule 7.3; and
>
> (d) the arrangement does not result in charging a fee that violates Rule 1.5.[44]

In support, the Kutak Commission advanced arguments similar to those who want to repeal or amend Rule 5.4 today: The "Legal Background" section that "circulated with drafts" of the proposal argued that "[a]dherence to the traditional prohibitions has impeded development of new methods of providing legal services."[45] The Kutak Commission further asserted that there was, in reality, nothing to fear about lawyers partnering with nonlawyers: "[t]he assumed equivalence between employment [of a lawyer by a lay organization] and interference with the lawyer's professional judgment is at best tenuous."[46] And, because of the supposedly "tenuous" connection to any ethical concerns, the existing rules, the Kutak Commission argued, "may be viewed as" nothing more than "economic protectionism for traditional legal service organizations."[47]

ABA Staunchly Defends Protections

The prevailing consensus of the ABA House of Delegates, however, was staunchly opposed to the Kutak Commission's proposed rule and its asserted rationales on at least four different grounds.

First, the ABA House of Delegates worried that the Commission proposal "would permit Sears, Montgomery Ward, H&R Block, or the Big Eight accounting firms, to open law offices in competition with traditional law firms"[48]—not unlike the massive, well-capitalized TPLF firms of today, which, as explained in detail below, stand ready to acquire law firms at the moment they are allowed to by changes to Rule 5.4.

Second, the Delegates feared that the inevitable entry of these massive profit-seeking firms into the legal profession would severely "interfere with the lawyer's professional independence."[49] One participant in the debate noted that he could not "conceive that a lawyer can maintain his independence and his independent judgment over a period of time when he's on a salary from a corporation that's looking over his shoulder at his results in terms of profit."[50] Another suggested that "[t]he one who has the gold makes the rules, and the one [who] has the gold under [the proposed version of Rule 5.4] is going to be the nonlawyer."[51]

Third, the House of Delegates observed that "nonlawyer ownership would destroy the lawyer's ability to be a 'professional' regardless of the economic cost."[52] One participant in the debate acknowledged that it is not always "cost-effective" to "provide full representation," "zealously represent your client," and "spend enough time with your client to get the job properly done."[53] Whereas a trained attorney would view these tasks as nevertheless necessary to the practice of law, profit-driven businesses would not necessarily "view it that way."[54]

> "… [T]he House of Delegates observed that 'nonlawyer ownership would destroy the lawyer's ability to be a "professional" regardless of the economic cost.'"

Fourth, the "proposed change would have a fundamental but unknown effect on the legal profession."[55] At least one observer also noted that the safeguards prescribed by the proposed Rule 5.4 would fail to prevent the dangers identified above in no small part because the safeguards would be enforced against the lawyer; the business "venture isn't even under the jurisdiction" of the bar.[56] Ultimately, these arguments—which echoed many of the same arguments that guided the original enactment of Canons 33 through 35—carried the day and "an amendment offered by the ABA Section on General Practice, which basically substituted the prior Model Code provisions for the Commission proposal, was adopted."[57]

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Until very recently, "[e]very jurisdiction besides the District of Columbia ha[d] adopted a version of Model Rule 5.4 that is very similar to the one that appears in the ABA Model Rules."[58] Even in D.C., there are still significant limits on the ability of nonlawyers to take an ownership interest in a law firm. Under D.C.'s version of Rule 5.4, "a lawyer and a nonlawyer may … form a partnership" only if, among other requirements: (1) the "sole purpose" of the partnership is "providing legal services to clients"; (2) all persons with a financial interest in the form "undertake to abide by" the Rules of Professional Conduct regulating lawyers; (3) the lawyers agree to be responsible for the actions of the nonlawyer participants; and (4), critically, the nonlawyer "performs professional services which assist the organization in providing legal services to clients."[59] As this fourth requirement makes clear, the D.C. rule still does not allow "passive investment by nonlawyers or firm acquisitions by investors."[60] It instead has simply allowed a "small minority of D.C. firms [to] have one or more partners who are lobbyists or public relations professionals, rather than lawyers."[61]

Resolution Reaffirms Rule 5.4 Commitment

During a meeting in August 2022, the ABA's House of Delegates again reaffirmed its commitment to Rule 5.4. The House of Delegates issued a resolution reaffirming that "[t]he sharing of legal fees with nonlawyers and the ownership or control of the practice of law by nonlawyers are inconsistent with the core values of the legal profession."[62] In reaffirming these prohibitions, the House of Delegates offered several justifications for them.

First, excessive "nonlawyer involvement" in the practice of law "may invite, or at least open the door to, regulation of the practice of law and the legal profession by others besides the courts."[63] According to the House of Delegates, "self-regulation" of the legal profession is critical; it "helps maintain the legal profession's independence from government domination," and "abuse of legal authority is more readily challenged by a profession whose members are not dependent on government for the right to practice."[64]

Second, echoing a justification that has been offered since at least as early as the 1928 adoption of the Canons, the House of Delegates noted that "[l]awyers are subject to rigorous training in the law," but this is "not so for those outside the profession."[65]

Third and similarly, lawyers are "subject to the highest ethical standards"—including ethical standards that protect client confidentiality and prevent conflicts of interest, as discussed above—and "are accountable when they do not meet them," but nonlawyers are not.[66] Where "nonlawyers are not subject to a lawyer's management authority but share in the fee, there is no way to assure that the twin pillars of confidentiality and conflicts of interest are observed by the nonlawyer."[67]

