UNMATURED ATTORNEYS' FEES AND CAPITAL FORMATION IN LEGAL MARKETS

Anthony J. Sebok†

ABSTRACT

Attorneys in the United States are under increasing pressure to change and adopt practices commonly found in the world of finance and business. Over the past thirty years the bar and legal academics have debated what to do; the focus of this debate has been over changes to MRPC 5.4 to allows attorneys to practice in partnerships with non-lawyer partners or are owned by non-lawyer shareholders.

One of the reasons attorneys are debating changes in Rule 5.4 is that the practice of law depends on capital, and the old methods for raising capital are no longer sufficient. Rather than raise capital from non-lawyers by partnering with them of selling equity to them, I recommend that attorneys look to their own fees as a source of capital.

I argue that there has confusion among state bar ethics committees and some ethics commentators about whether the sale of future, or unmatured, fees is unethical. The argument that lawyers may not sell unmatured fees is based on the claim that it would be fee-splitting. I argue that those who think that the sale of unmatured fees is fee-splitting are relying on a theory of Rule 5.4 called the Direct Relation Test, which takes as its premise that it is unethical for an attorney to allow a non-lawyer to invest in her productive capacities with the aim of earning a profit. I argue that the Direct Relation Test is incoherent, and cannot be consistently maintained in a system, like ours, that allows attorneys to factor their earned fees. I also argue that the Direct Relation Test is a deontological principle that lacks any normative appeal.

I conclude that ethics committees, courts, and legal ethicists should reject the Direct Relation Test and recognize that the sale of unmatured fees is not fee-splitting.

I. INTRODUCTION

Capital lies beneath the foundations of American law. Of course, the legal profession's foundations are its obligations to the public and loyalty to clients.[1] These are quite real and are not merely a façade. But, in the United States, at least, the bedrock which supports legal practice are the financial resources that pays for everything from rent, salaries, and other overhead, as well as litigation expenses, if they are advanced by the attorney.[2] Some of this capital comes from the public fisc, when it supports federal, state, and municipal attorneys in both civil and criminal practice.[3] Some of it comes from private

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† Professor of Law, Benjamin N. Cardozo School of Law and Co-Director of the Jacob Burns Center For Ethics In the Practice Of Law. The author would like to thank Cardozo Law School for funding the research and writing of the Article. Many friends and colleagues have provided invaluable comments and suggestions, including Christopher Bogart, Christopher Buccafusco, Mauro Bussani, David Carlson, Anthony Davis, Nora Engstrom, Gary Friedman, Myriam Gilles, Bruce Green, Jon Molot, Alex Reinert, Ralph Sutton, W. Bradley Wendel, and Ellen Yaroshefsky. The author serves as a consultant to Burford Capital, however the views expressed in the Article are the Author's alone, and the Author is responsible for all mistakes within it.

1 The central premise of the regulation of attorneys in the United States since the Founding has been that law is a profession and not a business. *See, e.g.* Russell G. Pearce, *The Professionalism Paradigm Shift: Why Discarding Professional Ideology Will Improve the Conduct and Reputation of the Bar*, 70 N.Y.U. L. REV. 1229, 1231 (1995) (describing the self-conception of American law as a profession in contrast to business) *and* Rayman L. Solomon, *Five Crises or One: The Concept of Legal Professionalism, 1925-1960*, *in* LAWYERS' IDEALS/LAWYERS' PRACTICES: TRANSFORMATIONS IN THE AMERICAN LEGAL PROFESSION 147 (Robert L. Nelson *et al.* eds., 1992) (noting that "the interests of the client and the public are to take precedence over the lawyer's economic self-interest"). As a profession, law is characterized by "the practitioner's self-interest is overbalanced by devotion to serving both the client's interest and the public good." ABA Commission on Professionalism, *In the Spirit of Public Service: A Blueprint for the Rekindling of Lawyer Professionalism* 18 (1986).

2 There are various efforts to measure the size of the American legal market. According to one measure, total expenditures on legal services in the United States grew from approximately $100 billion to approximately $210 billion between 1996 and 2013. *See* Ben Barton, *A Comparison Between the American Markets for Medical and Legal Services,* 67 HASTINGS. L.J. 1331, 1336 (2016) (*citing* the Bureau of Economic Analysis ("BEA") GDP by Industry Analysis). According to legal publisher Thomson Reuters, the American legal market represented $467 billion in spending in 2016. *See* Legal Executive Institute, "The Size of the U.S. Legal Market," January 16, 2016 at http://legalexecutiveinstitute.com/the-size-of-the-us-legal-market-shrinking-piece-of-a-bigger-pie-an-lei-graphic/ (last visited on February 11, 2017).

3 *See, e.g.,* Lynn Bauer & Steven D. Owens, *Justice Expenditure and Employment in the United States, 2001* at 4 (Bureau of Justice Statistics Bulletin, May 2004, NCJ 202792) (total expenditures by federal, state, and municipal governments on salaries for the justice system was approximately $38 billion in 2001). Note that this figure in-

sector entities that employ attorneys only for their own benefit, and do not engage in the practice of law generally.[4] But for the very large proportion of lawyers engaged in the practice of law – in large Am Law 100 firms and small solo practices – their firm's access to capital is ultimately the only source of funds for their practice.[5]

Anxiety over the negative effect that inadequate capital has on attorneys in private practice has been a constant source of concern for the bar. The 1986 report by the ABA's Commission on the Profession – whose title, "A Blueprint for the Rekindling of Lawyer Professionalism" indicated its focus – began with a description of the increasingly difficult economic environment faced by attorneys in private practice.[6] The average attorney, the report noted, earned a little less than $50,000 per year and over half practiced alone. The report cited a 1985 study by a law firm economic consulting group which found that in "established firms . . . it costs $62,000 a year to keep the average lawyer in business before he or she takes the first dollar home," and from this concluded that firms have to bill twice the expected average income of their attorneys "putting a continuing squeeze on lawyer income."[7] These pressures, the report cautioned, could not excuse the decline in professionalism, but they had to be

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cludes salaries and overhead for judges and other employees of the judicial branch, which is not included in the BEA figures cited in note 2 *supra*. *See* NCAIS, Legal Services, at https://www.census.gov/eos/www/napcs/finalized/web_5411_final_reformatted_edited_US082208.pdf (last visited on February 21, 2017).

[4] *See, e.g.,* BTI Consulting's 2014 "Market Outlook and Client Service Review" (40% of all legal services expenditures were by in-house counsel) at http://businessoflawblog.com/2014/01/bti-consulting-us-legal-market-exceeds-100-billion/ (last visited on February 21, 2017).

[5] Thomson Reuters estimated in 2016 that large firms (more than 175 lawyers) have 35% of the available market for legal services; while mid-sized firms (30 – 174 lawyers) have 26% of the market, and small firms (1 – 29 lawyers) have 39% of the market). *See* Legal Executive Institute, "The Size of the U.S. Legal Market," *supra* note 2.

[6] *See* ABA Commission on Professionalism, *In the Spirit of Public Service, supra* note 1 at 8 ("Any realistic understanding of the pressures faced by lawyers today must take account of certain economic realities.").

[7] *Id.* at 9. *See also* Edward S. Adams & John H. Matheson, *Law Firms on the Big Board?: A Proposal for Nonlawyer Investment in Law Firms*, 86 Calif. L. Rev. 1, 24 (1998) (from 1975 to 1985 overhead increased by 161% but gross per-attorney receipts rose only 123%, and average partner compensation went up only 90%) (*citing* Susan Raridon, *The Practice of Law: The Next 50 Years,* LEGAL ECON., Apr. 1989, at 31).

acknowledged before any effort to "rekindle" professionalism could be attempted.[8]

Since 1986, many things have changed – the size of the American legal market has grown faster than either the economy or the rate of inflation,[9] and concern over the lack of available capital to lawyers in private practice has only increased[10] – but the sources of capital to attorneys has not changed.[11] Since the early Twentieth Century, the only way that an attorney can raise capital is either by investing her own funds or borrowing. This is a result of the broad interpretation of the rule against the "sharing" of fees currently expressed as Rule 5.4 in the Model Rules of Professional Conduct and has been adopted in almost identical form in all 51 jurisdictions in the United States.[12] As Gillian Hadfield has noted, this means that lawyers are limited to using financial tools that are primitive compared to the modern advances in finance that have occurred over the past two centuries.[13]

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[8] ABA Commission on Professionalism*, In the Spirit of Public Service, supra* note 1 at 9.

[9] There is some evidence that the growth of the legal market, which exceeded the growth of the economy in the 1980's and 1990's, has tracked the growth of the United States' GDP since 2006. *See* Barton, *A Comparison*, *supra* note 2 at 1336. There is also some evidence that the inflation rate for the cost of legal services has exceeded the inflation rate for consumer prices between 2001 - 2012. *See* THE ECONOMIST, "Guilty as Charged", February 2, 2013 at http://www.economist.com/news/leaders/21571141-cheaper-legal-education-and-more-liberal-rules-would-benefit-americas-lawyersand-their (last visited on February 21, 2017).

[10] *See* Adams & Matheson, *Law Firms on the Big Board? supra* note 7 at 24 (between 1988 – 1998 per-lawyer overhead increased more than 81%, while per-lawyer revenues increased only 73%) (*citing* Altman Weil Pensa Survey of Law Firm Economics).

[11] *See* Jack A. Guttenberg, *Practicing Law In the Twenty-First Century In a Twentieth (Nineteenth) Century Straightjacket: Something Has To Give*, 2012 MICH. ST. L. REV. 415, 481 (2012) ("The traditional law firm practice model requires that firms are either self-funded--the partners contribute to the capital needs of the firm by devoting a portion of each partners share to the capital needs of the firm--or the firm must borrow from outside sources, usually banks.").

[12] Model Rules of Professional Conduct ("MRPC") Rule 5.4 is titled "Professional Independence Of A Lawyer" and it has four parts. Section (a) prohibits an attorney from sharing legal fees with a non-lawyer except under certain limited conditions. Section (b) prohibits the formation of a partnership for the practice of law with a non-lawyer. Section (c) prohibits non-lawyer interference with an attorney's independent professional judgment. Section (d) prohibits an attorney from working in a corporation of association that is owned (to any degree) or controlled by a non-lawyer (absent certain narrow exceptions).

[13] *See* Gillian Hadfield, *Legal Barriers to Innovation: The Growing Economic Cost of Professional Control over Corporate Legal Markets*, 60 STAN. L. REV. 1689, 1726-

Over the past two decades, legal scholars have identified the negative consequences that flow from restricting attorneys to capital raised only from the two sources permitted under the Model Rules. The first negative consequence is that innovation is stifled, since attorneys cannot afford to invest in either research or the capital-intensive technologies that research might produce, the way that entrepreneurs in Silicon Valley have done.[14] A second negative consequence is the inability of attorneys to exchange equity in their practices for capital in order to plan along much longer time horizons than the current rules allow. Long-term planning could take different forms, all of them yielding different advantages. For plaintiffs firms that do contingency fee work, the ability to raise working capital means that they could spread the risk of failure or subpar performance over a group of lay investors and not just a portfolio of clients' cases.[15] For large Wall Street firms, the ability to sell equity would provide firms with a way to reward attorneys at every point in their career to avoid "short-termism", either by finding a way to reward partners for investing in the training of younger attorneys, or to find some way to compensate "rainmakers" to remain with a firm without engaging in expensive (and risky) bidding wars with other firms over salary.[16]

1727 (2008) (Attorneys are "restricted to the plowed-back profits and owner-manager mechanisms that financed companies in the late-nineteenth century before the advent of the modern corporation, which brought with it the separation of ownership and control and the explosion of stock markets and financial institutions that prompted significant economic growth in the first part of the twentieth century.").

14 *See id.* at 1714 ("A 'start-up,' even one dreamt up by a lawyer, cannot seek angel investors or tap into venture capital networks to build the business."). *See also* Adams & Matheson, *Law Firms on the Big Board? supra* note 7 at 32 (comparing law firms to stock brokerages that needed outside capital to invest in new technologies in the 1960's).

15 *See* Adams & Matheson, *Law Firms on the Big Board? supra* note 7 at 34 – 35 (contingent fee attorneys could pursue more cases and take on more risky cases if they were able to raise capital from lay investors) *and* Thomas Markle, *Comment: A Call to Partner with Outside Capital: The Non-Lawyer Investment Approach Must Be Updated*, 45 ARIZ. ST. L.J. 1251, 1263-1264 (same). *See also* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 706 n.103 (1986) ("Plaintiff's firms lack access to the equity markets because legal ethics preclude any division of fees with a nonlawyer or the formation of a partnership with a nonlawyer.").

