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Changing the stakes: how evolving law firm ownership rules could (or could not) re-shape the legal industry

By Roger E. Barton, Esq., Barton LLP

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It has long been the case that law firms have been owned by lawyers. Whereas most companies that offer equity shares do so to a large pool of investors, law firms are strictly limited to lawyer shareholders. The American Bar Association's Model Rules of Professional Conduct specify in Rule 5.4 (https://bit.ly/3gd3BbQ) that nonlawyers cannot partner with or share legal fees with lawyers and cannot hold ownership interest in law firms. This rule was originally conceived as a safeguard to prevent lawyers' professional judgment from being influenced by nonlawyers.

However, calls for changes to Rule 5.4 have picked up steam in the past several years. Australia and several countries in Europe have already implemented changes that are allowing outside ownership of law firms, and the U.S. has begun to explore the prospect more seriously. The impetus for change has primarily come from advocates and legal ethicists who argue (https://stanford.io/3k64u7v) that nonlawyer ownership of law firms will provide more access to justice for underserved individuals.

Besides the question of whether changes to law firm ownership will indeed improve the accessibility of routine legal services (e.g., divorce filings, lease negotiation, will drafting, etc.), it is useful to consider how such changes would reverberate across the higher end of the professional legal services spectrum. How would changes ostensibly affect the service delivery models of BigLaw firms, midmarket firms, accounting firms, or alternative legal service providers (ALSPs)? What businesses would theoretically be best positioned to capitalize on these changes — and would they actually do it?

Before fully committing to any permanent regime changes, the U.S. is trying to answer some of these questions. In August 2020, Arizona became the first state (https://bit.ly/3gctOr7) to totally eliminate Rule 5.4, allowing nonlawyer investment and fee-sharing opportunities for firms that complete a rigorous application process. Utah also made changes in August 2020, creating a seven-year "regulatory sandbox" (https://bit.ly/3iTGB3F) pilot program where firms can apply to test out various "alternative business structures" (ABSs).

Florida also recently announced (https://bit.ly/37N4pzP) that it plans to launch a three-year "laboratory" program modeled after Utah's regulatory sandbox. The program would allow nonlawyers to hold non-controlling equity interest in law firms but would ban passive ownership from outside third parties. Several other states, including New York, North Carolina, Connecticut, California, and Illinois, are at different stages of considering changes to Rule 5.4.

Outside of the U.S., law firm ownership rules have evolved at a quicker pace. In 2001, New South Wales, Australia, became the first (https://bit.ly/2XzlPhs) common law territory to allow fee-sharing and firm ownership with nonlawyers. The United Kingdom (England and Wales) followed suit a few years later with the enactment of the Legal Services Act of 2007, (https://bit.ly/3iTCKn7) which also allowed for the use of ABSs.

This subsequently led to the first Australian and U.K. law firms to go public (https://yhoo.it/3k1XbgT) — personal injury firm Slater Gordon in 2007 and full-service firm Gateley in 2015. While Gateley has enjoyed relative success in its growth, Slater Gordon was forced to recapitalize to avoid insolvency after a series of regulatory issues tanked its share prices.

Outside of law firms, alternative legal service providers are also looking to cash in on the shifting landscape of law firm ownership. LegalZoom, a popular document preparation ALSP, was the first (https://bit.ly/37PM4C1) U.S. business to be a licensed ABS in the U.K. in 2015 and has successfully partnered with and acquired U.K. law firms. LegalZoom and Rocket Lawyer (another document preparation company) have also filed applications for ABS licenses in Arizona, while Rocket Lawyer is currently active in the Utah sandbox.

While ALSPs are known for dealing in primarily lower-end, commoditized work, they may gain new strength if partnerships with lawyers allow them to offer higher-end legal services as well.

However, U.S. firms likely remain wary of rushing into such partnerships when the fate of Am Law 200 firm LeClairRyan and ALSP UnitedLex is still fresh in the industry's collective memory. LeClairRyan, a national firm based in Virginia, went bankrupt shortly after pursuing a joint venture with tech and legal support company UnitedLex in 2018 — a move that was meant to outsource certain back-office operations. A LeClairRyan trustee subsequently filed a $128 million lawsuit (https://bit.ly/3CTCcpa) against UnitedLex, claiming that the ALSP contributed to the law firm's demise by pushing it further into insolvency and engaging in the unauthorized practice of law. The case is currently ongoing and has potentially

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had a cooling effect on firms considering exploring alternative business structures or partnering with ALSPs.