Fourth, while lawyers are driven by the "profession's core values" like "undivided loyalty, competence, and confidentiality," nonlawyer investors will "not have this focus."[68] Fifth, lawyers who must respond to nonlawyer investors will inevitably be faced with the tension between the "competing duties to the client on the one hand, and to the shareholder, on the other."[69] Sixth, "[a]s officers of the court, lawyers must be independent and free from the influence of those who would compromise [lawyers'] ethics and the client interest"—like nonlawyer investors, including TPLF firms, who are driven more by maximizing the return on their investment than the best interest of the client.[70]

The House of Delegates rested its resolution not just on theoretical justifications for these prohibitions, but also empirical reality. The Resolution notes that most proponents of modifying Rule 5.4 argue that doing so will "improve[e] service to clients" and "advanc[e] access to justice."[71] But, the Resolution notes, "where programs have been implemented with these sorts of reforms, the impact does not appear to support that even these benefits will result."[72] For example, in Arizona, which has eliminated its version of Rule 5.4 (as discussed in detail below), the approved alternative business structures "do not appear to be focused on traditionally underserved practice areas ... like domestic relations, small claims, and landlord and tenant."[73]

Chapter

04

States Experiment With Weakened Protections

Despite the fact that nearly every jurisdiction has followed Rule 5.4 in some form for over a century, some jurisdictions have recently modified the rule. Other states have recently rejected Rule 5.4 modifications on many of the same grounds on which similar efforts have been rejected in the past.

The movement to eliminate or modify Rule 5.4—from which TPLF firms stand to benefit enormously—has had success so far in only two jurisdictions: Arizona and Utah. Arizona recently became the first and only state to eliminate its version of Rule 5.4, but this change was not without its detractors. Utah, taking a far more cautious approach, has begun experimenting with changes to Rule 5.4 within the context of a closely monitored regulatory "sandbox."

Arizona Eliminates Rule 5.4

In August 2020, Arizona entirely eliminated its version of Rule 5.4. In its place, the state implemented an "alternative business structure program" to license businesses that join nonlawyers with lawyers.[74]

Arizona recognized that it was implementing "the most far-reaching changes to the regulation of the practice of law of any state thus far."[75] Arizona Supreme Court Chief Justice Robert Brutinel said that the goal of these unprecedented measures was "to improve access to justice and to encourage innovation in the delivery of legal services."[76] The Chief Justice also warned, however, that "the changes must maintain the professional independence of lawyers and protect the public from unethical and unprofessional conduct."[77]

The Arizona rule change was not without its detractors. Chief Judge Peter B. Swann of the Arizona Court of Appeals, Division I, observed that there was no clear link between the elimination of Rule 5.4 and improved access to justice. While "[v]ague references to 'innovation' and 'a capital-intensive marketplace' make good fodder for brochures," the Chief Judge noted, "they do nothing to explain how [the rule change] would benefit the public or the profession."[78] Chief Judge Swann also warned that entities with a purely financial interest in a firm—untethered from any ethical obligation or client focus that would otherwise guide a lawyer—"ha[ve] no reason to care if a client has prevailed"

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and instead "care[] only about whether the value of its capital has been maximized."[79] While lawyers know they have an ethical obligation to implement practice techniques that constitute the "best measures for a client," institutional investors, by contrast, "can be expected to require practice techniques that represent the lowest cost."[80] Judge Swann further reasoned that the elimination of Rule 5.4, which exists in part to minimize conflicts of interest in general, could create more conflicts of interest: "a nonlawyer could own multiple firms—even on different sides of the same case"—and in "smaller communities, a nonlawyer could effectively monopolize the entire practice of law."[81]

A Failing Experiment?

Arizona's elimination of Rule 5.4 went into effect on January 1, 2021. By November of 2021, the state "ha[d] approved 12 legal companies to take part in its alternative business structure program."[82] As noted by the ABA House of Delegates' August 2022 Resolution reaffirming Rule 5.4, the "approved ABSs do not appear to be focused on traditionally underserved practice areas—those areas where the need for access has long been identified as greatest—like domestic relations, small claims, and landlord and tenant."[83] The Resolution notes that "[o]f the fifteen ABSs identified on the Arizona judicial branch's webpage, four focus on estate planning and wealth management; three deal with personal injury cases; three focus on taxation, business, and accounting services; two address general civil law issues (including LegalZoom); and two address immigration."[84] This calls into question whether modifying Rule 5.4 truly extends access to justice to those who need it the most, as many often argue.

While it is unclear whether underserved clients have benefited from Arizona's elimination of Rule 5.4, it is clear that a separate group—TPLF firms—stands ready to benefit enormously. Predictably, Arizona's elimination of its version of Rule 5.4 drew the attention of TPLF firms. William Farrell Jr., the co-founder and managing director of TPLF firm Longford Capital Management LP, noted that "[e]quity investors will start to take notice," and "[t]he first of those groups will likely be large-scale litigation funders like Longford Capital because we have the greatest relationships and insights into what makes law firms successful."[85] Farrell has made it clear that his firm "want[s] to be ready to seize [the] opportunities" created by these changes to Rule 5.4. Similarly, Burford Capital

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has referenced Arizona's elimination of Rule 5.4 as an opportunity for "legal finance providers" to "help law firms find innovative new paths to growth."[86]

Utah Tentatively Weakens Rule 5.4

In August 2020, the Utah Supreme Court issued Standing Order No. 15, which "establishe[d] a pilot legal regulatory sandbox and an Office of Legal Services Innovation to assist the Utah Supreme Court with overseeing and regulating the practice of law by nontraditional legal service providers or by traditional providers offering nontraditional legal services."[87] The Utah Supreme Court cited the "access-to-justice gap" as the basis for its decision and noted that this would be the court's "boldest step toward" addressing that issue.[88] The Standing Order predicts that the modifications will "shrink the access-to-justice gap by fostering innovation and harnessing market forces, all while protecting consumers of legal services from harm."[89]