16 *See, e.g.,* John T. Molot, *What's Wrong With Law Firms? A Corporate Finance Solution To Law Firm Short-Termism*, 88 S. CAL. L. REV. 1, 5 (2014) ("Due to law firms' lack of permanent equity, they are ill-equipped to make long-term investment decisions and have a decidedly short-term bias - a bias that harms both clients and lawyers.").

A third negative consequence has received a great deal of attention since the financial crisis of 2008. Starved of capital from any outside source other than debt, attorneys will borrow.[17] Excess debt may have certain negative consequences.[18] As one analyst observed, the fact that the only outside source of capital available to law firms was conventional debt put them in an especially vulnerable position during the Great Recession when business slowed and lenders lacked liquidity:

> [The firms that failed] borrowed substantial amounts of money to fuel growth as well as to pay partners during periods of cash shortfalls. Many of these firms were thinly capitalized - some almost as a matter of philosophical principle - a condition that drove an increased need for debt financing. High debt levels put these firms at particular risk when external economic conditions turned against them.[19]

Even in periods of normalcy, debt may be an inferior method to raise capital compared to outside investment, especially for plaintiffs firms whose practice includes complex and capital-intensive contingent fee cases.[20] Contingent fee firms "may place heavier reliance on debt financing because the timing and size of revenue streams is harder to predict . . . but contingent fee firms have a harder time borrowing from banks precisely because their revenues are harder to predict."[21] The lack of credit may result in these firms partnering with

[17] According to Citi Private Bank, law firm debt was 19.8% of net income 2000, and that declined to 14.1% in 2006 (and this was *before* the 2007 crisis). Leigh Jones, *Firms Ask Partners to Pony Up*, NAT'L L.J., July 8, 2008. As a result of tightening credit, personal borrowing by individual partners increased, in order to make up the difference in new demands on attorney equity contributions. *Id. See also* Matthew W. Bish, *Note: Revising Model Rule 5.4: Adopting a Regulatory Scheme That Permits Nonlawyer Ownership and Management of Law Firms*, 48 WASHBURN L.J. 669, 687 (2009) (law firms in need of capital rely primarily on borrowing because of Model Rule 5.4).

[18] *See* Heather A. Miller, *Note: Don't Just Check "Yes" Or "No": The Need For Broader Consideration Of Outside Investment In The Law*, 2010 U. ILL. L. REV. ONLINE 311, 319 (Brobeck, Phleger & Harrison had "close to $ 90 million in debt" when it collapsed in late 2002 and Heller Ehrman, had "close to $ 30 million of debt" when it collapsed in 2008).

[19] Erin J. Cox, *Comment: An Economic Crisis Is a Terrible Thing to Waste: Reforming the Business of Law for a Sustainable and Competitive Future*, 57 UCLA L. REV. 511, 522 (2009).

[20] *See* Molot, *What's Wrong With Law Firms?*, *supra* note 16 at 41 (describing drawbacks of bank lending for contingent fee firms), *and* Markle, *Comment: A Call to Partner with Outside Capital*, *supra* note 15 at 1263 (same).

[21] Molot, *What's Wrong With Law Firms?*, *supra* note 16 at 41.

other firms for no reason other than to raise capital, resulting in a dissipation of expected earnings.[22]

Finally, lenders may exercise control over attorneys depending on the covenants written into the debt agreements. This point goes beyond the risk observed above, which is that failure to comply with the specific payment requirements of bank debt may trigger loan covenants, thus putting the fate of the firm out of the attorneys' hands.[23] The control exercised by a lender can be more than just the power to exercise liens it has on property in the event of default. It could be actively exercised during the life of the loan and in order to govern decisions that are conventionally associated with the management of the practice of law by attorneys, including the deployment of manpower and other resources on behalf of current clients.[24] Lenders like Citigroup, which already use covenants to force attorneys to "control . . . discretionary spending, cut[] bonuses, freeze associate salaries, postpone new hires or initiatives, lay[] off professional and administrative staff, and revamp[] partner compensation schedules," could go even further and instruct attorneys about the staffing of cases, the pricing of motions, and even whether to withdraw from representation of certain clients.[25]

Debate over how to solve attorneys' concern over access to capital has gone on for probably almost as long as the concerns themselves have been expressed. Most have centered around rewriting the ethics doctrines that form

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22 *Id.*

23 *See* Larry E. Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749, 774 (2010) *and see* Bernard Sharfman, *Note: Modifying Model Rule 5.4 to Allow for Minority Ownership of Law Firms by Nonlawyers,* 13 GEO. J. LEGAL ETHICS 477, 486 (2000) (overdependence on bank borrowings "may put a severe financial strain on a law firm and its lawyers, putting pressure on their independence of judgment about what is best for the client").

24 *See* Cox, *An Economic Crisis Is a Terrible Thing To Waste, supra* note 19 at 522 (describing how, for nearly a year, lenders controlled the law firm Thelen's expenditures).

25 *Id.* at 524 (*citing* Susan A. Berson, *Loans and Moans: Past Firm Failures Mean Tougher Credit Rules*, A.B.A. J., Sept. 2009). *See also* Larry E. Ribstein, *Ethical Rules, Law Firm Structure and Choice of Law*, 69 U. CIN. L. REV. 1161, 1173 (2001) (noting that the firm McKee Nelson Ernst & Young, which was created under the District of Columbia's modified MRCP 5.4, was, in essence, capitalized with a nonrecourse loan from an accounting firm accompanied by repayment obligations may have provided the lender so much control that the agreement violated the ethics rules "in all 50 states" and possibly even D.C.).

MRCP 5.4 and its predecessors. Although each proposal may vary in countless details, the efforts at reform can be divided into four general families.[26]

(1) Allow Corporations to Practice Law. Allowing corporations to practice law solves the problem of capital formation for attorneys by allowing non-lawyers to contribute capital to corporations which could then be used to fund salaries, investments and overhead. This is not actually a reform, since it was permitted in the beginning of the Twentieth Century.[27] Before 1928, corporations formed that offered legal services.[28] The corporate practice of law drew widespread criticism from certain parts of the bar, and was soon prohibited by many states.[29] The ABA's 1928 Canon 35 adopted a broad rule that complemented the states' prohibition of the corporate practice of law.[30] Canon

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[26] *But see* Ted Schneyer, *"Professionalism" As Pathology: The ABA's Latest Policy Debate on Nonlawyer Ownership of Law Practice Entities*, 40 FORDHAM URB. L.J. 75, 78 (2012) (listing five different categories of reforms).

[27] *See* Adams & Matheson, *Law Firms on the Big Board? supra* note 7 at 4.

[28] *See* Roy D. Simon, Jr., *Fee Sharing Between Lawyers And Public Interest Groups*, 98 YALE L.J. 1069, 1076 – 78 (1989).

> [T]he Associated Lawyers' Company . . . employed an astonishing six thousand lawyers nationwide . . . [and] offered one-stop shopping for collection work and litigation. . . Another pioneer law corporation was the Co-operative Law Company. Through its legal staff, Cooperative transacted "a general law business, including the prosecution and defense of suits; incorporation of business enterprises; drawing of contracts, leases and agreements, drawing and probating of wills, management of estates, etc." In re *Co-operative Law Co*., 198 N.Y. 479, 481, 92 N.E. 15, 15 (1910).

Id. at 1038 n.38.

[29] *Id.* at 1079 ("[b]y 1935, nearly half the states had passed laws prohibiting corporations from furnishing lawyers for profit"). "The lives of Associated and Co-operative were glorious but short. After New York passed a statute forbidding corporations from practicing law, neither corporation was able to renew its corporate charter." *Id.* at 1038 n.38 (citations omitted).

[30] Canon 35 stated "[t]he professional services of a lawyer should not be controlled or exploited by any lay agency, personal or corporate, which intervenes between client and lawyer." Annual Report of the American Bar Association, 53 A.B.A. 779 (1928). The 1928 Canons codified various bar association disciplinary committee opinions that expressed the organized bar's hostility to non-lawyers' involvement in the practice of law. *See* Bruce A. Green, *The Disciplinary Restrictions on Multidisciplinary Practice: Their Derivation, Their Development, and Some Implications for the Core Values Debate,* 84 MINN. L. REV. 1115, 1134 – 41 (2000).

35's prohibition on the corporate practice of law was carried forward into the 1969 ABA Code of Professional Responsibility and MRPC Rule 5.4 in 1983.[31]

Before the 1983 Rules were adopted a version of Rule 5.4 was proposed in 1981 that would have allowed for non-lawyer ownership of an entity that employed attorneys as long as the attorney's independent professional judgment was insulated from the non-lawyer owners of the entity.[32] Technically, since the 1981 version of Rule 5.4 explicitly prohibited a corporation (by definition a non-lawyer) or a non-lawyer manager from controlling an attorney-employee's practice of law, it did not return attorneys to the pre-1928 status quo.[33] It was, still, too radical and was never adopted.[34]

(2) Allow attorneys to form professional partnerships with non-lawyers (especially non-lawyer professionals). This could take two forms: (i) multidisciplinary practices (MDPs) that have attorney and non-lawyer owners where the non-lawyer partners provide services that are not necessarily connected to the practice of law by the attorney partners and (ii) law firms owned in part by nonlawyers whose role is limited to helping firm lawyers provide legal services (e.g., the version of Rule 5.4 adopted by the District of Columbia).[35] A proposal to allow MDPs in some form was debated and rejected by the ABA in 2000.[36] An effort to adopt the District of Columbia's version of Rule 5.4 was debated and rejected in 2012.[37]

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[31] *See* Adams & Matheson, *Law Firms on the Big Board? supra* note 7 at 6 – 10.

[32] This was known as the Kutak Commission proposal. *Id.* at 594 – 96.

[33] The Kutak Commission proposal was to permit attorneys to participate in an ALPS ("Alternative Law Practice Structures") – "for-profit entities in which lawyers practice law but which, unlike traditional law firms, are owned at least in part by nonlawyers." Schneyer, *"Professionalism" As Pathology, supra* note __ at 78.

[34] The Kutak Commission proposal was rejected by the ABA's House of Delegates for a variety of reasons, including, most infamously, the so-called "Fear of Sears". *See* Susan Gilbert & Larry Lempert, *The Nonlawyer Partner: Moderate Proposals Deserve a Chance*, 2 GEO. J. LEGAL ETHICS 383, 392-400 (1988) (noting that debate about reform to Model Rule 5.4 during a February 1983 ABA meeting was essentially shut down on the affirmation by Prof. Geoffrey Hazard that it would allow Sears to own and operate a law firm).

[35] *See* Schneyer, *"Professionalism" As Pathology, supra* note 26 at 79 - 81.

[36] *See id.* at 105 – 09 (describing the proposal forwarded by the Commission on Multidisciplinary Practice that "Rule 5.4 be amended to permit lawyers to share legal fees with non-lawyers in an MDP" and its rejection by the House of Delegates).

[37] *See id.* at 81 – 83 (describing the proposal forwarded by the ABA Commission on Ethics 20/20 Working Group on ALPS to allow attorneys to practice in firms with non-

(3) Allow attorneys to sell equity in their practice. While this idea has often been conflated with allowing a corporation to either employ or practice law, it need not mean anything more than allowing non-lawyers to have a beneficial interest in an attorney's property interest in her legal practice (that is, its assets and debts). Academics have offered variations on this idea since at least 1998, spurred in part by changes in Australia and the United Kingdom that have allowed non-lawyers to have ownership interests in law firms.[38] Ownership in a law practice may lead to control of the law practice, but the two do not necessarily go together.[39] Control by non-lawyers can be separated from ownership through a number of mechanisms, including sale of a derivative[40], limiting the managerial control of the practice to attorneys (preferably attorneys in the firm)[41], or mandating that the attorney or attorneys who sell ownership interests in their practice maintain majority ownership or control.[42]

(4) Allow non-lawyers to purchase an interest in attorney's expected (or unmatured) fees. By advancing money to an attorney in advance of the

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lawyer partners who assisted in the firm's practice of law, and the rejection of the proposal by the Commission).

38 *See, e.g.,* Adams & Matheson, *Law Firms on the Big Board? supra* note 7, Thomas R. Andrews, *Non-Lawyers in the Business of Law: Does the One Who Has the Gold Really Make the Rules?* 40 HASTINGS L.J. 577, 629 (1989), Sharfman*, Modifying Model Rule 5.4 to Allow for Minority Ownership of Law Firms, supra* note 23, Bruce MacEwen et al., *Law Firms, Ethics, and Equity Capital*, 21 GEO. J. LEGAL ETHICS 61, 69 (2008), Milton C. Regan, Jr., *Lawyers, Symbols, and Money: Outside Investment in Law Firms*, 27 PENN ST. INT'L L. REV. 407 (2008), Hadfield*, Legal Barriers to Innovation, supra* note 13, Cox, *An Economic Crisis Is a Terrible Thing To Waste, supra* note 19, Edward S. Adams, *Rethinking the Law Firm Organizational Form and Capitalization Structure*, 78 Mo. L. Rev. 777 (2013), *and* Molot, *What's Wrong With Law Firms?, supra* note 16. For a review of Australia's Legal Profession Act 2004 (which allows law firms to adopt the corporate form) and the United Kingdom's Legal Services Act 2007 (which allows non-lawyer investment in firms), *see* Adams, *Rethinking the Law Firm Organizational Form, id* at 802 – 03.

