Making Sense of the Fee-Splitting Rule

Author : W. Bradley Wendel

Date : February 27, 2018

Anthony Sebok, *Selling Attorney's Fees,* **U. Ill. L. Rev.** (forthcoming 2018), available at SSRN.

The humble fee-splitting rule—Rule 5.4(a) of the Model Rules of Professional Conduct and its substantial equivalents in various states—plays an outsized role in structuring the delivery of legal services in the United States. The rule provides that, with limited exceptions, "[a] lawyer or law firm shall not share legal fees with a nonlawyer." The fee-splitting rule is substantially the same even in jurisdictions with quirky rules of professional conduct, such as California, New York, and Texas. The only exception is the District of Columbia. Historically the concern of the fee-splitting rule was mostly payments to nonlawyers for referrals of cases, or the use of "runners" or "cappers" to solicit personal-injury clients. It featured prominently, however, in the debate in the early 2000's over the proposal to allow multidisciplinary practices (MDPs), such as partnerships between accountants and lawyers. The acrimonious MDP debate ended with lawyers doubling down on the claim that the practice of law is a profession, not a mere business, and that avoiding the sharing of fees with nonlawyers is an essential firewall protecting lawyer professionalism. (Insert snark here about how an industry with total revenues of $86.7 billion—the 2017 AmLaw 100—can claim with a straight face not to be a "business.")

Tony Sebok's article, *Selling Attorneys' Fees*, begins on familiar ground. The inability of law firms to obtain equity investments from nonlawyers limits their sources of capital to firm revenues and debt financing. This leaves them strapped for the cash that might catalyze Silicon-Valley-style innovation in the delivery of legal services and makes them vulnerable to economic downturns. One of the motivations for the ABA's Ethics 20/20 Commission was to consider whether regulatory innovations might enhance the delivery of affordable legal services. However, the proposal to permit certain types of alternative business structures, which would have required relaxing the fee-splitting rule, went down in flames. The Illinois Bar Association filed a formal resolution opposing changes to the fee-splitting rule, and the Ethics 20/20 Commission responded by tabling any consideration of alternative business structures.[1]

The first question Sebok addresses concerns the application of the fee-splitting rule to law firm financing transactions. If the policy underlying the fee-splitting rule is protecting the independent professional judgment of lawyers (and Sebok shows that this is the best constructive interpretation of the rule), then one would think the rule would focus on the extent of control exercised by a third party. That is sometimes the way the rule is applied, but not always. Here is an illustration from the Hazard, Hodes & Jarvis *Law of Lawyering* treatise, which Sebok uses in his article: Three lawyers would like to construct a law office; each is required to contribute $50,000 to the project. Lawyer A borrows $50,000 on a line of credit with a bank. Lawyer B obtains $50,000 from a wealthy friend, in exchange for a promise to pay 10% of his net legal fees. Lawyer C takes $50,000 from a recent settlement of a client's matter and plows it back into the construction costs.[2] Which of these lawyers has violated Rule 5.4(a)?

If the answer depends on whether attorneys' fees are *literally* shared with a nonlawyer, then Lawyers A and B both violated it. There is plentiful authority, however, supporting the conclusion that making interest payments on an ordinary commercial line of credit with a bank does not violate the fee-splitting rule. One of the many contributions of Sebok's article is to show that the covenants in loan agreements with banks grant a significant degree of control to the lender over the operation of the law firm. If the concern underlying Rule 5.4(a) is preventing outsiders from meddling in the representation of clients by lawyers, Lawyer A may be in trouble also if she accepts covenants potentially granting control to the lender. As for Lawyer B, one might rely on the principle that it is permissible to pay a fixed interest rate to a lender, one not contingent on the outcome of any given matter, but there are some state bar ethics opinions prohibiting these sorts of fixed-rate contingent advances. The prohibition becomes more uniformly applied where the return to the lender is calculated as a percentage of the proceeds of a litigated matter handled for a client. Further complicating the analysis, law firms commonly engage in factoring transactions, in which they sell their accounts receivable to a nonlawyer, in exchange for a discounted cash payment. A recent U.S. District Court decision in Massachusetts followed the well-established rule that selling accounts receivable – which, after all, *necessarily* are comprised of attorneys' fees – to a nonlawyer does not violate the fee-splitting rule.[3]

It is then but a small step to recognize the permissibility of factoring unmatured attorneys' fees, as distinguished from payments due for services already completed. ("Unmatured" here means that a definite obligation to pay the lawyer a specific amount has not yet accrued; in a contingent-fee representation, for example, the client may have agreed to pay 1/3 of the gross proceeds, but until judgment or settlement, the precise extent of the client's obligation has not yet been established.) As Sebok notes, "attorneys are factoring unmatured contingent fees today" (P. 32.), courts are aware of the practice, and have allowed the existence of this practice to pass without comment. Interestingly, one New York decision he cites inverts the "core values" objection to fee-splitting and contends that a formalistic application of the fee-splitting rule treats lawyers worse than other similarly situated businesses. (P. 33.)