The Standing Order describes its "regulatory sandbox" as "a policy tool through which a government or regulatory body permits limited relaxation of applicable rules to facilitate the development and testing of innovative business models, products, or services by sandbox participants."[90] Under this model, the Utah Supreme Court has created a system for allowing a limited number of market participants to act with limited or no restrictions on nonlawyers partnering with lawyers. Under the Standing Order, the Office of Legal Services Innovation (the Innovation Office) is tasked with: "evaluating potential entrants to the Sandbox and recommending to the Supreme Court which entrants should be admitted"; "developing, overseeing, and regulating the Sandbox, including establishing protocols and monitoring nontraditional legal providers and services therein, as well as terminating an entrant's participation in the Sandbox where deemed appropriate"; and "recommending to the Supreme Court which entrants be permitted to exit the Sandbox and enter the general legal market."[91] The Standing Order also prescribes five "regulatory principles" to guide the Innovation Office's rulemaking within the sandbox: (1) the regulation should be "based on the evaluation of risk to the consumer"; (2) that risk "to the consumer should be evaluated relative to the current legal services options available"; (3) the regulations "should establish probabilistic thresholds for acceptable levels of harm"; (4) the regulations "should be empirically driven"; and (5) the regulations "should be guided by a market-based approach."[92]

Utah's sandbox effort is, by its very nature, more tentative and exploratory than Arizona's. John Lund, Chair of the Innovation Office, has said "[t]he key element of difference between [Utah] and Arizona" is that Utah has "set this up as an experimental arena."[93] "None of the changes in Utah have been permanently embedded in the rules yet."[94] By contrast, "Arizona ... just decided to let [Rule 5.4] go away and do [alternative business structures] permanently."[95]

As of May 2021, there had been 28 sandbox participants in the Utah program.[96] These companies include: Xira Connect, a "software-based platform that connects legal consumers with Utah lawyers and state-licensed paralegal practitioners"; Hello Divorce, which "provides services to help dissolve marriages through a tech platform and lawyer employees"; and Lawpal, which provides "software-facilitated legal document assistance in family and housing law."[97] These and other sandbox participants involve lawyers employed or managed by nonlawyers, partial ownership by nonlawyers, or lawyers sharing legal fees with nonlawyers.[98] The entry of Hello Divorce and Lawpal into the sandbox might suggest that modifying Rule 5.4 might extend access to justice to traditionally underserved needs like domestic relations and housing law. But, given the experimental nature of Utah's regulatory sandbox, on which Utah is "collecting data," it is likely too early to tell whether these entities will be successful.[99]

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Chapter

05

Efforts to Weaken Rule 5.4 in Other States

While Arizona and Utah have relaxed their restrictions on nonattorney ownership of law firms, other states have recently reaffirmed their commitment to Rule 5.4 despite efforts to eliminate or modify the rule. Those states include Florida and California.

Florida Supreme Court Rejects Nonlawyer Ownership, Fee-Sharing

On November 6, 2019, the Supreme Court of Florida requested that The Florida Bar conduct a study "into whether and how the rules governing the practice of law in Florida may be revised to improve the delivery of legal services to Florida's consumers and to assure Florida lawyers play a proper and prominent role in the provision of these services."[100] The Florida Bar appointed a Special Committee to look into these issues, including the issue of splitting fees with nonlawyers.[101]

On June 28, 2021, the Special Committee returned with a Report recommending several revisions to Florida's version of Rule 5.4, all of which were relatively modest. First, the Report recommended amending Florida's Rule 5.4 "to permit nonlawyers to have a non-controlling equity interest in law firms with restrictions."[102] The Report endorsed the modest rule that was adopted in the District of Columbia (discussed above), which would require the nonlawyer with a non-controlling equity interest to be "actively support[ing] the work of the law firm."[103] The Report expressly stated that the rules "should not be amended to permit passive ownership of law firms,"[104] noting that allowing passive ownership would create "the risk of conflicts of interest and a possible impact on the lawyer's independent professional judgment."[105]

Second, the Report "recommend[ed] the elimination of the restriction on fee sharing with nonlawyers" within the confines of a Law Practice Innovation Laboratory Program that is analogous to Utah's regulatory sandbox.[106] This would allow lawyers to develop "more innovative ways to deliver legal services" like teaming up with technology companies "to streamline referrals, the engagement process, or case flow for situations where the client wants extra help."[107] Confining the launch of these changes to a Law Practice Innovation Laboratory Program would "permit[] the drafting of a final regulatory scheme based on empirical data rather than anecdotal observations and conjecture."[108]

On March 3, 2022, the Supreme Court of Florida rejected these proposals.[109] The court did not provide a lengthy explanation for the basis of its rejection.

"This language suggests that the court is concerned about the pressure that amending Rule 5.4 would put on the exercise of a lawyer's professional judgment."

But it did task the Florida Bar with a follow-up study of "alternative proposals," other than the rejected ones, to "improve the delivery of legal services to Florida's consumers and … assure Florida lawyers play a proper and prominent role in the provision of these services."[110] This language suggests that the court is concerned about the pressure that amending Rule 5.4 would put on the exercise of a lawyer's professional judgment.