39 *Compare* Adams & Matheson, *Law Firms on the Big Board? supra* note 7 at 38 – 40 (assuming that lawyers would be the managers and would control shareholders) *with* Andrews, *Non-Lawyers in the Business of Law*, *supra* note 38 at 629 (assuming that shareholders would install non-lawyer professional managers who would "control" the attorneys but not interfere with their independent professional judgment).

40 *See* MacEwen et al., *Law Firms, Ethics, and Equity Capital*, *supra* note 38 at 69.

41 *See* Adams, *Rethinking the Law Firm Organizational Form supra* note 38 at 787.

42 *See* Tyler Cobb*, Note, Have Your Cake and Eat It Too! Appropriately Harnessing the Advantages of Nonlawyer Ownership,* 54 ARIZ. L. REV. 765, 796 (2012), Cox, *An Economic Crisis Is a Terrible Thing To Waste, supra* note 19 at 528 and 547 - 48, *and* Sharfman, *Modifying Model Rule 5.4 to Allow for Minority Ownership of Law Firms, supra* note 23 at 494.

attorney receiving a fee, the non-lawyer is providing capital to the attorney. This method of raising capital is more modest than the other three methods outlined above. First, since the amount of capital is linked to the expected earned fees of an attorney (or her net fees – her profits), the investment advanced by the non-lawyer would not include other forms of future equity. Second, since the only thing that would be sold would be earnings, there is no risk that a non-lawyer could control the attorney by becoming either the owner or manager of the attorney's practice. On the other hand, unlike debt financing, this method of raising capital avoids the problems described above associated with debt. The danger of financial collapse in the event of a slowdown in business is clearly limited, since the capital provider's right to payment is directly linked to the attorney's success. While it is true that a non-lawyer seeking to purchase an interest in fees might insist on inserting conditions relating to the future conduct of the attorney, it is not obvious that these conditions would necessarily be more onerous than the covenants that lenders may already impose on attorneys.[43]

All of the foregoing reforms have been resisted one way or another by the organized bar. The corporate practice of law was met with stiff resistance in the early Twentieth Century, and the arguments for its rejection helped shape Rule 5.4.[44] The reasons for rejecting the Kutak Commission's amendments to Rule 5.4 are still influential today. Critics were, and continue to be concerned that non-lawyer investors would engage in the unauthorized practice of law, interfere with attorneys' independent professional judgment, cause attorneys to reveal client confidences, and weaken attorneys' professionalism, causing attorneys to regard law as a business.[45] Those same concerns were revived to defeat new efforts over the past two decades to allow MDPs.[46] As the debate moved from reforms concerning non-lawyer ownership to MDPs, the concern

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[43] *See* Regan, *Lawyers, Symbols, and Money, supra* note 38 at 427 (control by passive investors is no different than "the case now with lenders who provide funds to firms"). *See also* L. Harold Levinson, *Independent Law Firms that Practice Law Only: Society's Need, the Legal Profession's Responsibility*, 51 OHIO ST. L.J. 229, 248 (1990) (recognizing that bank debt may be just as threatening to a firm's independence as passive non-lawyer investment).

[44] *See supra* notes 28 - 31 and accompanying text.

[45] *See* Gilbert & Lempert, *The Nonlawyer Partner, supra* note 34 at 390 *and* John H. Matheson & Edward S. Adams, *Not "If" But "How": Reflecting on the ABA Commission's Recommendations on Multidisciplinary Practice*, 84 MINN. L. REV. 1269, 1281 – 82 (2000).

[46] *See* Paul R. Koppel, *Under Siege From Within and Without: Why Model Rule 5.4 Is Vital to the Continued Existence of the American Legal Profession*, 14 GEO. J. LEGAL ETHICS 687, 692 (2001).

over the weakening of professionalism was reframed as the need to protect the "core values" of the profession.[47]

The last two reforms in the list above, the sale of equity in law practices and the sale of unmatured fees, have not been explicitly rejected as much as ignored. For example, when the ABA reached out to its members to discuss amendments to Rule 5.4, it recognized that non-lawyer ownership of law firms was an option that could be considered, but decided *sua sponte* not to allow the membership to consider it.[48] The idea of allowing the sale of unmatured fees has received even less attention from the defenders of the traditional conception of Rule 5.4 than the idea of selling equity. No explicit resistance has been necessary since there has been no concerted effort to amend or otherwise interpret Rule 5.4 to allow and encourage capital formation by the sale an interest in unmatured fees.[49] The reason for this is the assumption – which this Article will challenge – that the sale of fees not yet earned is a form of fee-splitting in violation of Rule 5.4.[50]

The history of efforts to reform Rule 5.4 has been dominated by arguments over the corporate practice of law, non-lawyer ownership of law practices, and partnerships formed by attorneys and non-lawyers. The reasons for this

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47 John S. Dzienkowski & Robert J. Peroni, *Multidisciplinary Practice and the American Legal Profession: A Market Approach to Regulating the Delivery of Legal Services in the Twenty-First Century*, 69 FORDHAM L. REV. 83, 137 (2000) (defining the core values as (1) independence of judgment, (2) confidentiality, (3) loyalty and (4) competence) *and* Markle*, A Call to Partner with Outside Capital, supra* note 15 at 1260 (rejection of 2000 amendments to Rule 5.4, although similar to rejection of the Kutak Commission proposal, now included a concern for "core values").

48 *See* ABA Comm'n on Ethics 20/20, *Discussion Draft for Comment, Alternative Law Practice Structures* (2011) (passive outside investment or ownership in law firms would "depart sharply from U.S. traditions and raised significant ethical concerns").

49 The large litigation finance firms do not purchase unmatured fees in individual cases. *See* Ben Hancock*, Ethics Rule Has Lit Funders Treading Carefully in Class Actions,* THE RECORDER, February 15, 2017, http://www.americanlawyer.com/id=1202779263898?keywords=Hancock (last accessed February 21, 2017). At least one post-settlement legal finance firm has purchased unmatured fees in a large products liability case. *See Order Instituting Proceedings In the Matter Of RD Legal Capital, LLC*, Securities and Exchange Commission, July 14, 2016, https://www.sec.gov/litigation/admin/2016/33-10111.pdf (detailing purchase of approximately $6 million unmatured legal fees arising from multiple lawsuits against various manufacturers of bisphosphonates). Published opinions in multiple state and federal cases reveal that that legal finance firms have purchased unmatured attorneys' fees with some frequency over the past decade. *See infra* notes __ - __ and accompanying text.

50 *See infra* Section IV.

are outside the scope this Article. This Article examines an idea that has not received attention, that is, the sale of unmatured fees. It too is a way that attorneys may raise capital, and therefore it serves some of the same purposes as the more well-known topics of controversy such as MDPs and publicly-traded law firms. It is also subject to attack for being a violation of Rule 5.4, for some of the same reasons that defenders of the status quo have argued that MDPs and publicly traded law firms violate Rule 5.4.[51]

The sale of unmatured attorney's fees deserves serious attention for two reasons. First, because it is a way of raising capital that does not necessarily involve the sale of a property interest in an attorney's practice or by placing the attorney under the control of a firm owned by non-lawyers. Therefore, the arguments raised against MDPs and the publicly-traded law firms should be weaker and carry less weight than they have in the past. Second, as this Article will argue, strong arguments can be made that the sale of unmatured fees is consistent with the current Rule 5.4 – assuming, of course that the interpretation of "fee sharing" offered in this Article is found persuasive by state bar ethics committees and courts. If both these reasons hold, then the sale of unmatured fees could be an important new source of capital for attorneys. It would not fully substitute the other reforms that have been urged on the ABA since the early Twentieth Century, since MDPs and other forms of ALPS serve important and specific functions in addition to capital formation. However, to the extent that attorneys' struggle to raise capital can be addressed by creating a market in unmatured fees, there is no reason not to encourage the development of such a market even if the debate and controversies over other issues related to Rule 5.4 are left open and unresolved.

The structure of the Article is as follows. In Section II, I provide a history of the concept of fee-splitting as an interpretation of the modern legal concept of fee-splitting, which I characterize as the "Direct Relation Test". In Section III, I analyze the practice of factoring legal fees and I argue that there is no difference between "standard" factoring of legal accounts receivables and the factoring of unmatured fees, or accounts. In Section IV, I argue that the general acceptance of the sale of accounts receivables in legal fees puts courts and ethics committees on the horns of a dilemma: either they are obliged to prohibit the sale of legal accounts receivables or they must articulate a principled basis for distinguishing between "standard" factoring of legal accounts receivables and the factoring of unmatured fees. In Section V, I argue that the "Direct Relation Test" is impossible to implement practically and has almost no normative attraction. In Section VI, I conclude that if attorneys are not constrained under the Direct Relation Test, then there is no reason that Rule 5.4 prevents them from selling their unmatured fees to raise capital.

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[51] *See infra* notes 79 - 89 and accompanying text.

II. Taking Fee-Splitting Seriously

A. The Historical Roots of the Prohibition Against Fee-Splitting

Critics of the reforms debated by the ABA since the Kutak Commission have always seen a deep connection between Rule 5.4's central purpose – "to prevent non-lawyers from influencing the practice of law" – and Rule 5.4(a)'s specific prohibition on an attorney sharing fees with a non-lawyer.[52] According to some courts, ethics committees, and professional responsibility treatises, Rule 5.4(a)'s reach extends – in theory, at least – to any agreement by an attorney to pay a non-lawyer an amount of money drawn from her fee.[53] As a 1925 ABA Formal Ethics Opinion put it, "[a]s the attorney cannot share his professional responsibility with a layman or lay agency, he cannot properly share his professional emoluments with them."[54] According to one commentator, the prohibition in Rule 5.4(a) is central to the regulation of law as a profession: "Virtually all professions prohibit splitting fees with lay persons . . .

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[52] *See* Koppel, *Under Siege From Within and Without, supra* note 46 at 701. Model Rule 5.4(a) provides that:

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

[53] *See* Koppel, *Under Siege From Within and Without, supra* note 46 at 701 – 02 (reviewing case law and ethics opinions) *and* GEOFFREY C. HAZARD, JR., W. WILLIAM HODES & PETER R. JARVIS, THE LAW OF LAWYERING (4th ed. 2014) § 45.04 (reviewing Rule 5.4(a)).

[54] ABA Formal Opinion 8 (1925).

[o]bviously, if a lawyer gives a portion of his fee to someone else, he is doing so for a reason" of concern for the profession.[55]

First, a note about nomenclature. While the term "fee-splitting" commonly found in published judicial opinions[56], bar committee opinions[57], and treatises[58], it is not, in fact, a term of art or a defined term. In fact, the term "fee-splitting" is does not appear in any statute or in any of the rules of professional conduct regulating lawyers.[59] The reason for this is that for centuries it has been understood that "fee-splitting" simply *is* impermissible fee-sharing, and this is so obvious to courts and commentators that the terms are used interchangeably.[60] When the New York legislature prohibited the "sharing" or "dividing" of fees by lawyers with non-lawyers, the courts instantly understood this to be a prohibition on fee-splitting.[61] State ethics committees have understood the ABA's prohibition on the sharing of fees with non-lawyers in Rule 5.4(a) in a similar way.[62]

Fee-splitting is in fact an unruly term whose meaning is informed by a variety of legal sources. Courts use it to explain why certain contracts between

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55 Cindy Alberts Carson, *Under New Mismanagement: The Problem of Non-Lawyer Equity Partnership in Law Firms*, 7 GEO. J. LEGAL ETHICS 593, 625 (1994).

56 *See, e.g. Rich v. Simoni*, No. 1:12CV12, 2014 U.S. Dist. LEXIS 138352 (N.D.W. Va. Sep. 30, 2014) (university professor who attended law school but did not pass the bar could not "split fees" with an attorney with whom he worked on an asbestos case).

57 *See, e.g.,* N.Y. State Op. 1068 (2015) ("Aiding Unauthorized Practice of Law; Referrals from Nonlawyers; Fee-Splitting").

58 *See* HAZARD, ET. AL., THE LAW OF LAWYERING, *supra* note 53 at § 45.04 ("fee-splitting" is a synonym for "fee-sharing with a non-lawyer prohibited by law").