But the factoring of unmatured fees would violate what Sebok calls the Direct Relation Test (DRT), which is his attempt to make sense of the incoherence in fee-splitting cases and ethics opinions. The DRT prohibits the payment of legal fees to a nonlawyer if and only if the nonlawyer's profit or loss is directly related to the success of a lawyer's representation of a client. (P. 21.) "Direct" here means something like "linked to the result in a particular case or small subset of cases." Courts and bar associations therefore have a choice: Either prohibit factoring of unmatured fees, thus applying the DRT, or permit this common practice and junk the DRT.

It is impossible in this short comment to do justice to the sophistication and subtlety of Sebok's argument. His resolution of the dilemma is ingenious. If I understand correctly, the DRT is not implicated in the factoring of unmatured fees because what the attorney sells to the buyer is a peculiar type of property—a lien on the proceeds of the lawsuit. The lien creates an equitable assignment of property (the client's cause of action) in favor of the nonlawyer. Because the property interest never passes into the hands of the lawyer, the lawyer seller is not sharing fees with the nonlawyer buyer. (Pp. 38-39.) If courts and ethics committees analyze the fee-splitting rule in this way, however, it becomes possible for clever lawyers and financiers to draft around the rule's prohibitions. Non-recourse loans, for example, can be reworked as the purchase of a property interest in an unmatured fee.[4] It is therefore impossible to hold onto a principled interpretation of the DRT, because a return to an investor that is directly related to the attorney's performance may fall outside the fee-splitting rule. Regulators may be tempted to respond by overcorrecting in the direction of a highly formalistic interpretation of Rule 5.4(a) that would prohibit a form of financing commonly engaged in by contingent-fee lawyers.

One solution to the dilemma identified by Sebok would be to focus not on the nature of the property interest conveyed, but on the effect of the transactional structure on the lawyer's exercise of independent professional judgment. (He suggests this reading when he notes that one of the most important sticks in the bundle of property rights is control over any portion of the interest.) Briefly, the question would be, is there any circumstance under which the lawyer would do better financially by taking actions that adversely affect the client's matter? That is one way to synthesize many of the state ethics opinions he cites, and is consistent with the policies underlying the rule. But regulators have a distressing tendency to veer erratically between formalistic and functional or policy-sensitive interpretations of Rule 5.4(a). Furthermore, as Sebok has shown, the possibility of control and interference by third-party financiers is much more pervasive than lawyers may realize.

At the end of the day, Sebok's proposed resolution is a kind of unjust-enrichment revision of the rule, under which "non-lawyers may not benefit from gains generated by legal resources that were enabled by the non-lawyer for the use of an attorney on behalf of her client." (P. 51.) The client's recovery is supposed to depend on the lawyer's "knowledge, skill, experience, and time expended." (P. 51, quoting Texas Bar Op. 576.) If a third-party financial investment helps the attorney maximize the effect of her skills, that is fine; the client then benefits directly, and the investor indirectly. What is impermissible is for third parties as well as clients to benefit directly from their investment. The direct benefit would somehow convert them into "officious intermeddlers," in the language of many old champerty cases.

I am not entirely persuaded that the functional approach to the interpretation of the fee-splitting rule should be abandoned. To my mind, a focus on the "productive or generative" relationship between the nonlawyer's financial contribution and the lawyer's provision of professional services is getting far afield from Rule 5.4(a)'s emphasis on the lawyer's independence. It's true that some aspects of third-party financing of litigation are best explained in terms of the nonlawyer's motivations. Sebok himself has written the definitive article rationalizing the law of champerty and maintenance along these lines.[5] Whether in the end courts and bar associations follow Sebok's suggested interpretation, there is no doubt that this article is by far the most comprehensive and ambitious treatment in the literature of an important, if under-appreciated feature of the law governing the legal profession.

1. For this history, see Jayne R. Reardon, *Alternative Business Structures: Good for the Public, Good for the Lawyers*, 7 **St. Mary's J. on Leg. Malpractice & Ethics** 304 (2017).
2. Geoffrey C. Hazard, Jr., W. William Hodes & Peter R. Jarvis, **The Law of Lawyering** (4th ed. 2014) § 45.04.
3. Santander Bank, N.A. v. Durham Comm. Capital Corp., Civil Action No. 14-13133-FDS, 2016 U.S. Dist. LEXIS 5430 (D. Mass. Jan. 15, 2016).
4. Non-recourse loans are simply those in which the lender does not have the right to proceed against the borrower's assets, but is limited to recovering against property that was used as collateral for the loan.
5. Anthony J. Sebok, The Inauthentic Claim, 64 **Vand. L. Rev.** 61 (2011).

Cite as: W. Bradley Wendel, *Making Sense of the Fee-Splitting Rule*, JOTWELL (February 27, 2018) (reviewing Anthony Sebok, *Selling Attorney's Fees,* **U. Ill. L. Rev.** (forthcoming 2018), available at SSRN), https://legalpro.jotwell.com/making-sense-fee-splitting-rule/.