The Supreme Court of Florida may also have been persuaded by various groups that opposed the proposed changes. For example, The Florida Bar's Board of Governors unanimously opposed the two amendments to Florida's Rule 5.4 proposed by the Special Committee. As one Board member, Josh Chilson, put it: "I'm troubled by the profound conflicts of interest the proposal would create between lawyers and their ethical obligations and nonlawyers that the court can't regulate who are entirely driven by profits."[111] Mr. Chilson, much like Chief Judge Swann in Arizona, was also concerned about the lack of an empirical link between relaxing Rule 5.4's restrictions and the stated goal of improving access to justice, saying: "I'm troubled that this is being offered with no real evidence that the proposal will improve access to justice," and "I'm troubled by the fact that the committee by its own admission never looked at what some of the proposals have done to other professions, including doctors, without improving access to the consumers."[112]

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California Staves off Revisions Amid Controversy

More recently, the California legislature sent a message to the State Bar of California that efforts to allow nonattorney ownership of law firms or the sharing of legal fees with nonlawyers would not be permitted anytime soon. Assembly Bill 2958 (2021-2022) added a new provision, § 6034.1, to the state's Business and Professions Code that holds that:

> [a]ny entity of the State Bar of California exploring a regulatory sandbox or the licensing of nonattorneys as paraprofessionals shall do all of the following: … [e]xclude corporate ownership of law firms and splitting legal fees with nonlawyers, which has historically been

> banned by common law and statute due to grave concerns that it could undermine consumer protection by creating conflicts of interests that are difficult to overcome and fundamentally infringe on the basic and paramount obligations of attorneys to their clients.[113]

The California Legislature approved the bill on August 22, 2022, and it was signed into law by California Governor Gavin Newsom on September 18, 2022.[114]

The legislation was passed after the State Bar of California had, in 2020, "convened a working group to examine modifying ethics laws to allow nonlawyers to share legal fees or own law firms" as part of a "regulatory 'sandbox' program" similar to Utah's.[115] One of the bill's co-sponsors, Assemblymember Mark Stone, said that the law was meant to focus the State Bar on more important issues. After controversy surrounding the State Bar's "mishandling of allegations involving … a high profile plaintiffs' lawyer who [was] accused by a rival law firm of using client settlement funds to fund a lavish lifestyle," the bill, according to Assemblymember Stone, would return the State Bar's focus to its "core mission of protecting the public."[116] Nevertheless, despite these resource-focusing justifications for the law, it is also clear from the text of the bill, as quoted above, that the legislation was driven at least in part by many of the justifications underpinning the common-law and statutory prohibitions on nonattorney ownership of law firms that have prevailed for over a century. The failed effort to modify Rule 5.4 in California also came against the backdrop of comments submitted to the State Bar of California by the U.S. Chamber of Commerce Institute for Legal Reform (ILR), warning that these modifications "could turn California courts into casinos," "undermine attorney-client privilege by fueling third-party litigation funding," and "make it even easier for funders to exert undue influence and control over litigation."[117]

Other States Mull Changes

Other states that have recently considered legal regulatory changes to their own jurisdiction's version of Rule 5.4 include New York, Illinois, Michigan, and North Carolina.[118] Many well-capitalized institutional investors have watched these efforts to eliminate or modify Rule 5.4 with keen attention, recognizing the potential for profit that awaits.

A number of these potential investors are already in the business of TPLF. TPLF has become massive, with some commentators estimating that, as of 2019, "[l]itigation finance [had] soared to a $39 billion global industry."[119] Eliminating Rule 5.4 would allow this industry to expand even further. As indicated by the quote above from Longford Capital Management

Managing Director William Farrell Jr., "[e]quity investors will start to take notice" of these changes to Rule 5.4, and "large-scale litigation funders like Longford Capital" are likely to get involved in the ownership of law firms in states that allow them to.[120] Similarly, the managing director of Burford Capital, another major TPLF firm, noted that eliminating Rule 5.4 would give Burford even more opportunities than current TPLF approaches because it would allow Burford to be a "broader investor in the [law] firm's profitability over time" rather than confining itself to individual claims or tranches of claims.

Consequently, TPLF firms are ready and waiting to move beyond the funding of discrete litigation matters to full ownership of law firms. According to David B. Seserman, the co-chair of the ABA Litigation Section's Solo & Small Firm Committee, "the biggest barrier" to these firms' entry into law firm ownership is "Rule 5.4."[121] Accordingly, TPLF's migration into law firm ownership is likely conditioned only on the number of states that elect to eliminate or reduce the restrictions of Rule 5.4.

Similarly, the managing director of Burford Capital, another major TPLF firm, noted that eliminating Rule 5.4 would give Burford even more opportunities than current TPLF approaches because it would allow Burford to be a "broader investor in the [law] firm's profitability over time" rather than confining itself to individual claims or tranches of claims.

Chapter

06

The Many Dangers of Treating Law as a Business

The core problem with allowing nonlawyers to acquire a financial interest in a law firm has been articulated time and again throughout the history of the rules prohibiting such arrangements.

Allowing nonlawyers to invest in law firms—essentially becoming the law firm's shareholders—risks replacing the lawyer's independent judgment with concerns about maximizing profit, no different from any other business. This will have significant adverse effects on clients, lawyers, judges, and the public. For these reasons, states should resist efforts to roll back their own versions of Rule 5.4.

Nonattorney Ownership Undermines Independence

Allowing nonattorney ownership of law firms would allow nonlawyer investors in law firms to improperly interfere with the professional independence of lawyers. Model Rule 1.3 requires lawyers to "act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf." A nonlawyer financier of a law firm has no similar obligation or motivation and is driven instead by the pursuit of profits.

The problems associated with these divergent interests are already apparent in the context of TPLF arrangements, where the litigation funder is motivated by maximizing its investment rather than the best interests of the underlying client. Indeed, TPLF firms are typically accountable to investors; in late 2021, Longford Capital boasted of $682 million that it had raised for a new fund.[122] These investors, like investors in any other enterprise, are looking for a return on their capital, and TPLF firms are under pressure to deliver. These firms openly boast of the market-beating returns their investments can offer, even and especially when TPLF firms opportunistically take advantage of economic downturns and resulting corporate malfeasance. Burford Capital's 2022 Interim Report notes that because "[t]he reality of business life is that downturns and economic pressures ... give rise to bad behavior by companies which in turn leads to litigation and insolvency," TPLF firms like Burford Capital "tend to do well in periods like these."[123] ILR has previously conducted extensive research on the harms presented by TPLF arrangements and recorded its conclusions

> "These investors, like investors in any other enterprise, are looking for a return on their capital, and TPLF firms are under pressure to deliver."