59 This is true even where the title of the law or rule uses the expression. *See* N.M. Stat. Ann. § 36-2-31 (although titled "Fee splitting prohibited; division of fees by attorneys excepted," the text of the statute does not refer to fee "splitting" but instead refers to fee "sharing"); CAL. ST. BAR RULES OF PROCEDURE, Standard 2.8 (although titled, "Fee-Splitting With Non-Lawyers," the text refers to a lawyer who "shares" fees illegally, not one who "splits" fees).

60 This is not because legislators and the drafters of the professional responsibility codes do not know how to directly regulate fee-splitting. In other professions, such as medicine, "fee splitting" is frequently the subject of state law. *See, e.g.* Wis. Stat. Ann. § 448.08 (defining and prohibiting "fee-splitting" by physicians).

61 *See, e.g. Heer v. N. Moore St. Developers, L.L.C.,* 2016 NY Slip Op 05246, 140 A.D.3d 675, 36 N.Y.S.3d 93 (App. Div.) (*discussing* NY CLS Jud. L. § 491).

62 *See, e.g.,* State Bar of Georgia, Formal Advisory Opinion No. 05-9 (2005). It appears that the ABA is the last hold-out: it never refers to prohibited forms of fee-sharing as "fee-splitting" in its formal opinions.

lawyers and other lawyers, as well as lawyers and non-lawyers, will be enforced (or not enforced) according to the law of contract, and bar committees (and occasionally courts) use it to explain why certain conduct by lawyers is subject to sanction. The sources of law that inform these various judgments about whether fee-splitting has occurred are not the same and are informed by different purposes.

The common law's rule prohibition against fee-splitting can be traced to a 1729 English Act of Parliament barring an attorney from allowing any non-attorney to use the attorney's name for profit.[63] In 1819 an English court invalidated an agreement by an attorney to pay one-third of his profits to his non-lawyer clerk in lieu of salary on the grounds that it permitted a non-lawyer to use the attorney's name for profit.[64] In 1879 the United States Supreme Court observed in *Meguire v. Corwine* that, in the United States, fee-sharing agreements with non-lawyers were "forbidden by a statute or condemned by public policy" and were "clearly illegal."[65] In late Nineteenth Century New York, contracts between lawyers and non-lawyers to share contingent recoveries were held to be unenforceable and could result in both the disbarment and criminal prosecution of the attorney under N.Y. Code Civ. Proc. §§ 73 – 75.[66]

In 1908 the ABA added to the body of rules that limited fee-splitting with the promulgation of the Canons of Professional Ethics. Canon 28 prohibited lawyers from paying non-lawyers for referrals but the Canons did not otherwise prohibit fee sharing with non-lawyers.[67] The Canons left open the possibility that lawyers could ethically remit their fees to a non-lawyer, such as a corporation, as part of an employment contract.[68] The ABA's 1928 Canons adopted a broad rule that complemented the prohibition of the corporate practice of law discussed in Section I.[69] Canon 34 directly prohibited fee sharing with non-lawyers by providing that "[n]o division of fees for legal services is proper, except with another lawyer, based upon a division of service or respon-

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[63] Simon, *Fee Sharing*, *supra* note 28 at 1076 (*citing* Regulation of Attorneys and Solicitors Act, 2 Geo. 2, ch. 23 (1729)).

[64] *Id.* at 1077, *citing Tench v. Roberts,* 56 Eng. Rep. 1047 (1819).

[65] 101 U.S. 108, 111- 12 (1879).

[66] *See In re Clark*, 108 A.D. 150, 95 N.Y.S. 388 (App. Div. 1905) *and Hirshbach v. Ketchum,* 5 A.D. 324 (App. Div. 1896).

[67] Canon 28 said it was "disreputable" for a lawyer "to pay or reward, directly or indirectly, those who bring or influence the bringing of such cases to his office." CANONS OF PROFESSIONAL ETHICS, Canon 28 (1908).

[68] Simon, *Fee-Sharing*, *supra* note 28 at 1079.

[69] *See supra* note 30 and accompanying text.

sibility."[70] Canon 34's injunction against fee-splitting has been carried forward in each of ABA's subsequent major revisions to its model codes in 1969[71] and 1983.[72]

B. Fee-Splitting Today

1. The Many Faces of Fee-Splitting

The range of financial arrangements with non-lawyers deemed fee-splitting is broad. It includes cases involving impermissible forms of payment to law office employees and independent contractors working for the attorney.[73] It includes cases involving the payment of referral fees to non-lawyers, which are no different from the practice of hiring "runners" to bring cases to lawyers.[74] It includes cases involving the payment of a portion of a law firm's fees to a "professional employer organization," (which provides "back office" personnel support to law firms) in exchange for the vendor taking over all of the payroll and benefits management for the firm, since the vendor is a non-lawyer.[75] It has been extended to bar lawyers from New York who practice in

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70 CANONS OF PROFESSIONAL ETHICS, Canon 34 (1928).

71 Disciplinary Rule 3-102(A) provided: "A lawyer or law firm shall not share fees with a non-lawyer."

72 As a result of the defeat of the Kutak Commission proposal, the current Rule 5.4(a) was adopted. *See supra* note 34.

73 *See, e.g. Patterson v. Law Office of Lauri J. Goldstein, P.C.*, 980 So. 2d 1234 (Fla. Dist Ct. App. 2008) (fee-splitting agreement between lawyer and her paralegal deemed void) *and Atkins v. Tinning,* 865 S.W.2d 533 (Tex. App. 1993) (lawyer's promise to pay investigator one third of his contingent legal fee was unethical because it was fee-splitting).

74 See *Trotter v. Nelson*, 684 N.E.2d 1150, 1154 (Ind. 1997) (lawyer may not pay a clerk 5% of fee earned as referral fee); *Vidrine v. Abshire*, 558 So. 2d 288, 292 (La. Ct. App. 1990) (holding against a "runner" who sought 10% of the cases he brought to the attorney); *and Plumlee v. Paddock*, 832 S.W.2d 757, 759 (Tex. Ct. App. 1992) (attorney may not pay an ambulance company a fee including a portion of the attorney's fee earned for steering cases to the attorney).

75 *See* NYCBA Formal Op. 2015-1 ("Use By A Law Firm Of A Professional Employer Organization") *and* North Carolina Bar Formal Op. 6 (2003) ("Contracting with Professional Employer Organization to Handle Human Resources, Payroll, and Other Functions for Law Firms"). New York State Bar ethics opinions permit the payment of fees to nonlegal service providers, *so long as they are not calculated based on legal fees*. *Compare* N.Y. State Eth. Op. 565 (1984) (attorney may not pay marketing company a commission based on fees earned from clients introduced by the marketing company)(emphasis added), *with* N.Y. State Eth. Op. 917 (2012) (attorney may pay bonus to marketer for advertising services if bonus is not based on fees paid by clients).

New York from working for London law firms if their fees would be distributed to English firms that had non-lawyer equity partners.[76]

In most of these decisions, the prohibition on fee-splitting can be seen as serving certain policy goals that have been traditionally identified as part of the "core values" served by the modern regime of legal ethics.[77] The prohibition of fee-splitting with non-lawyer employees and agents serves the goal of preventing the unauthorized practice of law (UPL), which has certainly been a core concern of both public law and the bar associations regulating the profession.[78] The public must be protected against UPL for multiple reasons.[79] Obviously, insuring competent representation is one. Another relates to the fear that financial incentives affect non-lawyers differently than lawyers, or, to put it differently, since non-lawyers lack the ethical muscles developed by lawyers, they are more likely to pursue their own self-interest, all things being equal, than lawyers.[80] Ethics opinions barring fee splitting with non-lawyer agents emphasize that there is an ineliminable risk that, when an agent's earnings are contingent on the outcome of a case on which he works, he may act against the client's interests by directing (or otherwise causing) the attorney to invest time and other resources among multiple clients based on which case promises the greatest reward.[81]

The prohibition of fee-splitting to prevent referrals from non-lawyers reflects a deeply entrenched set of concerns, this time felt especially by the bar itself.[82] One justification for preventing lawyers from paying for referrals from

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[76] N.Y. State Eth. Op. 911 (2012) *and* N.Y. State Eth. Op. 1038 (2014) (same conclusion applied to a D.C. firm, which has amended Rule 5.4 to allow non-lawyers to form professional partnerships that engage in law-related activities).

[77] *See* Green, *The Disciplinary Restrictions on Multidisciplinary Practice, supra* note 30 at 1145–46 (describing the five premises upon which the "core values rationale" relies).

[78] *See O'Hara v. Ahlgren, Blumenfeld & Kempster*, 127 Ill. 2d 333, 342 (1989) (fee-splitting arrangements facilitate UPL).

[79] "Prohibitions against nonlawyers practicing law have been common in this country for at least a hundred years." Andrews, *Nonlawyers in the Business of Law, supra* note 38 at 579.

[80] *See Hildebrand v. State Bar of Cal.,* 225 P.2d 508, 520 (Cal. 1950) ("lay [persons] who solicit cases and then sell them to attorneys are apt to seek out, not the most competent attorney, but the one who will pay the most for a case").

[81] *See* Tex. Disciplinary Rules of Prof'l Conduct R. 5.04 cmt. 1 *and* D.C. Bar, Op. 322 (2004).

[82] *See* Joseph M. Perillo, *The Law Of Lawyers' Contracts Is Different*, 67 FORDHAM L. REV. 443, 460 (1998).

non-lawyers is client protection.[83] An additional argument has to do with the dignity of the profession. The 1908 Canon was a product of "the lawyers who made up the membership of the ABA [who] looked with disdain on the scrambling, ungraceful efforts to gain business engaged in by some newcomers to the bar," (including the use of runners and paid referrals).[84] Even today, the Restatement, after listing various client-protection concerns about fee-splitting and referrals, adds: "beyond that, the prohibition reflects a general hostility to commercial methods of obtaining clients."[85]

The prohibition of fee-splitting within partnerships that contain non-lawyer owners has also been justified by reference to the core value of the professional independence of the attorney, which is seen as imperiled by the ends necessarily pursued by non-lawyers.[86] It is not clear whether professional independence is valued because it maximizes the likelihood that a client will get the most competent and efficacious advice, given her ends, or because it maximizes the likelihood that the client will receive advice filtered through special non-instrumental values that lawyers employ which are inaccessible to laypersons.[87]

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[83] *Id.* ("The rationale usually given for the prohibition of fee splitting with non-lawyers is that '[a] person entitled to share a lawyer's fees is likely to attempt to influence the lawyer's activities so as to maximize those fees. That could lead to inadequate legal services.'") (*quoting* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §11 cmt b).

[84] Susan D. Carle, *Lawyers' Duty to Do Justice: A New Look* at *the History of the 1908 Canons*, 24 LAW & SOC. INQUIRY 1, 8 (1999) *and In re Krasner,* 204 N.E.2d 10, 14 (Ill. 1965) (splitting fees with non-lawyers who solicit clients invites "derision [for] and disrespect" of the profession).

[85] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 59 cmt. b. It may be that the prohibition on fee-splitting is one of the many tools used by the bar and the state in "protecting the legal profession's image and reputation." *See Alexander v. Cahill,* 598 F.3d 79, 102 (2d Cir. 2010) (recognizing state's interest in preserving lawyers' reputations).

[86] *See, e.g.,* Lawrence J. Fox*, Accountants, the Hawks of the Professional World: They Foul Our Nest and Theirs Too, Plus Other Ruminations on the Issue of MDPs*, 84 MINN. L. REV. 1097, 1106 (2000) (arguing that Rule 5.4 guards against "interference by non-law trained masters who wish us to take short cuts to maximize profits").

[87] The latter option is distinguished from the former in two ways. First, an attorney's reasons for action cannot be simply a mirror of her client's reasons, and second, an attorney's reasons for action are informed by a role morality that other third parties (such as financially interested non-lawyers) do not share. The content of that role morality can vary greatly, as is illustrated by the different conceptions of the role morality of lawyers presented by David Luban and W. Bradley Wendel. *See, e.g.* DAVID LUBAN, LEGAL ETHICS AND HUMAN DIGNITY (2007) *and* W. BRADLEY WENDEL, LAWYERS AND FIDELITY TO LAW (2010).

Sometimes defenders of the prohibition on fee- splitting with non-lawyer partners suggest the former[88], and sometimes the latter.[89]

Given the heterodox origins of the prohibition on fee-splitting, there is no point trying to discern the "original intent" of any single legislator behind the rule, regardless of whether that legislator was the ABA in 1908 or New York State in the mid-Nineteenth Century. The ABA and the states, when they adopted limitations on fee-sharing, left it to the courts and to the ethics committees to implement those limitations using the concept of "fee-splitting" as a legal term whose meaning would be developed through interpretation. Currently, the leading interpretation is something that this Article calls the "Direct Relation Test" (DRT).