For BigLaw firms, watching and waiting may simply be the safest option. BigLaw firms are already multibillion-dollar-generating machines with plenty of access to capital through partnership capital calls and lender networks. Most of these firms are also international, meaning they have the option of using ABSs in other countries that permit them. Experimenting with ABSs in the United States may end up posing more risk and disruption than opportunity. Because state laws differ on firm ownership rules, BigLaw firms would likely have to subdivide (https://bit.ly/2W3CdWt) into separate entities in order to take advantage of fee-sharing or nonlawyer ownership. Additionally, there is still very little empirical evidence to date showing that ABSs are beneficial to large firms engaged in complex legal services.

The Big Four accounting firms (Deloitte, EY, PwC, KPMG) are in a similarly situated position. Although they could theoretically become some of the biggest law firms, they are already generating multibillion-dollar revenues with their current scope of services in the U.S. and are already practicing law in Europe. These firms would also face the same dilemma of varying state regimes if they did decide to pursue ABS licenses in Arizona or Utah.

Midmarket law firms are perhaps the most uniquely positioned amidst the ongoing conversation on law firm ownership. On one hand, these MidLaw firms could benefit immensely from fresh injections of capital by outside investors. Currently, the cash flow for midmarket firms is heavily dependent on the investment of equity partners and firm revenue generated through fees. However, if the door were to be opened for private equity firms, venture capitalists, hedge funds, and even corporations to invest in these firms, it could drive innovation and allow for the creation of new, expanded offerings.

MidLaw firms could also entice new talent with the prospect of equity stakes. Business professionals in complementary industries (e.g., IT, business management, project management, marketing, finance systems, etc.) could be incentivized to join these firms, which in turn could result in the implementation of new technology and more efficient business processes. More access to funding could also level the playing field to an extent, allowing midmarket firms to compete with larger firms that have traditionally had greater sources of capital.

However, changes to Rule 5.4 may just as easily result in challenges or even threats to MidLaw firms. Some states are considering restrictions on law firm ownership rule changes that would render the benefits to most midmarket firms moot. For example, while Florida will allow outside investment in firms within its "laboratory," the state's ban on passive ownership (https://bit.ly/3spq9el) will prevent non-related third-party entities (such as private equity firms) from owning any shares.

As another example, while California continues to debate the format of its own upcoming regulatory sandbox, some authorities have argued that ABS licenses should strictly be limited to businesses catering to underserved demographics, which would exclude most higher-end corporate law firms.

Additionally, if any BigLaw firms or the Big Four *did* decide to aggressively pursue alternative business structures and were successful, it could spell trouble for MidLaw firms. There are fears that this kind of restructuring could give rise to a "Wal-Mart effect" where the legal industry would become dominated by a handful of large, one-stop-shop law firms. In this scenario, smaller firms could easily get squeezed out if they themselves don't adapt.

Despite the potential benefits, many midmarket firms will likely be in no hurry to take unnecessary risks, especially given the historic opposition by lawyers themselves to Rule 5.4 amendments. In February 2020, the American Bar Association passed an intensely contested Resolution 115 (https://bit.ly/3yX0M63), which encouraged states to consider regulatory innovations that could increase access to justice. However, the resolution was only passed after a caveat was added stating that the resolution should not "… be construed as recommending any changes to any of the ABA Model Rules of Professional Conduct, including Rule 5.4, as they relate to nonlawyer ownership of law firms…"

It simply may be that it's still too early to tell how evolving law firm ownership rules will or won't reconfigure the legal industry. While interest is strong among certain providers, it remains tepid with others. Perhaps once the various pilot programs in select states have concluded, the U.S. legal industry will have a better gauge of what works and what doesn't, and midmarket firms will have a litmus test for where the opportunities and obstacles lay. Until then, those in the legal industry — especially MidLaw firms — should keep an eye on any ongoing developments with strategies in mind for how to adapt and use such changes to their businesses' benefit.

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About the author

Roger E. Barton is the managing partner of New York City-based **Barton LLP** and a litigator. He represents clients in the capital markets and financial services industries and is a fellow of the Litigation Counsel of America. He speaks nationally and internationally on law firm innovation and the practice of law as a business and can be reached at rbarton@bartonesq.com.

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