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JOURNAL of LAW REFORM ONLINE

COMMENT

PROVIDING CAPITAL FOR LAW FIRMS IN A CREDIT CRISIS: NON-LAWYER EQUITY OWNERSHIP

Brett Novick*

Last year, a New York federal district court dismissed a lawsuit by Jacoby & Meyers LLP attacking a New York law that prevents non-lawyers from owning an equity interest in law firms.¹ On November 21, 2012, the U.S. Court of Appeals for the Second Circuit resuscitated the lawsuit, remanding the case to the district court and granting Jacoby & Meyers LLP leave to amend its complaint.² Non-lawyers owning an equity interest in law firms is not a new idea, as countries such as Australia and the United Kingdom already allow it,³ and the United States should follow their example to a limited extent. Despite the ethical issues present with non-lawyer equity ownership in law firms,⁴ this Comment proposes that the ABA, as well as subsequent state law, create a system that allows law firms to get funding from investors without breaching legal ethics rules.

Model Rule of Professional Conduct (“MRPC”) 5.4(d)(1) provides that “[a] lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law

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1. *Jacoby & Meyers, LLP v. Presiding Justices of the First, Second, Third and Fourth Dep’ts, Appellate Div. of the Supreme Court of N.Y.*, 847 F. Supp. 2d 590 (S.D.N.Y. 2012).

2. *Jacoby & Meyers, LLP v. Presiding Justices of the First, Second, Third and Fourth Dep’ts, Appellate Div. of the Supreme Court of N.Y.*, 488 F. App’x 526 (2d Cir. 2012), *amended*, (Jan. 9, 2013); *see also* David Glovin & Don Jeffrey, *Jacoby & Meyers Wins Round in Nonlawyer-Investor Dispute*, BLOOMBERG (Jan. 9, 2013, 4:38 PM), <http://www.bloomberglaw.com/news/2013-01-09/jacoby-meyers-wins-round-in-nonlawyer-investor-dispute.html>.

3. *See* Jason Krause, *Selling Law on an Open Market*, A.B.A.J. (July 1, 2007, 5:52 PM), http://www.abajournal.com/magazine/article/selling_law_on_an_open_market/; John Eligon, *Selling Pieces of Law Firms*, N.Y. TIMES, Oct. 28, 2011, at B1, *available at* <http://www.nytimes.com/2011/10/29/business/selling-pieces-of-law-firms-to-investors.html?pagewanted=all>. In fact, the Australian law firm Slater & Gordon became publicly traded in May 2007. Krause, *supra*.

4. *See* MODEL RULES OF PROF’L CONDUCT R. 5.4 (2012).

for a profit, if a nonlawyer owns any interest therein.”⁵ Thus, lawyers are not allowed to work for a LLC or LLP that practices law if a non-lawyer has an equity interest in the organization. The main ethical concern motivating this rule is that non-lawyer funding of law firms may lead attorneys to place the financial concerns of outside investors ahead of client interests.⁶ However, decision-making in law firms is already driven by financial considerations, as attorneys seek to maximize profits and constantly increase metrics such as profits-per-partner.⁷

Moreover, non-lawyer ownership of law firms currently exists in Washington, D.C., where non-lawyers may own an equity interest in firms that only engage in the practice of law and do not provide other work or services for clients.⁸ While some adjustments might be necessary to ensure that law firm partnerships meet proper ethical standards, adopting the D.C. system allows law firms to have access to funding from sources other than banks, which many firms currently rely on.⁹ The problem with funding from banks is that firm bankruptcy may follow if these firms default on their loans, which happened in 2012 with Dewey & LeBoeuf LLP after the firm’s inability to repay the \$225 million that it owed to banks.¹⁰ Some have also argued that the current economic crisis is indicative of the future of law firms, a future in which firms like Dewey will be unable to use leverage to grow the firm.¹¹ If firms are instead able to sell non-transferable equity ownership to non-lawyers, firms could receive funding similar to that received from banks without having to rely on meeting loan obligations. Further, the incentives of these

5. *Id.* Rule 5.4(d)(2) deals with non-lawyers who are firm directors or officers, and Rule 5.4(d)(3) deals with non-lawyers who control the “professional judgment” of lawyers. *Id.* Neither of these rules should be affected by this Comment.