2. The Direct Relation Test

The DRT has been stated in a leading treatise in the following way:

> The phrase "shall not share legal fees" [in Rule 5.4(a)] is intended to bar *any* financial arrangement in which a nonlawyer's profit or loss *is directly related* to the successfulness of a lawyer's legal business.[90]

As will be argued below, the DRT is flawed in two ways – it is almost impossible to implement in a principled fashion and it is normatively unattractive – but the purpose of this section is to demonstrate that it is the best interpretation of what courts and ethics committees say that they are doing when they implement the prohibition against fee-splitting.

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[88] *See, e.g.* Anthony J. Sebok, *What Do We Talk About When We Talk About Control?* 82 FORDHAM L. REV. 2939, 2950 (2014) ("Critics of non-lawyer investment have argued that loyalty to clients will be compromised by demands of investors to cut expenses or divert resources to cases on the basis of their potential return to the law firm and not based on the needs of the firm's clients.").

[89] *See, e.g.,* Green, *The Disciplinary Restrictions on Multidisciplinary Practice, supra* note 30 at 1146 ("Even if the legal services were rendered exclusively by lawyers in the multidisciplinary firm, lawyers could not be counted on to serve skillfully and in accordance with the legal profession's *ethics* rules . . . . The clients should not be allowed to contract to accept service under *a different set of norms* from those governing the attorney-client relationship. . . .") (emphasis added).

[90] HAZARD, ET. AL., *supra* note 53 at § 45.04 (emphasis added). *See also* Prof'l Ethics Comm. for the State Bar of Tex., Op. 576 (non-lawyer cannot "directly" benefit from the attorney's legal skills).

In addition to the scenarios described above involving payments to employees and agents, referral fees, and partnerships with non-lawyers, the prohibition on fee-splitting has been applied to bar many proposed financing agreements between lawyers and non-lawyers. For example, Hazard, Hodes and & Jarvis's treatise (which, at this point, may as influential with courts and ethics committees as the Restatement) contains a "black letter" illustration that contrasts three lawyers, A, B, and C, each of whom are planning to construct a law office and each of whom who need $50,000. A borrows $50,000 on a line of credit with a bank; B "borrows" $50,000 from a wealthy friend in exchange for 10% of his net legal fees, and C takes a $50,000 fee earned from a client and uses it to pay for the construction costs. Hazard, et. al. observe that, although the transactions are "substantially similar" from an economic point of view, "Lawyer B has certainly violated Rule 5.4(a)."[91]

In the example above, all Lawyer B has done is seek capital and, in exchange, promise to give a contingent sum of money to a non-lawyer upon the occurrence of certain future events in exchange for that capital. Unlike in the cases of solicitation by "runners" or the coordination of services with private investigators discussed above, there is no explicit obligation or expectation that the non-lawyer do anything other than advance capital.[92] Therefore, the DRT's reach is not limited to cases where the non-lawyer performs a service for the attorney or that he enhances the conditions under which the attorney practices law.[93] The transaction sought by Lawyer B involves the funder in the attorneys' practice no more than the loan transaction sought by Lawyer A, as Hazard, Hodes, and Jarvis note.[94] Lawyer B has simply advanced capital to the attorney, nothing more; although, since the advance is non-recourse, it is technically not a loan.[95]

3. *Applying the DRT to Capital Advances*

Transactions involving capital advances like the one sought by Lawyer B are not the subject of many court opinions or ethics decisions, but they have been challenged; and when they are, the DRT has been applied with varying degrees of strictness. The DRT has been applied by state bar ethics committees

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91 *Id.*

92 *See supra* note 74 and accompanying text.

93 The non-lawyer is not, for example, providing a nonlaw-related activity, like managing the attorney's office or providing accounting advice to the attorney's clients.

94 *Id.*

95 *See, e.g., Odell v. Legal Bucks, LLC,* 665 S.E.2d 767, 776 – 77 (N.C. Ct. App. 2008) (the nonrecourse purchase of litigation proceeds is not a loan, although it is an advance).

to capital advances that fall in to two rough categories: those that offer a fixed return and those that offer a return that is contingent upon the size of the attorneys' fee.

a. Fixed-Return Contingent Advances

A handful of ethics committees have held that a non-recourse loan priced through a fixed interest rate is fee-splitting. Under this interpretation of the DRT, an attorney may not promise to a non-lawyer "lender" to repay any capital she receives, plus interest, contingent on her earning a fee. Although called a non-recourse loan, this transaction is really a fixed-return contingent advance.[96] Ethics opinions in Maine, Missouri, and Nevada have prohibited fixed-return contingent advances.[97] Not all ethics committees agree: a Philadelphia bar ethics committee, for example, observed that since a fixed-return contingent advance is "no different than when an attorney negotiates a loan from a bank," it is not fee-splitting.[98]

b. Percentage-Return Contingent Advances

The committees that deemed fixed-return contingent advances to be fee-splitting must have assumed that, under the DRT, any non-recourse advance between an attorney and a non-lawyer is fee-splitting. One need not make this assumption; it is conceivable, at least, to hold that non-recourse advances that cost the attorney a fixed interest rate are not fee-splitting but non-recourse ad-

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[96] *See, e.g. Kelly, Grossman & Flanagan, LLP v. Quick Cash, Inc.,* 950 N.Y.S.2d 723, 35 Misc. 3d 1205(A) (N.Y. Sup. Ct. 2012) at **13 (where attorney who received advance was never at risk of recourse, "such circumstances simply cannot be stated to constitute a 'loan'").

[97] *See* Nev. Standing Comm. on Ethics & Prof'l Responsibility, Formal Op. No. 36 (2007) (rejecting all "non-recourse lending by third parties" to lawyers); Mo. Bar, Informal Op. 2003-0022 ("it is not permissible for the repayment of the loan [to a lawyer] to be based on the outcome of the lawsuit"); *and* Maine Prof. Ethics Comm. Formal Op. 193 (2007) (fixed interest loan prohibited where "attorney must repay . . . only if the attorney is successful and recovers a fee").

[98] Phila. Bar Ass'n, Op. No. 2003-15. Utah Ethics Advisory Opinion No. 97-11 prohibited a fixed return contingent advance where "a non-recourse promissory note is secured by the attorney's interest in [his/her] contingent fee"). The ethics opinion left open the possibility that a fixed return contingent advance that gave the non-lawyer an unsecured interest or a security interest in other property owned by the attorney would not be fee-splitting, a position that seems to be supported by a later opinion that allowed a non-lawyer to advance capital to an attorney in exchange for a percentage-return contingent advance as long as the non-lawyer did not hold a security interest in the attorney's contingent fee. Utah Ethics Advisory Opinion No. 06 – 03 *and see infra,* notes 175 - 179 and accompanying text.

vances that cost the attorney a percentage of her fee are fee-splitting. The latter type of advance is a percentage-return contingent advance. A North Carolina bar ethics committee drew exactly this contrast between a fixed-return contingent advance and a percentage-return contingent advance.[99] It was asked by an attorney if he or she could accept a fixed-return contingent advance from a non-lawyer, and the committee gave its permission but cautioned that were the attorney to go further and promise the non-lawyer "a percentage of the attorney's fee in a given case" the transaction would cross the line into fee-splitting.[100]

Although it has been silent on whether fixed-return contingent advances are fee-splitting, Texas has rejected the percentage-return contingent advance as fee-splitting in three different ethics opinions. In Texas Op. 558, an attorney asked whether he or she could, in addition to paying a fixed interest rate to a funder who lent money for case expenses, agree to pay the funder a percentage of the attorney's contingency fee.[101] The committee held that this would be fee-splitting.[102] In Texas Op. 576, an attorney asked whether he or she could enter an agreement with a non-lawyer identical to the arrangement proposed in Texas Op. 558, except that the attorney's non-recourse obligation to the non-lawyer for the funds advanced would be a contingent sum calculated as a percentage of the attorneys' fee, capped at a multiple of the funds advanced.[103] The Texas ethics committee said that this would be fee-splitting.[104] In an interesting twist on the more conventional forms for capital formation, in Texas Op. 467 an attorney asked whether he or she could "enter into a lease of office space with a non-lawyer landlord under the terms of which rent equals the greater of a specified minimum rental or a percentage of the law firm's gross receipts."[105] The Texas ethics committee said this would be fee-splitting.[106]

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[99] *See* North Carolina Formal Ethics Op. 2006-12.

[100] *Id.*

[101] Prof'l Ethics Comm. for the State Bar of Tex., Op. 558 (2005).

[102] "It is a violation of Rule 5.04(a) of the Texas Disciplinary Rules of Professional Conduct [Texas' version of Rule 5.4(a)] for a lawyer to agree to pay a percentage of the lawyer's contingency fee . . . in connection with obtaining a loan." *Id.* Even if the fixed interest fee on the loan were recourse (which is not clear from the decision) the additional payment was clearly non-recourse and determined by the quantum of the attorney's fee.

[103] Prof'l Ethics Comm. for the State Bar of Tex., Op. 576 (2006).

[104] *Id.* ("The funding fee . . . would be tied directly to the amount of recovery in the underlying litigation . . . [t]his is tantamount to fee-splitting.").

[105] Prof'l Ethics Comm. for the State Bar of Tex., Op. 467 (1990).

[106] *Id.*

Analytically, the only difference between a fixed-return contingent advance and a percentage-return contingent advance is the way that the price of the advance is determined. From the perspective of the "buyer" (the attorney) the chief advantage of the fixed-return contingent advance is that if she receives no fee, she does not have to repay the advance. The fact that the price of taking that chance is a fixed interest rate as opposed to a percentage of her fee should matter much less than the fact that any payment to the non-lawyer is contingent on the case generating proceeds.[107] And the converse is true for the "seller" (the non-lawyer providing the advance) – for him, the big risk is that he will receive nothing due to the contingent nature of the transaction. The size of his recovery, if there is a recovery, is of secondary importance.[108]

For this reason, the treatment of contingent advances by the state bar ethics committees should not turn on the difference between fixed and percentage returns. This is borne out by a review of the opinions, where the committees express concern about self-dealing referrals and non-lawyer interference with independent professional judgment.[109] These policy concerns, as was shown above, have been part of the historical rationale for the rule against fee-splitting. These functional concerns cannot in themselves explain why the committees decide to treat some contingent advances as within the reach of the rule against fee-splitting (and not others) or why loans are excluded entirely.[110]

The explanation of how the committees identify which advances fall under the rule against fee-splitting is found in the way that they identify a certain feature or characteristic of the transactions. For example, The Maine ethics

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[107] This assumes that, for every advance, its price could be expressed as a fixed interest rate or the percentage of the attorney's fee, and that the difference between them, while important to the parties, would not be dramatic. (For example, if a fixed-return contingent advance involves periodic payments to the non-lawyer before the resolution of the underlying litigation, the interest rate in the fixed-return contingent advance would have to be unusually high for it to be more attractive to the attorney than a percentage-return contingent advance.) These details have never been explored in any of the bar ethics opinions that have discussed contingent advances.

[108] *See supra* note 96 and accompanying text.

[109] *See, e.g.* Maine Prof. Ethics Comm. Formal Op. 193 (2007) (the underlying rationale for the rule against fee-splitting in this case is "that any fee-sharing arrangement creates an unacceptable risk that the professional independence of the lawyer will be influenced by the non-lawyer who has an interest in the attorney's fee") and Prof'l Ethics Comm. for the State Bar of Tex., Op. 576 (2006) (policy basis for prohibiting fee-splitting in this case is to prevent referrals by a non-lawyer with an interest in an attorney's fee).

[110] Recall that conventional recourse lenders may have the same incentives and abilities to interfere with attorney independence as so-called non-recourse lenders. *See supra* notes 23 - 25 and accompanying text.

committee held that a fixed-return contingent advance was fee-splitting because the interest paid to the non-lawyer was evidence that he was "*sharing in the prospects of success* or failure of the particular litigation."[111] Similarly, one of the Texas bar committees explained that the reason a percentage-return contingent advance was fee-splitting was because "[b]y tying the proposed funding fee to a percentage of the recovery, the lending company would be *directly benefiting* from the lawyer's knowledge, skill, experience and time expended to the detriment of the lawyer. . . ."[112] The feature or characteristic of the advances that define them as fee-splitting is that they are made by the non-lawyer with the expectation that the attorney's efforts will create new proceeds that will be paid to the non-lawyer. The DRT is designed to prevent this beneficial relationship between attorney and non-lawyer, and the prevention of this beneficial relationship is why these committees have held that all forms of contingent advances are fee-splitting.