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in a white paper entitled *Selling More Lawsuits, Buying More Trouble: Third Party Litigation Funding a Decade Later*.[124] That paper warned that giving a third-party funder "a financial stake in a lawsuit" will "naturally" result in that funder "seek[ing] to control the lawsuit and, as a result, the lawyers being funded by that third party will be controlled by that third party, sometimes to the detriment of the actual party in interest."[125] This control would be even more acute and unbridled if funders—or any other well-capitalized, profit-driven entity—were permitted to invest in entire law firms, and not just the individual claims that they handle.

Funders Are Incentivized to Seek Control

There is little question that a third party with a financial interest in a law firm would seek to exert control over the operation of the individual matters handled by that law firm. Any nonlawyer that is "likely to be attracted to make such an investment would want to be financially dominant in the law firm, and it is reasonable to assume that financial dominance confers control, either through outright ownership, or through the functional equivalent of outright ownership."[126] Entities seeking to acquire ownership of law firms "are businesses, operated with the [same] goal of maximizing return on investments" that motivates any other business in any other industry. And in order to "protect their investments and to maximize the expected value" of the claims handled by the law firm, the nonlawyer owners of the firm would, just like third-party funders currently do, "seek to exercise some measure of control over the litigation, including the identity of lawyers pursuing the claims, litigation strategy to be employed, and whether to accept a settlement offer or refuse it and continue to trial."[127]

Some may suppose that nonlawyer law-firm owners or legal-fee sharers would be content with ownership of a law firm without exercising control over it. But the reality of the TPLF context reveals that truly passive investment of this kind is rare. To the contrary, there are numerous examples of funders insisting on contractual rights of control over the claims that they fund, and there is no reason to think that nonattorney owners of law firms would behave any differently. For example, in one Florida case, the court found that a TPLF agreement gave the funder the right "to approve the filing of the lawsuit; controlled the selection of the plaintiffs' attorneys; recruited fact and expert witnesses; received, reviewed and approved counsel's bills; and had the ability to veto any settlement agreements."[128]

Many such other examples abound. In *White Lilly v. Balestriere*, a federal case in New York, a third-party funder itself filed a lawsuit. In its complaint, the funder alleged that its TPLF agreement required that the plaintiff in the underlying lawsuit was to be represented by a specific lawyer, chosen by the funder, who had an existing relationship with the funder. The complaint also alleged that the funder was entitled to make key decisions throughout the course of the lawsuit, insisting on the general right to an "'ombusdman' to oversee the cases it ultimately invested in, and to ensure that the [lawsuits] asserted viable claims and were litigated properly and efficiently."[129]

Similarly, the U.S. Court of Appeals for the Sixth Circuit held that a series of agreements between a litigant and a funder violated Kentucky's prohibitions on "champerty"—which is the funding of a lawsuit by someone with no other interest in the dispute—because the terms of those arrangements gave "substantial control over the litigation."[130] Among other restrictions, the agreements "limited [the claimant's] right to change attorneys without [the funder's] consent" or else the claimant would be "required to pay [the funder] immediately."[131] The funder also "had the right to examine the 'case files and to inspect the correspondence, books and records relating to [the plaintiff's] case or claim.'"[132]

Gbarabe v. Chevron Corp.

Likewise, an agreement between a funder and the litigants in the case of *Gbarabe v. Chevron Corp.* called for the funder and counsel to develop a "Project Plan" for the litigation.[133] The agreement prohibited deviations from the Project Plan; for example, the client was prohibited from hiring expert witnesses that had not been approved by the funder.[134] The agreement expressly prohibited the lawyers from engaging any co-counsel or experts "without [the funder's] prior written consent."[135]

The agreement further required that counsel "give reasonable notice of and permit [the funder], where reasonably practicable, to attend as an observer at internal meetings, which include meetings with experts, and send an observer to any mediation or hearings related to the Claim."[136]

Chevron Corp. v. Donziger

Additionally, in *Chevron Corp. v. Donziger*, the TPLF agreement provided funder Burford Capital with control over the litigation through the "installment of 'Nominated Lawyers'" that had been "selected by the Claimants with the Funder's approval."[137] The agreement required the appointment of "a firm with close ties to the Funder" as a "condition precedent to the funding."[138] In addition to "exerting control, it [was] clear that the" funder-selected and funder-controlled Nominated Lawyers "control[led] the purse strings," "serve[d] as monitors," and "supervise[d] the costs and course of the litigation."[139]

Compromising Professional Judgment

Even TPLF providers' own operational manuals indicate a clear preference for control over their investments. The 2017 "best practices" guide of Bentham IMF, one of the world's largest TPLF firms, noted the importance of setting forth specific terms in TPLF agreements that address funder control. According to this manual, it is a best practice for a TPLF provider to insist on contractual rights to: "[m]anage a litigant's litigation expenses"; "[r]eceive notice of and provide input on any settlement demand and/or offer, and any response"; and participate in settlement decisions.[140]

Even if the financier's control over litigation is not memorialized clearly in an agreement, the mere economic pressure exerted by the funding will likely be enough to make the lawyer change their decisions if the funder wants them to. That is because lawyers backed by "outside investors are likely to be concerned about the enterprise's reputation within the investor community."[141] The "failure to meet a projected financial target can lead to a drop in stock price or the loss of a needed private equity investor."[142] And the concern about reputation in the investor community "may make these enterprises more likely to focus on meeting investors' targets" and less on the best interests of the clients. These financial pressures may also force a law firm away from "public-spirited goals" like pro bono work and other risky but publicly important cases.[143]