6. Krause, *supra* note 3.

7. *Id.*

8. James Podgers, *Ethics 20/20 Commission Seeks Input on Alternative Business Structures for Law Firms*, A.B.A. J. (Apr. 5, 2011, 12:53 PM), http://www.abajournal.com/news/article/ethics_20_20_commission_seeks_input_on_alternative_business_structures_for_.

9. *Cf. Law Firms & Attorneys*, CITI PRIVATE BANK, https://www.privatebank.citibank.com/our_services/law_firms.htm (last visited Mar. 28, 2013) (noting that over 650 law firms use services provided by the Citi Private Bank Law Firm Group).

10. See Peter Lattman, *Dewey & LeBoeuf Files for Bankruptcy*, N.Y. TIMES DEALBOOK (May 28, 2012, 10:21 PM), <http://dealbook.nytimes.com/2012/05/28/dewey-leboeuf-files-for-bankruptcy/>.

11. See John Gapper, *Law Firms Have Struck the Limits of Partnership*, FIN. TIMES, May 10, 2012, at 9. *But see* Eligon, *supra* note 3 (noting that top-tier firms make large profits and would have no problem borrowing from banks if they actually needed to).

new “equity partners” would parallel those of the law firm: working to ensure the firm’s health and success. Banks, on the other hand, care only that the firm meets its loan obligations, not about the firm’s long-term success.

When adopting a system of non-lawyer ownership like that in D.C., ethical standards still need to be maintained. An ABA Commission previously considered a model for non-lawyer ownership that has two characteristics distinguishing it from the system currently used in D.C.¹² First, only attorneys could maintain voting rights and control the firm’s financial interests.¹³ This provision advances the goal of allowing non-lawyer ownership solely for funding purposes. Additionally, it would prevent non-lawyers from exercising other control over the business, which addresses the concern of placing financial goals ahead of client interests. While non-lawyers could try to exercise control indirectly by threatening to withdraw from the equity partnership, this can be countered by an investment lock-up period or by covenants allowing the non-lawyer investor to withdraw only for specific reasons. Second, lawyers must examine the professional integrity of non-lawyers before the latter are allowed to purchase a financial interest in a firm.¹⁴ This makes sense in light of the high ethical standards that lawyers themselves are required to satisfy, including: following the MRPC; having to pass the MPRE before gaining admission to the bar in most states; and meeting the state bar requirement for character and fitness examination.

Thus, it is possible to conceive of a system in which non-lawyers can have equity ownership in law firms without sacrificing legal ethics. Funding provided by non-lawyers is best used as a last resort or as an alternative to traditional funding methods such as loans from banks or capital provided by the existing law partners of the firm.¹⁵ However, non-lawyer equity

12. James Podgers, *Nonlawyer Ownership Interests in Law Firms Remains an Unsettled Issue for Ethics 20/20 Commission*, A.B.A. J. (Feb. 3, 2012, 7:21 PM), http://www.abajournal.com/news/article/nonlawyer_ownership_interests_in_law_firms_remain_an_unsettled_issue/.

13. *Id.*

14. *Id.*

15. *Cf.* Steven Benathen, *Non-Lawyers Owning Law Firms*, ILL. BUS. L.J. (Oct. 21, 2012, 7:47 PM), <http://www.law.illinois.edu/bljournal/post/2012/10/21/Non-Lawyers-Owning-Law-Firms.aspx>. This article argues that law firms should have outside investing, such as shares of law firms being sold on the open market, in order to turn law firms into businesses run

funding would be particularly useful during a credit crisis—when access to capital comes at a great cost—or during times of firm expansion if the firm hopes to avoid a fate similar to Dewey & LeBoeuf's. Given the recent recession, the ABA would be wise to change its rules to allow limited non-lawyer ownership of law firms. This will ensure the financial health of firms by providing an additional avenue to obtain working capital.

by businessmen rather than lawyers. In turn, having outside ownership would help to combat growing industry trends, such as smaller associate class sizes and diminishing numbers of partners, since partners could cash out their shares and leave the law firm while associates can be compensated with higher fixed salaries knowing that they will not attain equity partnership in the traditional sense.