III. The Problem with Factoring

A. Factoring

This section has two goals. First, it draws attention to the fact that one form of factoring by lawyers – when law firms sell their accounts receivables of fees billed to client but not yet paid – does not run afoul of the DRT. This is a somewhat banal claim. Second, it argues that a factoring contract between an attorney and a non-lawyer for fees that will be billed to clients once they are earned is the same, from the point of view of commercial law, as a factoring contract for earned fees that have been billed to client but not yet paid. This second claim has been endorsed by various state courts but one state bar ethics committee has held that the sale of unearned or "unmatured" fees violates the DRT.[113]

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[111] Maine Prof. Ethics Comm. Formal Op. 193 (2007) (emphasis added).

[112] Prof'l Ethics Comm. for the State Bar of Tex., Op. 576 (2006) (emphasis added).

[113] Three courts have either held or stated in dicta that the sale of unmatured accounts receivables by an attorney is not fee-splitting. *See Lawsuit Funding, LLC v. Lessoff*, 2013 WL 6409971 at *5 (NY Sup. Crt. 2013); *Counsel Fin. Servs., L.L.C. v. Leibowitz*, 2013 Tex. App. LEXIS 9252, 2013 WL 3895331, at *7-8 (Tex. App. 2013), *reh'g overruled* (2013), *rev. den.* (2014)); *and PNC Bank v. Berg,* 1997 WL 529978, at *10 n.5 (Del. Super. Ct. 1997). One state bar ethics committee has held that a lawyer cannot sell unearned fees to a factor. *See* Advisory Opinion, Ohio Supreme Court's Board of Commissioners on Grievances and Discipline, Opinion 2004-2.

B. Standard Factoring

This section introduces the concept of factoring of accounts receivables and applies it to earned legal fees. Factoring is a practice that is deeply woven into the fabric of commercial law in England and the United States.[114] As one practice treatise puts it,

> Factoring in modern commercial practice is understood to refer to the purchase of accounts receivable from a business by a "factor" who thereby assumes the risk of loss in return for some agreed discount. . . . Factoring of accounts receivable is a process by which a seller who acquires accounts receivable from the sale of goods or services, instead of retaining these accounts receivable until paid by the purchaser, obtains cash for them by selling or assigning them to a factor or by borrowing against them from a factor.[115]

When law firms when law firms sell their accounts receivables of fees billed to client but not yet paid, they are engaged in factoring. The following example illustrates standard factoring.[116]

> <u>Standard Factoring of Hourly Fees</u>. At T_1 L is retained on an hourly rate contract. At T_2 L works three hours at $100 per hour. At T_3 L bills C for $300. C has 30 days to pay L $300. At T_4 B buys L's accounts receivables for $290. At T_{30} B tenders demand for $300 to C, which C pays.

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[114] *See* Dan T. Coenen, *Priorities in Accounts: The Crazy Quilt of Current Law and a Proposal for Reform,* 45 VAND. L. REV. 1061, 1066-1067 (1992) ("The emergence of factoring as a form of commercial activity illustrates the recognition of a new variety of value-maximizing exchange. The account-purchasing factor made money on the spread between the face value of the receivable and the discounted cash price the factor paid for it. In turn, the cash paid for the account provided the account seller with capital needed to fund current business operations.") *and* GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 8.1 (1965) at 250-53 (detailing the development of accounts receivable financing).

[115] 24A FLA. JUR., "Factors and Commission Merchants" § 3 (2nd 2015).

[116] Standard factoring of earned hourly fees is a common practice today. *See* Nell Gluckman, *As Collections Loom, Law Firms Seek Investors Willing to Spread the Risk*, THE LEGAL INTELLIGENCER, Nov. 30, 2016, at 1 (describing how a litigation finance firm would, before the end of the calendar year, "pay $45 for a right to the first $50 that a firm collects" from clients who have been billed but may not pay until after the calendar year has passed).

This example is drawn from *Santander Bank, N.A. v. Durham Comm. Capital Corp.*[117] A law firm, Connolly, Geaney, Ablitt & Willard, PC (CGAW), earned hourly fees by doing work for a client, Santander Bank. CGAW then sold its accounts receivables in those fees to a factor, Durham. Santander and CGAW disagreed over certain billing statements, and Santander did not pay the disputed bills. Eventually, CGAW went bankrupt. Durham sued Santander for payment of the accounts receivables it had purchased from CGAW. Santander sought a declaratory judgment that Durham had no standing to seek the fees for the work that CGAW allegedly earned. The court rejected Santander's arguments and noted that the transaction at issue was not unusual.[118] It rejected Santander's argument that earned fees cannot be treated as "accounts receivables" under Massachusetts law because doing so would violate public policy, either by allowing lawyers to violate their duty of confidentiality to their clients or because it would be fee-splitting.[119]

Additional variations on the *Santander* case of standard factoring can be illustrated. For example:

> Standard Factoring of Fixed Fees At T_1 L is retained on fixed fee basis of \$300. At T_2 L performs the legal work promised. At T_3 L bills C for \$300. C has 30 days to pay L \$300. At T_4 B buys L's accounts receivables for \$290. At T_{30} B tenders demand for \$300 to C, which C pays.

There is no difference between Standard Factoring of Hourly Fees and Standard Factoring of Fixed Fees except that in the latter the fee earned and assigned is based on a fixed fee not an hourly fee.

Yet one more variation on the *Santander* case of standard factoring can be described:

> Standard Factoring of Contingent Fees. At T_1 L is retained on a contingent fee contract of 30%. At T_2 L performs the legal work promised. At T_3 D and C settle for \$1000 and the court

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[117] *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).

[118] *Id.*. at *2 n.1 ("Factoring is a process by which a business sells to another business, at a small discount, its right to collect money before the money is paid.") (*quoting Houston Lighting & Power Co. v. Wharton*, 101 S.W.3d 633, 636 (Tex. App. 2003)).

[119] *Id.* at *17 and *18 n.5 ("assignments of law-firm account receivables do not constitute 'fee-sharing'") *and see Durham Commer. Capital Corp. v. Select Portfolio Servicing, Inc.*, No. 3:14-cv-877-J-34PDB, 2016 U.S. Dist. LEXIS 143229 (M.D. Fla. Oct. 17, 2016) (same).

> approves the settlement. D has 30 days to pay C $1000. At T_4 B buys L's accounts receivables for $290. At T_{30} B tenders demand for $300 to C, which C pays.[120]

There is no difference between Standard Factoring of Hourly Fees and Standard Factoring of Contingent Fees except that in the latter the fee earned and assigned is based on a contingent fee not an hourly fee.

Given the thin cash flow of many plaintiffs' firms, the decision by the attorney in the last example to engage in standard factoring is unremarkable. Standard factoring of contingent fees is typically the sale of a fee post-settlement. In fact, a large industry exists to provide this service.[121]

Despite the ubiquity of post-settlement purchases of accounts receivables, and the apparent willingness of courts to enforce the purchases, one state, Ohio, has indicated that it is a violation of that state's rules of professional responsibility for an attorney to "sell or assign" his or her legal fee even after settlement.[122] The bar ethics committee was asked whether an attorney, "upon reaching a settlement" could "sell or assign his or her legal fee to a funding company in exchange for immediate cash at a small discount to the full value of the legal fee."[123] The committee did not distinguish between a settlement that still required court approval and a settlement that already had been approved by a court (or did not require court approval). The committee's reasoning would apply, therefore, with equal force to settlements pre- and post– court approval.[124] The committee observed that an attorney's duty to his or her client did not end until the money in a settlement had been disbursed to the client; since

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[120] It is possible that L holds the proceeds in escrow and releases $300 to B. It is even possible (however unlikely) that B receives the $300 directly from D.

[121] *See* Radek Goral, *Justice Dealers: The Ecosystem of American Litigation Finance*, 21 STAN. J.L. BUS. & FIN. 98, 107-08 (2015). *See also* Carmen Germaine, *SEC Sues NJ Atty, Litigation Fund Over Misleading Investors,* Law360, July 14, 2016, https://www.law360.com/articles/817528/sec-sues-nj-atty-litigation-fund-over misleading-investors (RD Legal Capital LLC, a hedge fund, invested millions of dollars to "purchase discounted legal receivables, such as attorneys' fees, from law firms in settled proceedings") (last accessed February 21, 2017).

[122] *See* Advisory Opinion, Ohio Supreme Court's Board of Commissioners on Grievances and Discipline, Opinion 2004-2.

[123] *Id.*

[124] The reasoning in Ohio Ethics Op. 2004-2 does not apply only to contingent fee cases. The same reasoning applies to the assignment of fully earned legal fees based on an hourly rate or a fixed fee as long as the last duty the attorney has is to insure the disbursement of funds to the client.

the risk of failed disbursement exists post-judgment as well.[125] The committee did not explain why the attorney's loyalty or incentive to represent his or her client would be impaired after a settlement, either pre- or post court approval, and at least one Ohio court has suggested that the committee's reasoning was flawed and the opinion should be treated as merely advisory.[126]

C. Factoring Unmatured Fees

This section introduces the concept of factoring accounts receivables of fees yet to be earned ("unmatured" fees). The following example illustrates how an unmatured fixed fee could be sold by an attorney.

> Factoring Unmatured Fixed Fees. At T_1 L is retained on fixed fee basis of $300. At T_2 L performs some of the work required on the C v. D matter. At T_3 B buys "all the accounts receivables in the C v. D matter" for $280. At T_4 L performs the remainder of legal work required on the C v. D matter. At T_5 L bills C for $300. C has 30 days to pay L $300. At T_{30} B tenders demand for $300 to C, which C pays.

There is no difference between Standard Factoring of Fixed Fees and Factoring Unmatured Fixed Fees except that in the latter the fee is fully earned after L assigns the accounts receivables to B. Commercial law recognizes that accounts receivables in a fee not yet earned may be assigned, pledged, or sold, just like accounts receivables in fees earned.[127] Although courts and commentators may differ about the exact portion of the UCC under which unmatured fees fall when they are pledged in loans as opposed to when they are assigned or sold, there appears to be a consensus that an unmatured legal fee, when it is

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[125] "Until the money agreed upon in the settlement is paid and disbursed, the attorney has not completed his or her legal representation of the client." *Advisory Opinion, Ohio Supreme Court's Board of Commissioners on Grievances and Discipline*, Opinion 2004-2.

[126] *Core Funding Grp., L.L.C. v. McDonald*, 2006-Ohio-1625, 2006 Ohio App. LEXIS 1523, at *31-*33 (Ohio Ct. App. 2006).

[127] *See PNC Bank,* 1997 WL 529978 at *28 ("both the hourly billing and the contingency fee contracts meet the definition of 'contract rights,' and therefore 'accounts,' within the meaning of the Uniform Commercial Code"). *See also* PETER F. COOGAN, ET. AL., SECURED TRANSACTIONS UNDER THE UCC ¶ 19.02 (2016 Matthew Bender) ("[r]ights of lawyers under contingent fee contracts are 'contract rights' or possibly 'accounts' in which an Article 9 security interest may be created)."

factored, is an "account" under U.C.C. § 9-102.[128] The *PNC Bank* court explained that, because an attorney who grants a security interest or assigns an unmatured fee is not fee-splitting, a lien held by a non-lawyer on unmatured fees is not unenforceable because it violated public policy.[129]

In theory, accounts receivables arising from any kind of legal fee, including hourly fees, may be sold in their unmatured form. For example:

> Factoring Unearned Defined Hourly Fees. At T_1 L is retained on an hourly rate contact of \$100/hour. At T_2 B buys the accounts receivables of "the first three hours earned by L for work performed for C" for \$280. At T_3 L works three hours for C and earns \$300. At T_4 L bills C for \$300. C has 30 days to pay L \$300. At T_{30} B tenders demand for \$300 to C, which C pays.

There is no difference between Factoring Unearned Defined Hourly Fees and Factoring Unmatured Fixed Fees. In both, B assumes the risk that L may not earn the full amount of the anticipated fee, since there is always the possibility that because of some unanticipated circumstance L will not perform enough work to earn the fixed fee or to bill three full hours and C will only owe L *quantum meruit*.[130] But on a practical level, this is a remote risk.

The previous example illustrates that in every case where unmatured fees are factored, the capital provider assumes a risk inherent to the fact that the attorney has not yet earned the fee, but expects to; this expectation can be reduced to a greater or lesser probability. For example, consider this variation of the previous example:

> Factoring Unearned Undefined Hourly Fees. At T_1 L is retained on an hourly rate contact of \$100/hour. At T_2 B buys from L "all the accounts receivables payable in the C v. D mat-

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[128] *See U.S. Claims, Inc. v. Flomenhaft,* 519 F. Supp. 2d 515 (E.D. Pa. 2007), *U.S. Claims, Inc. v. Flomenhaft & Cannata, LLC*, 519 F. Supp. 2d 515 (E.D. Pa. 2006), *Core Funding,* 2006 Ohio App. LEXIS 1523, *and PNC Bank,* 1997 WL 529978.