The realities of these financial pressures are already apparent in foreign countries that allow nonlawyer ownership of law firms. For example, Quindell, an alternative business structure lawyer-referral program in the United Kingdom, "lost half its stock value in one day after an unfavorable market report" from a firm shorting its stock.[144] And when a nonlawyer-owned law firm, Slater & Gordon, lost a major consumer drug class action in 2012, it led to a 10.5 percent profit loss for the firm that year.[145] This very public defeat led its chairman to reassure the market that it would change the class actions it selected.[146] These stories serve as a warning sign that if nonlawyers are permitted to acquire an ownership interest in law firms, the lawyers' "professional judgment [will likely] be compromised by the need to hit certain quarterly goals."[147]

> "The realities of these financial pressures are already apparent in foreign countries that allow nonlawyer ownership of law firms."

Funder Control De-Prioritizes Client Interests

As explained above, there can be little doubt that a nonlawyer entity with a purely financial interest in a law firm will desire to exert control over the operation of the law firm and the individual matters that the law firm handles. It is equally clear that these entities will exercise that control with an eye toward maximizing profit, rather than protecting the best interest of the client. Commentators have observed that, in the TPLF context, the "efforts of suppliers to maximize the return on their investment may create incentives and effects that differ from what would be expected in a similar case in which [alternative litigation funding] was not present."[148] For example, clients often file lawsuits not for monetary compensation but to pursue what they perceive to be the just outcome. This motivation would be utterly irrelevant to a nonlawyer investor in a law firm.[149] The pressure to turn a profit on each matter would thus likely "interfere with the lawyer's exercise of candid, objective, independent judgment on behalf of the client" and the client's objectives.[150]

Diverging Interests

There are many junctures in litigation at which a nonlawyer financier's interest may deviate from the client's. For example, who is the lawyer to listen to when a nonlawyer financier and a litigant disagree about whether to settle a claim early or press on for a substantial but unlikely jury verdict? In this situation, the funder, driven primarily by the desire to maximize its profit, may be more willing to take the risk of trial in hopes of a windfall profit. Indeed, as an executive of a prominent TPLF company recently acknowledged, litigation funders "make it harder and more expensive to settle cases."[151] This admission makes clear that funders are already influencing decision-making in cases they fund and are likely to do so on a larger scale if they are permitted to acquire ownership interests in entire law firms.

> "The pressure to turn a profit on each matter would thus likely 'interfere with the lawyer's exercise of candid, objective, independent judgment on behalf of the client' and the client's objectives."

Similarly, in decisions over hiring expert witnesses, a funder would likely focus on the expert who can deliver the greatest payout at the lowest cost, rather than an expert whose fees are higher but who, relatedly, is more respected in their field and thus whose opinion is more likely to be accepted by the trier of fact. So too with decisions about whether to hire co-counsel or local counsel—and, if so, which counsel to hire. As explained above, TPLF funders already exert control over all of these decisions in individual matters, and there is no reason to think that law firm investors would behave any differently. As recognized years ago at the House of Delegates' debate over Rule 5.4, while a lawyer would approach each of these decisions with the goal of "provid[ing] full representation" and "zealously represent[ing] [her] client," a profit-maximizing nonlawyer investor likely would not "view it that way."[152]

The on-the-ground reality in the TPLF context has confirmed these divergent incentives. For example, in *Weaver, Bennett & Bland, P.A. v. Speedy Bucks, Inc.*, one party alleged that a TPLF firm "keeping tabs" on its investment forced the funded plaintiff to reject a reasonable settlement offer because, it was inferred, the funder thought more money could be secured at trial.[153] Similarly, in the *White Lilly* case discussed above, the TPLF entity asserted that it had been assured before funding the matter that the "proposed litigation" would settle "quickly," thus creating a finance-backed expectation of early settlement, regardless of whether the client wanted to proceed to trial.[154]

Funder Control Plus Nonattorney Ownership: A Recipe for Divided Loyalties

Eliminating Rule 5.4's prohibitions on litigation funders having an ownership interest in law firms would exacerbate the negative consequences that TPLF creates for plaintiffs. By stripping these protections, funders will be able to exercise control over entire law firms and their decision-making processes, not just the individual cases or portfolio of cases they are financing. The greater scope of investment in legal services by nonlawyers, including third party funders, in the context of eliminating Rule 5.4 has at least two negative ramifications for clients.

First, it could lead to a law firm not selecting clients whose claims are meritorious and just, but not lucrative (or as lucrative as others). Clients often pursue lawsuits not for compensation but to effectuate what they perceive as justice for wrongs against them. Third-party owners of law firms would likely pressure law firms not to take these cases at all. As one commentator has observed, "[l]itigation finance ownership would be a radical shift in how firms are structured and run" because while "[c]urrently, the financiers pay for individual lawsuits—or tranches of them"—their ownership of law firms "would give the funders more say in how firms spend money and which cases they take."[155] In this way, TPLF would ironically decrease access to justice.

Second, with TPLF, the client usually at least has the option of whether to agree to a TPLF arrangement with respect to particular claims. In this sense, a client at least has the appearance of a choice about whether to subject itself to all the conflicts of interest inherent in TPLF. But by giving financiers the ability to control entire law firms, prospective clients will be left with far less choice. Perhaps a particular law firm is the most experienced in the subject of the client's matter in the client's market. If that law firm is controlled by a nonlawyer investment company, the client may be forced to proceed with using it anyway. The client will have had no real say in whether it agreed to the conflicts

> **“Clients in [smaller] communities may be rejected altogether—or, at a minimum, forced to look outside their own geographical area—if those clients are motivated by justice rather than money, if their claim is not as lucrative as others, or if their claim is otherwise not worth the financial investment.”**

of interest that are often inherent when a third party invests in a legal matter.

