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Navigating the Sea Change in Law Firm Finance and Ownership in the U.S.

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For years, Australia and the U.K. have been the pioneering jurisdictions regarding ownership of law firms. Now, there's a new kid on the block. Recent developments in a few U.S. states, predominantly Arizona, and a new approach by the American Bar Association (ABA) signal a broad reexamination of the long-entrenched prohibition on non-lawyer participation (ownership and management) in law firms. Regulation of American lawyers and law firms takes place at the state level, with regulatory innovations in one state often inspiring others. It is unsurprising, therefore, that other states are already following Arizona and actively considering making similar changes. If the precedent of the global rise of third-party funding is any guide, the changes in the U.S. will likely lead to an acceleration of non-lawyer participation in the practice of law globally. This post surveys and analyzes the recent changes in the U.S., identifies some of their likely effects on international arbitration, and concludes with a call for action to the international arbitration community and, in particular, arbitral institutions.

The prohibition on non-lawyer participation in the practice of law has long been the rule in every U.S. state, typically under each state's version of ABA Model Rule 5.4 of their Rules of Professional Conduct, which includes a prohibition on fee-sharing and joint law firm ownership between lawyers and non-lawyers. The District of Columbia, however, is not (yet) a state, and for decades, the sole exception to the fee-sharing prohibition in the U.S. has been Rule 5.4(b) of the D.C. Rules of Professional Conduct, which allows partial, limited non-lawyer ownership of law firms. In the 1980s, D.C. adopted this exception to Rule 5.4's general prohibition on fee-sharing with non-lawyers to allow law firms to recruit former government employees, lobbyists, politicians, and other non-lawyers by offering them lucrative ownership positions in law firms, rather than employee positions. Although there have been a few notable instances of non-lawyer owners of D.C. firms, there has never been large-scale, non-lawyer ownership of law firms in D.C. Instead, other states have led the changing conversation regarding how law firms are owned, lawyer fees are shared, and legal services are funded.

New York provides a recent example of a state reinforcing, and then rethinking, its Rule 5.4 prohibitions. The proliferation of portfolio funding—the funding of pools of cases with funding being provided directly to law firms rather than to clients—garnered the attention of the New York City Bar Association (NYCBA). The practice raised questions concerning compliance with Rule 5.4 of New York (State) Rules of Professional Conduct, which prohibits fee-sharing between

lawyers and non-lawyers. In July 2018, the NYCBA reaffirmed in Formal Opinion 2018-5 that "a lawyer [who] enter[s] into a financing agreement with a litigation funder, a non-lawyer, under which the lawyer's future payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters" violates Rule 5.4's prohibition on fee-sharing with non-lawyers.

After issuing this opinion, the NYCBA was pressured to rethink and revise its guidance since many New York law firms, including several prominent ones, were already engaged in the practice of portfolio litigation funding. In response, the NYCBA created a Working Group to revisit its position. In 2020, the Working Group issued its final report which reiterated its understanding regarding the existing state of the law but went a step further to conclude that "lawyers and the clients they serve would benefit if lawyers have less restricted access to funding." Due to the controversial nature of the emerging practice and its implications to law firms and lawyers, especially among different factions of the New York legal profession, no consensus was achieved on a concrete proposal for a change of the rules. Instead, the Working Group offered two alternative proposals for reform without endorsing either one. Both proposals relied heavily on disclosure of the funding to the clients as the main regulatory mechanism but differed on whether client consent should be required. To date, the debate in New York remains just that—a debate; the law in New York has not (yet) changed.

On the other end of the spectrum, Arizona has emerged as the vanguard state. In January 2021, Arizona eliminated its traditional Rule 5.4 prohibition on non-lawyers sharing in lawyers' fees. Instead, Arizona now allows non-lawyers to hold an economic interest in a law firm through an Alternative Business Structure (ABS), and to participate in the management of a law firm. Specifically, Arizona implemented significantly looser restrictions on who can legally own a law firm (pretty much anyone) and how much ownership they can have (a majority) as well as a framework for licensing, regulation, and sanctions for misconduct of ABSs under the auspices of the Arizona Supreme Court. Interestingly, however, Arizona has rejected the notion that disclosure is the sole, or even main, component of the proper regulation of non-lawyer participation in law firms. Instead, Arizona opted to apply the main pillars of its legal ethics regulations to the non-lawyer participants and to add new ethical requirements to ABSs. ABSs and their non-lawyer owners and managers are all subject to the core ethics requirements that apply to lawyers, such as avoiding conflicts of interest, guarding their independent judgment, and upholding their commitments as officers of the courts.

Still, Arizona is not the only U.S. jurisdiction to consider jettisoning Rule 5.4. Utah currently has a "regulatory sandbox" in which experimentation in the same vein as the Arizona regime is conducted to determine whether to make a permanent regulatory change. California, Florida, and Illinois are considering similar liberalization of their legal professions. And, in a stunning reversal, on September 8, 2021, more than 35 years after the ABA had recommended to states the adoption of the original prohibitive Rule 5.4, the ABA's Standing Committee on Ethics and Professional Responsibility published Formal Opinion 499 titled "Passive Investment in Alternative Business Structures" stating that a lawyer may *passively* invest (but not actively practice) in a licensed ABS—in Arizona or D.C., for example—even if that lawyer is admitted to practice in a jurisdiction that does not allow ABSs (i.e., the other 48 states).

The further growth and acceptance of non-lawyer ownership and management of law firms around the world will have broad implications in international arbitration for individual counsel, law firms, tribunals, and arbitral institutions. For example, international arbitration lawyers practicing in a law

firm with a U.S. presence may now face increased conflicts and interference with their independent professional judgment due to the presence of non-lawyer investors and managers. Lawyers who passively invest in ABSs may create new conflicts requiring disclosure. The trend toward spinning off international arbitration practices in large firms into independent boutiques will likely accelerate as the investment proposition becomes 'invest in a *law firm'* rather than 'invest in a *lawsuit*.' The increased conflicts and ethical challenges will likely play out in individual cases forcing tribunals, and consequently arbitral institutions, to develop doctrines and rules to address the new landscape.

Principally, arbitral institutions will be pushed to rethink the disclosure-based approach they have taken in response to the rise of litigation funding, even though disclosure has only recently become the norm. Arizona has demonstrated a regulatory structure in which disclosure of the funder's identity is assumed and the emphasis is instead placed on the ethics of lawyers and their investors. Arizona's approach reflects an acknowledgment of and concern for the possible erosion of the traditional characteristics of the fiduciary attorney-client relationship as lawyers and ABSs become "servants of two masters" —clients and investors—whose interests will not always align.

Certainly, not all (or even most) law firms in the common law world will choose the ABS route, but international arbitration boutiques may embrace the innovation at higher rates than other legal services businesses. And investors may instinctively resist the regulation of non-lawyer participation at the transnational level, but many jurisdictions are already suspicious of the ABS model—especially absent robust regulation. The international arbitration community should carefully examine the effects of the likely acceleration of non-lawyer participation given the already varying reactions of different jurisdictions as the ABS model steadily gains traction around the world. Disclosure requirements in international arbitration rules and tribunal procedural orders likely will not sufficiently address the conflicts of interest scenarios and public policy questions raised by direct non-lawyer participation. Institutions and tribunals should model prioritizing clients' interests above investors' profit-maximization, ensuring the autonomy and independence of lawyers' professional judgment, avoiding arbitrator conflicts of interest, and maintaining the integrity of the international dispute resolution system as a whole.

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