[129] *PNC Bank,* 1997 WL 529978 at *28 n.5 ("Parenthetically, the Court will note that there is no suggestion that it is inappropriate for a lender to have a security interest in an attorney's accounts receivable. It is, in fact, a common practice. Yet there is no real 'ethical' difference whether the security interest is in contract rights (fees not yet earned) or accounts receivable (fees earned) in so far as Rule of Professional Conduct 5.4, the rule prohibiting the sharing of legal fees with a nonlawyer, is concerned.") *and see Core Funding,* 2006 Ohio App. LEXIS 1523 at *32 (same, *citing PNC Bank*).

[130] *See* MRCP 1.5(a) (a lawyer shall not charge an unreasonable fee).

ter" for \$250. At T_3 L works for three hours. At T_3 L bills C for \$300. C has 30 days to pay L \$300. At T_{30} B tenders demand for \$300 to C, which C pays.

The difference between Factoring Unmatured Fixed Fees and Factoring Unearned Undefined Hourly Fees is that the value of the accounts receivables assigned by L to B in the latter is not a fixed dollar amount and is contingent on the number of hours L actually works. B bears a greater risk in the example of Factoring Unearned Undefined Hourly Fees than he does in the example Factoring Unearned Defined Hourly Fees, although L shares a symmetrical risk.[131] As with the original Factoring Unearned Defined Hourly Fees example, it is not clear why the Factoring Unearned Undefined Hourly Fees example should be treated differently than the Factoring Unmatured Fixed Fees example.

Finally, consider this final variation:

<u>Factoring Unmatured Contingent</u> Fees: At T_1 L is retained on a contingent fee contract of 30%. At T_2 L works on the C v. D case. At T_3 B buys "all the accounts receivables in the C v. D case" for \$200. At T_4 L performs more work on the case. At T_5 D and C settle for \$1000 but D has 30 days to satisfy the judgment. At T_{30} B tenders demand for \$300 to C, which C pays.[132]

The only difference between Factoring Unmatured Contingent Fees and Factoring Unmatured Fixed Fees (or Factoring Unearned Undefined Hourly Fees) is that the accounts receivables are earned under a contingent fee contract, not a fixed fee contract. The fact that factoring unmatured contingent fees involves a contingent fee and not an hourly fee or a fixed fee should not affect the permissibility of the assignment of L's account to B.[133]

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[131] If, in this example, L works for two hours on C v. D, and then the matter is unexpectedly resolved, B receives only \$200 from C and L is better off than expected. If L works four hours on C v. D because the matter is unexpectedly complex, B receives \$400 and L is worse off than expected.

[132] It is possible that L holds the proceeds in escrow and releases \$300 to B. It is even possible (however unlikely) that B receives the \$300 directly from D.

[133] In fact, the lawyers in *PNC Bank* pledged two types of accounts: unmatured hourly fees and unmatured contingent fees. The court held that they were indistinguishable from the perspective of the UCC:

> In the Court's opinion, both the hourly billing and the contingency fee contracts meet the definition of "contract rights," and therefore "accounts," within the meaning of the Uniform Commercial Code. The hourly billing contract is an "existing contract" creating a "right to

Attorneys are factoring unmatured contingent fees today.[134] Furthermore, the courts are perfectly aware of contracts in which law firms factor their unmatured contingent fees, and they have either enforced those contracts when they have been challenged, or acknowledged their existence without negative comment.[135] As one New York court put it, an attorney may "assign the future right to receive legal fees upon settlement or judgment, even though the fee may be uncertain, doubtful or contingent."[136] The court in *PNC Bank* took a somewhat blasé attitude towards the use of "unmatured contingency fees" in secured lending and observed that the objection that that it was "inappropriate" for lawyers to engage in what is a boring, commonplace form of business planning was to treat lawyers worse than other business people "under the guise of ethics."[137]

There are many cases where courts have noted in passing that an attorney assigned an unmatured contingency fee, either as security for a debt or by factoring, as in the Factoring Unmatured Contingent Fees example.[138] There

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> payment," the hourly fee, that is "to be earned by future performance," future work by an attorney on that case. In a contingency fee case the "right to payment" is more speculative, since the amount of payment to be earned by future performance depends upon whether the case results in a verdict or other recovery in favor of the client. This seems, however, to be a distinction without a difference.

PNC Bank, 1997 WL 529978 at *27.

[134] For example, the gravamen of the SEC's complaint against the hedge fund RD Legal Capital is not that it did anything wrong by purchasing unmatured legal fees. It is that it misled investors by representing that it was purchasing matured fees (accounts receivables) when it was in fact buying unmatured fees. (The unmatured fees purchased by RD Legal Capital included millions of dollars in pre-settlement contingent fees in a mass tort and millions of dollars of contingent fees in a $2 billion case against the Republic of Iran where there was a default judgment but, as of sale, no proceeds had yet been secured for the attorneys' clients.) *See In Matter of RD Legal Capital, supra* note 49 at 2. RD Legal Capital does not deny that it purchased the unmatured fees; it denies that it misrepresented to investors that it had purchased the unmatured fees. *See* Germaine, *SEC Sues NJ Atty, Litigation Fund Over Misleading Investors, supra* note 121 (an attorney for RD Capital said that "RD Capital has 'always been completely transparent with investors'").

[135] *See, e.g. Lawsuit Funding v. Lessoff,* 2013 WL 6409971, *Counsel Fin. Servs. v. Leibowitz,* 2013 WL 3895331, *and Core Funding,* 2006 Ohio App. LEXIS 1523.

[136] *Brandes v. N. Shore Univ. Hosp.*, 2008 N.Y. Misc. LEXIS 20 at *8 (Queens Sup. Ct.).

[137] *PNC Bank,* 1997 WL 529978 at n.5.

[138] They include: *Hamilton Capital VII, LLC v. Khorrami, LLP,* 2015 NY Slip Op 51199(U), 48 Misc. 3d 1223(A), 22 N.Y.S.3d 137 (Sup. Ct.); *Kelly, Grossman & Flanagan, LLP v Quick Cash, Inc.*, 35 Misc. 3d 1205(A) (N.Y. Sup. Ct. 2012); *RDLF*

are companies that rely on the assignment of unmatured contingency fees in order to secure non-recourse debt to law firms.[139] The sale of unmatured legal fees is a commercial reality in the United States today.

D. The Direct Relation Test and the Factoring of Fees

To be clear, with the exception of one informal ethics opinion from Ohio (whose conclusions have been challenged by Ohio courts), there are no bar ethics committee opinions squarely addressing the factoring of accounts receivables, whether earned or unmatured. And, to be equally clear, where courts have held that the factoring of accounts receivables in legal fees is not fee-splitting, such as in *Santander* and *Core Funding Grp.*, they have done so only in the context of ascertaining the status of the transaction as a matter of contract law, not advising lawyers as to professional obligations.[140] Therefore, the obvious question, which motivates this Article, is whether the factoring of legal fees is consistent with the DRT.

The question needs to be refined further: The real question is whether the factoring of unmatured fees is consistent with the DRT. It is hard to see how any plausible argument could be made that standard factoring violates the DRT. After all, the DRT prohibits a promise by an attorney to pay a capital provider a sum of money where the quantum of the sum is directly correlated to the quantum of the fee (if any) earned by the attorney. In standard factoring the attorney promises to pay a capital provider a sum of money where the quantum of the sum specified in advance – and therefore, by definition, is not directly correlated to the quantum of the fee earned by the attorney.[141]

Fin. Servs., LLC v. Esquire Capital Corp., 2012 NY Slip Op 50373(U), 34 Misc. 3d 1235(A), 950 N.Y.S.2d 610 (Sup. Ct.) *Cousins v. Pereira (*In re *Cousins)*, 2010 U.S. Dist. LEXIS 136139 (S.D.N.Y.); *U.S. Claims, Inc. v. Yehuda Smolar, PC*, 602 F. Supp. 2d 590 (E.D. Pa. 2009); *U.S. Claims, Inc. v. Flomenhaft,* 519 F. Supp. 2d 515 (E.D. Pa. 2007); *U.S. Claims, Inc. v. Flomenhaft & Cannata, LLC*, 519 F. Supp. 2d 515 (E.D. Pa. 2006) and *Douglas v. Benton*, 7 Misc 2d 872 (1957), *affd.* 7 A D 2d 633) (1958).

[139] See Nora Freeman Engstrom, *Lawyer Lending: Costs and Consequences*, 63 DEPAUL L. REV. 377, 394 - 95 (2014) (discussing "specialized nonrecourse funding lenders" such as Augusta Capital and Excalibur Funding Programs).

[140] *See Santander Bank,* 2016 U.S. Dist. LEXIS 5430 at n.5 *and Core Funding,* 2006 Ohio App. LEXIS 1523 at *32.

[141] This is probably what the court was trying to say in *Santander* when it explained its rejection of the argument that standard factoring violated Rule 5.4(a). It stated that "there is a significant difference between sharing legal fees with a non-lawyer and paying a debt with legal fees"). *See Santander Bank*, 2016 U.S. Dist. LEXIS at n.5 (*quoting Counsel Fin. Servs,* 2013 Tex. App. LEXIS 9252 at *7-8).

Arguably, however, an attorney always violates the DRT when she factors unmatured fees. When an attorney promises to a capital provider that, in exchange for $*x* dollars today, the capital provider has right to all or some of the dollars earned by the attorney in connection with a specific legal service, the attorney has, in exchange for $*x*, promised a payment to the capital provider of a sum that is directly affected by the quantum of the fee (if any) earned by the attorney.[142] It is hard to see why the capital provider – a non-attorney – is not "sharing in the prospects of success or failure of the [attorney's] particular litigation."[143]

IV. The Dilemma

The argument in the section above leaves state bar ethics committees with two options: (1) Permit standard factoring of legal fees and prohibit the factoring of unmatured fees or (2) permit standard factoring of legal fees and permit the factoring of unmatured fees.[144] The problem with Option One is twofold: First, it would require the committees to articulate a principled basis for distinguishing between standard factoring of legal accounts receivables and the factoring of unmatured fees, which as courts have pointed out, cannot be done on the basis of any distinction found in commercial law, and second, given that many lawyers are currently factoring their unmatured fees, a market which currently exists and around which expectation have been formed would be disrupted.

The problem with Option Two is also twofold: First, as argued above, it seems that by factoring an unmatured fee, an attorney is doing exactly what the DRT prohibits, and second, if the DRT does not apply to the sale of accounts receivables in unmatured fees, lawyers will be able to engage in a

[142] As noted above, the capital provider may enter a transaction involving unmatured fees with different expectations about the likelihood of his future gains corresponding to a anticipated amount, depending on various features of the specific deal. A capital provider who advances money in exchange for "the accounts receivables in the first three hours of fees earned" in a case where hundreds of hours of work are anticipated is probably highly confident that they will receive exactly what they anticipated, whereas a capital provider who advances money in exchange for accounts receivables in a percentage of a contingent fee may have little or no confidence that they will receive anything at all, and if they do, that it will correspond to a specific anticipated amount.

[143] Maine Prof. Ethics Comm. Formal Op. 193 (2007).

[144] As a logical matter, there is an Option Three: Prohibit standard factoring and prohibit the factoring of unmatured legal fees. (The "Ohio Option".) The Ohio Option would appear to be impractical, given that standard factoring has become a fixture of the legal market. It has even been rejected by courts applying Ohio law. *See Core Funding,* 2006 Ohio App. LEXIS 1523 at *32. Therefore it is not discussed in this Article.

wholesale evasion of the DRT by redrafting many of the transactions which are now prohibited under the DRT as sales of unmatured fees. As with all dilemmas, the solution is to examine the premises that lead to the dilemma, and in this case I hope to argue that the problem is with the DRT. The following sections will demonstrate each prong of the dilemma, starting with Option Two.