Both of these effects will be particularly pronounced in smaller communities. As Arizona Judge Swann recognized, in “smaller communities, a nonlawyer could effectively monopolize the entire practice of law.”[156] Clients in these communities may be rejected altogether—or, at a minimum, forced to look outside their own geographical area—if those clients are motivated by justice rather than money, if their claim is not as lucrative as others, or if their claim is otherwise not worth the financial investment. Alternatively, these clients may have no choice but to select a law firm that will be responsive not to the client’s own needs but to the investor’s balance sheet. These developments are thus likely to significantly decrease the availability and the quality of legal representation in America.

Walking a Legal Minefield

The conflicts of interest created by nonattorney ownership of law firms will exert enormous pressure on attorneys. That is because lawyers already owe many ethical duties to their clients. For example, Model Rule 1.3 requires lawyers to be “zealous advocates” for their clients: “A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client’s cause or endeavor.” The rule further provides that “[a] lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client’s behalf.” These duties will come under significant stress when a lawyer no longer reports only to clients and other lawyers subject to the same duties, but also to a nonlawyer investor whose sole motivation is the profitability of the firm.

Similarly, Model Rule 1.2 provides that “a lawyer shall abide by a client’s decisions concerning the objectives of representation and … shall consult with the client as to the means by which they are to be pursued.” This rule gives a client authority to decide whether to pursue a matter at all—a decision that may be, as explained above, driven by non-pecuniary motives—and the rule also gives clients express authority over decisions like “whether to settle a matter.” As shown by numerous examples above, without Rule 5.4, a lawyer answering to nonlawyer investors will be forced to consider other interests when making these decisions.

"Nonlawyer ownership of law firms would likely 'create[] a whole new set of fiduciary responsibilities' obligating the lawyer. 'Investors want to see a profit; shareholders are owed a fiduciary duty.'"

These conflicting obligations go beyond mere pressure to make the nonattorney investors happy. Nonlawyer ownership of law firms would likely "create[] a whole new set of fiduciary responsibilities" obligating the lawyer. "Investors want to see a profit; shareholders are owed a fiduciary duty."[157] A lawyer would likely have to answer, as a matter of law, to this new interest even though this obligation "ha[s] nothing to do with clients or their interests" and, indeed, directly contradicts the lawyer's obligation to her clients. How a lawyer is to navigate this legal minefield is entirely unclear.

These conflicting loyalties might also cause the public at large to lose trust in the legal industry. The 1926 Annotations warned that the "commercialization" of the law would suggest to the public that lawyers are dealing in "slothfulness, infidelity, and extortion," which would lead to "[a] loss of confidence in the courts and lawyers." By forcing lawyers to be torn between their competing legal obligations to both the client and investors, it is very likely that both communities would lose faith in the legal profession as a whole.

Endangering Judicial Impartiality

Allowing nonattorneys to own law firms would not only put lawyers in a legal and ethical minefield. It would also threaten to do the same for judges. According to Canon 2 of the Code of Conduct for United States Judges (the Codes of Conduct), which governs federal judges, judges must avoid even the appearance of impropriety in all activities.[158] Specifically, "[a] judge should not allow financial … or other relationships to influence judicial conduct or judgment."[159] The Codes of Conduct also require judges to carry out their duties "impartially," disqualifying themselves from any matters in which they have a "financial interest."[160]

While judicial impartiality, and the appearance thereof, has always been important, it has been particularly salient as of late. In 2021, the *Wall Street Journal* reported that "[m]ore than 130 federal judges" oversaw, in whole or in part, "court cases involving companies in which they or their family owned stock."[161] This occurred despite the fact that nearly every federal court requires litigants to disclose the parties that are interested in a lawsuit and federal judges themselves must disclose their financial investments.[162] Even this well-established disclosure regime was unable to stamp out all appearance of impropriety because of the realities of how these disclosure regimes were effectuated: some of the

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judges discussed in the *Wall Street Journal* report identified "flawed internal procedures" for the failure to notify the judges that recusal was necessary.[163]

These problems are already exacerbated by the current lack of disclosure of TPLF in individual cases; they will only be exacerbated further by allowing nonlawyers to obtain an ownership interest in law firms. Rather than considering only the parties involved in a dispute, judges will need to scrutinize the law firms representing those parties and those firms' investors to try to discern potential financial conflicts. This will prove extraordinarily difficult to do. Many of these law firms will likely be backed by multibillion-dollar global companies, just as many TPLF entities are, each of which having their parent companies, subsidiaries, and other affiliates. Disclosure regimes alone will be unlikely to provide a complete solution to the problem, just as existing disclosure regimes have failed to completely ensure impartiality with respect to the parties in litigation.

Concerns of this kind are already on display in the TPLF context. In a deposition in the *Donziger* case discussed above, the lead plaintiffs' lawyer was asked to identify the company that had financed the underlying lawsuit against Chevron.[164] After revealing that the funder was Burford, the special master in the case disclosed that he was former co-counsel with the founder of Burford, that he had received marketing materials from that same individual aimed at litigation funding, and that he was friends with Burford's former general counsel.[165] While the special master did not recuse himself—and the parties did not insist that he do so—this points to the potential conflicts that already exist in the opaque world of TPLF.[166] Allowing nonattorney ownership of law firms will only increase the complex web of interactions for judges, arbitrators, and other decision-makers, creating a severe threat to the appearance of judicial impartiality. This too risks eroding public trust in the judicial system.

Nonattorney Ownership Would Not Increase Access to Justice

As explained in detail below, there is no guarantee that the detriments created by nonattorney ownership of law firms will be outweighed by increased access to justice, which is perhaps the most often cited justification for modifying Rule 5.4. Eliminating Rule 5.4 would decrease access to justice for some clients, like those clients that are unpopular or those clients in small communities where a single third-party investor has monopolized the legal market. There is also “reason to doubt that” eliminating Rule 5.4 will “lead to significantly more access to legal services for poor and moderate income populations.”[167] That is because “[n]on-lawyer owners are likely to be attracted to legal sectors, like personal injury, that are relatively easy to commoditize and where expected returns are high.”[168] But “these lucrative sectors are less likely to have an access need because of long-standing practices like conditional or contingency fees.”[169] Other areas of law, like family or immigration law, that “require significant tailoring to the specific situation of the client” may be “difficult to scale or commoditize.”[170] It is thus likely that the areas of law in greatest need of increased access to justice will not benefit from nonattorney ownership of law firms, and the people in greatest need of legal representation will still be without it even after deregulation of nonattorney ownership of law firms. This is consistent with the analysis of the ABA House of Delegates, which observed that the currently registered ABSs in Arizona

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"do not appear to be focused on traditionally underserved practice areas ... like domestic relations, small claims, and landlord and tenant."[171]

Even if commoditization is possible in these contexts, persons with "civil legal needs frequently have few resources and complicated legal problems," meaning that "nonlawyer ownership is unlikely to provide these persons with significant new legal options, as they will still be unable to afford legal services."[172] Finally, many people in need of legal services are deterred by "cultural or psychological barriers"—not pricing—meaning that "there may not be as much price elasticity in the market for some legal services as advocates of deregulation suggest."[173] It is thus quite likely that eliminating or modifying Rule 5.4 would bring with it all the problems created when profit-driven investors interfere with a lawyer's representation of a client without doing much to increase access to justice in the areas that need it most.

Directly Harming the Public

While likely failing to deliver supposedly projected benefits, eliminating or weakening Rule 5.4 would also directly harm the public in a number of ways. First, these changes would likely saddle the courts—and undeserving defendants—with frivolous and abusive litigation. That is because the profit-seeking motive of third-party law firm funders would likely push them to gamble on questionable and sometimes fraudulent litigation. Even if a lawsuit has little or no merit, it may be worth the funder's investment if there is a possibility (however small) of recovering a very large sum of money. For example, in the *Donziger* litigation, it was revealed that the funded litigation had been riddled with fraud on the part of the plaintiff's lawyers. Nevertheless, despite being aware of at least the allegations of such fraud, Burford moved forward with funding the litigation, thereby showing the "high-risk appetites" of companies that would likely seek ownership of law firms and their willingness to "back claims of questionable merit."[174]

Second, nonattorney ownership of law firms could threaten national security and the independence of American courts from foreign influence. Among the investors currently involved in TPLF are sovereign wealth funds, which are state-owned investment funds comprised of money generated by governments. As one commentator notes, "[h]edge funds, private equity and sovereign wealth funds are piling billions into the outcome of high stakes court cases at a faster rate than ever before."[175] Allowing foreign governments to invest in American lawsuits would allow those governments to exercise significant influence in the American legal system, even in cases that do not involve the interests of foreign governments or companies located in foreign countries. As ILR's previous research on the subject has found, these foreign investors could: "seek to exert control over the strategy and outcome of a U.S. civil dispute by manipulating common provisions of litigation funding agreements that permit control or influence over the litigation"; "encourage and exploit commercial disputes involving U.S. companies to advance their national interests"; "use litigation funding to gain access to sensitive or otherwise unavailable information related to either of the litigants"; and "fund litigation focused on divisive issues to influence domestic U.S. politics in a way that advances its strategic interests."[176]

Third, as explained above, nonlawyer ownership of law firms would likely undercut the "public-spirited goals" that many law firms currently pursue. When law firms are subject to the review of profit-seeking investors, efforts like "pro bono work" or other financially risky but publicly important cases become particularly undesirable because they do not fit the purely pecuniary interests of the finance-backed firm.[177] Law firms might change their behavior in this respect not only "on the orders of nonlawyer owners," but also if the law firms "merely believe such a change will help increase their firm's reputation in the investor community."[178]

Fourth, another way in which firms' public-spirited goals may be undermined by nonattorney ownership is by the decreased representation of unpopular clients. Companies that provide legal services as well as other services "may be less likely to offer legal services to publicly unpopular clients out of fear of harming the larger brand of their company."[179] Law firms might already be subject to these pressures, but allowing nonattorney ownership of law firms will likely only exacerbate it. Interviews with decision-makers for third-party-funded legal services companies in the United Kingdom have revealed that these concerns do factor into decisions on which clients to represent.[180] Thus, these unpopular clients, "who already face discrimination from many law firms, might be further marginalized and have fewer alternatives in a market with a smaller number of providers that are highly sensitive to public opinion."[181]

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Chapter

07

Conclusion

Increasing access to justice is put forward as a rationale for many efforts to weaken or eliminate Rule 5.4. But whatever the motivations of this movement, the results are clear.

Allowing nonattorney ownership of law firms will allow large, well-capitalized, profit-seeking investment funds to supplant the professional judgment of lawyers who are obligated to serve their clients' best interests. This development would be a detriment to clients, lawyers, judges, and the public at large. Many of the negative effects on these groups can already be perceived in the context of TPLF. And the problems associated with TPLF would only be magnified if, rather than investing in individual claims or tranches of claims, these companies now were permitted to buy entire firms or shares of firms. For these reasons, the Florida Justice Reform Institute and ILR discourage the abandonment of Rule 5.4's prohibition on nonlawyer investment in law firms.

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