A. Option Two: Factoring Unmatured Fees Is Not Prohibited By the DRT

It could be argued that all that the bar ethics committees opinions reviewed in Section II teach is that *debt* secured by the accounts receivables in a single case is fee-splitting, not that an attorney who *sells* a property interest in his accounts receivables in a single case is fee-splitting. The hostility of the ethics committees to contingent advances could be nothing more than a hostility to non-recourse lending by attorneys. As mentioned above, there are some ethics opinions that take the broadest possible approach to non-recourse loans to lawyers and deem any form of non-recourse lending to be fee-splitting, regardless of whether the advance is secured at all.[145]

Option Two presupposes that the reason that non-recourse debt is subject to the DRT (regardless of whether the interest rate is fixed or based on a share of the fee recovered) is that the promise to pay upon the occurrence of the named event (the settlement or judgment), from the point of view of the parties, involves a transfer of property (money) upon the event of a future contingency – the attorney earning her fee. The non-lawyer has no property until the attorney, by paying over the proceeds of the fee to the non-lawyer, causes the title to the money to pass.[146] In this sense, the non-lawyer who provides a non-recourse loan stands in the same relation to the attorney as any vendor with whom the attorney transacts, regardless of whether it is an office supply store or a landlord. Until the money owed is in the possession of the non-lawyer, all he has (like a vendor or a landlord) is a legal right that the attorney perform the debt contract, and his remedy is a lawsuit for damages. The DRT becomes interested in the content of that contract (its terms) when the payment promised is not fixed (as it would be in the sale office supplies or the signing of a lease with fixed monthly payments) but is correlated with the success of the attorney's

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[145] *See* Nev. Standing Comm. on Ethics & Prof'l Responsibility, Formal Op. #36 (2007) (rejecting all "non-recourse lending by third parties" to lawyers) *and* Mo. Bar, Informal Op. 2003-0022 ("it is not permissible for the repayment of the loan [to a lawyer] to be based on the outcome of the lawsuit").

[146] The non-lawyer might have negotiated for a security interest in some collateral, such as the attorney's furniture, but that is not the same thing as a property interest in the fee.

earned fee. That is why the DRT prohibits directly linking payments to the existence or amount of the attorney's fee.[147]

On the other hand, from the point of view of the parties, the sale of accounts receivables in unmatured fees stands on a very different footing. The non-lawyer's legal interest is not in the attorney's performance of a contract, and the remedy available to the non-lawyer is not a lawsuit for damages. Title to the accounts receivables was transferred to the non-lawyer earlier, upon the purchase of the accounts receivables. To see why this is possible, it is important to start at the beginning – with the attorney's original acquisition of the property she sold to the non-lawyer.

Before the attorney and the non-lawyer make their contract, the attorney already has in her possession a property interest. It may seem odd to think of an unmatured contingency fee as a species of property. Indeed, it is important not to confuse the property held by the attorney upon being retained by a client with the assignment of the client's causes of action, in part or in whole.[148] It is not an ownership interest in the client's lawsuit.[149] It is, however, a lien on the proceeds that arise from the resolution of the client's lawsuit.[150] And that lien is itself a species of property: As the New York Court of Appeals put it, "[B]ecause a cause of action is a species of property, an attorney acquires a 'vested property interest' in the cause of action at the signing of the retainer agreement and thus a 'title to "property and rights to property"'"[151] The court went on to emphasize that an attorney's contract right is not "a *mere claim* against either property or payment" but property in its own right.[152]

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[147] *See, e.g., Rodriguez v. City of New York,* 721 F. Supp. 2d 148 (E.D.N.Y. 2010).

[148] In fact, as a rule, in the United States lawyers are prohibited from acquiring a property interest in their client's cause of action except under the limited circumstances discussed here, where the attorney takes a lien on the property interest they have in their earned fee. *See* MRCP 1.8(i).

[149] *See, e.g., LMWT Realty Corp.,* 649 N.E.2d 1183, 1186 (1995) ("The client's property right in his own cause of action is only what remains after transfer to the attorney of the agreed upon share upon the signing of the retainer agreement") *and High Point Casket Co. v. Wheeler,* 182 N.C. 459, 464 (1921) ("A right of action is assignable in this State, but by assigning an aliquot [partial] part of the fund recovered, or the recovery, or judgment, as it may be denominated, the assignee [the lawyer] gets no vested right in the cause of action. . .").

[150] *See, e.g., Gostin v. State Farm Ins. Co.*, 224 Cal. App. 2d 319, 325 (4th Dist. 1964) ("Under a contingency fee agreement creating an attorney's lien, the property upon which the lien is a charge is the obligation to pay the amount recovered upon the client's claim.").

[151] *LMWT Realty Corp.,* 649 N.E.2d at 1186 (citations omitted).

[152] *Id.* (citations omitted) (emphasis added).

The history of the right to this property is tied up with the evolution of one of the rules designed to protect lawyers from faithless clients – what is today known as the "charging lien".[153] A charging lien is a property interest because it is a lien on property – the property the client has in his or her chose in action.[154] Its origins are in the common law, in the form of an equitable assignment.[155] For example, where the fee agreement promised the attorney half of the land at issue in the client's suit, the common law made "the attorney the equitable owner of the undivided one-half of *whatever shall result from the prosecution or compromise of the suit* instituted by him to recover the land."[156] A fee agreement for a portion of a damage award was not "an obligation to pay upon the contingency named . . . [i]t was in effect a *constructive appropriation* in favor of the [lawyer] of so much of the money" that the client was awarded.[157]

It is because the equitable interest held by the attorney upon being retained is a species of property that it can serve as collateral or as a security interest in a loan.[158] And, for the same reason, it can also be sold outright, in exactly the same way that an earned fee can be sold outright in standard factoring.[159] But, unlike when the attorney's equitable interest in her client's property is used to secure a loan, the sale of the equitable interest does not fall under the DRT because when the client's property is reduced to a specific sum, the portion that the non-lawyer receives is not a share of the attorney's property, but the property to which the non-lawyer already has title. The reason the sale of accounts receivables looks like a loan is that the quantum of money received by the non-lawyer buyer is correlated with the attorney's success. But unlike a

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[153] The other rule is the "retaining lien", where "a lawyer claiming to be entitled to a fee may impound a client's papers, money, or other property that are in the lawyer's possession until the fee has been paid." *See* John Leubsdorf, *Against Lawyer Retaining Liens*, 72 FORDHAM L. REV. 849, 853 (2004).

[154] *See Fischer-Hansen v. Brooklyn H. R. Co.,* 66 N.E. 395, 396 (NY 1903). In New York the charging lien is a product of legislation. The modern version of the relevant statute is NY Jud. § 475.

[155] *See High Point Casket Co.,* 182 N.C. at 462.

[156] *Id.* at 465 (emphasis added). For example, "a contingent agreement to convey a portion of the land recovered by suit to the attorney for his fee will be specifically enforced, even though the land has greatly increased in value." *Id.* at 463.

[157] *Id.* at 465 – 66 (emphasis added).

[158] See *PNC Bank,* 1997 WL 529978.

[159] This is why the court in *Core Funding* adopted the UCC analysis in *PNC Bank* without even pausing to consider the fact that the transaction in the former was the sale of unmatured legal fees while in the latter the unmatured fees were pledged as a security. *Core Funding,* 2006 Ohio App. LEXIS 1523 at *32.

loan, the source of the money received by the non-lawyer is not the attorney's fee; it is an equitable property interest already owned by the non-lawyer, finally reduced to money. This is not unusual – it is the nature of an equitable property interest that that it may take various forms, and the fact that it does not ripen fully into a form of property over which the owner can take control (e.g. money) does not change the fact that it is nonetheless property already owned.[160]

The idea that the attorney's unmatured fee is an equitable property interest is a useful piece of doctrine that can help resolve the dilemma posed above. If the ethics committees that used the DRT to condemn the transactions in Section II wanted to find some basis to allow attorneys to continue to factor unmatured legal fees, they could draw the line at property: An attorney is not *splitting* her earned fee if she *sells* a portion of her property interest in her unmatured fee before it is reduced to a specific monetary amount. The DRT prohibits a promise by an attorney to pay a non-lawyer a sum of money where the quantum of the sum is directly correlated to the quantum of the fee (if any) earned by the attorney. If the money received by the owner of a property interest in the attorney's fee is the owner's own money – just converted into a form over which the owner can now take possession – then the attorney is not giving the non-lawyer a portion of her fee, and therefore the attorney cannot be splitting a fee.

This means, for example, that in theory, the ethics committees should permit the factoring of unmatured fees in *any* form, since all unmatured fees are a property interest. This is Option Two. In some cases, Option Two would be easy for an ethics committee to adopt – where, for example, the sale of an unmatured fee looks *almost* like the sale of an earned fee, as in the case of Factoring Unearned Defined Hourly Fees. The only difference between standard factoring and factoring unearned defined hourly fees is that in standard factoring, B *knows* in advance that L has worked three hours (or at least L has represented

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160 This principle has been applied to charging liens:

> Moreover, the general rule is that a lien upon property attaches to whatever the property is converted into and is not destroyed by changing the nature of the subject. Thus a lien upon timber ordinarily extends to the shingles made out of it; a lien upon domestic animals to their young subsequently born, and a lien upon a mortgage to the land into which the mortgage is converted by foreclosure. *It follows its subject and cannot be shaken off by a change of form or substance.* . . . So a lien upon a claim or a cause of action follows the fund created by a settlement of the claim. . . . The lien was not affected by the adjustment, but leaped from the extinguished cause of action to the amount agreed upon in settlement.

Fischer-Hansen, 66 N.E. at 502 - 02 (emphasis added).

that he has worked three hours on C's matter), whereas when unearned defined hourly fees are factored, B *anticipates* that L will work three hours on C's matter.[161] It is hard to see why this makes a difference, and, as noted in *PNC Bank,* the UCC treats both transactions as functionally equivalent.[162]

But how far could we expect ethics committees to go with Option Two, even if they were inclined to accept certain transactions involving unmatured fees that most resembled standard factoring, such as those involving defined hourly fees and fixed fees? The problem with Option Two is that, through clever drafting, most transactions held to violate the DRT in Section II could be presented as the sale of a contract right, or an account.[163] Once that door is opened, it is possible that almost any transaction prohibited under the DRT could be restated as a property transaction that would avoid the DRT's reach.

In fact, Option Two should allow any of the "non-recourse loans" prohibited by the ethics committees in Section II if they are restated as advances in exchange for a property interest in an unmatured fee. For example:

> <u>Accounts In Unmatured Contingent Fee Sold For Non-Recourse Advance</u>. At T_1 L is retained on a contingent fee contract of 30%. At T_2 B agrees to advance \$200 in exchange for ψ, where ψ equals "\$200 + ⅓(L's accounts receivables in C v. D)". At T_3 L works on the case. At T_4 D and C settle for \$1000 but D has 30 days to satisfy the judgment. At T_{30} B tenders demand for \$300 to C, which C pays.[164]

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[161] In the example Factoring Unearned Defined Hourly Fees, B bears a risk not present in standard factoring, which is that B will receive an amount less than the equivalent of three billable hours if C's matter does not justify billing three hours to C. *See supra* note 65.

[162] *See PNC Bank,* 1997 WL 529978 at *26 - *27:

> "It was the difference between being earned and unearned that distinguished 'account' from 'contract right' under the 1962 Code. . . . The 1972 amendment to the U.C.C. includes contract rights within the definition of account" (citations omitted).

[163] *Id.* at *24 ("The U.C.C. defines an 'account' as '(i) any right to payment for goods sold or leased or for services rendered, and (ii) any credit device account, which, in either case, whether or not it has been earned by performance.'" (*citing* 6 Del. C. § 9-106)).

[164] It is possible that, as in "Standard Factoring of Contingent Fees," L holds the proceeds in escrow and releases \$300 to B. It is even possible (however unlikely) that B receives the \$300 directly from D. *See supra* note 120.

This example achieves the economic goals of the lawyers who sought non-recourse loans that were prohibited by the ethics committees in Section II, but it is not a loan. At T_3, L already has in her possession a property interest. It is property in that it can be the subject of a lien, since the "property" is C's obligation to pay *x*.[165] The money paid by C to B belongs to B, not to L. It is hard to know what an ethics committee would make of this transaction. It is, after all, not that far from the transactions recognized by the courts in *Core Funding* and *PNC Bank* (as well as other cases). In fact, exchanging an advance for an unmatured contingent fee is functionally equivalent to factoring an unmatured undefined hourly fee.[166] If an ethics committee would permit factoring of unmatured undefined hourly fees, it is hard to see on what basis it would prohibit the transaction presented in "Accounts In Unmatured Contingent Fees Sold For Non-Recourse Advance".

Even the transaction in Tex. Op. 467, involving a landlord seeking a percentage of his attorney-tenant's gross receipts in lieu of rent, could be re-drafted to be allowed under Option Two.[167] To see why, it is first necessary to note that the Texas ethics committee did not say specifically whether the proposed rent exchange with the landlord was a contingent fee and, under the reasoning offered in the opinion, the landlord should not have been allowed to make the same deal with a transactional or family law attorney.[168] Keeping that in mind, the transaction in Texas Op. 467 could be restated so that it was not fee-splitting under Option Two. It would look like this:

> <u>Accounts in Unearned Undefined Hourly Fees Sold For Use of Real Property</u>. At T_1 L is retained on an hourly rate contact of \$100/hour. At T_2 (May 1) B exchanges the accounts receivables of "all the accounts receivables payable in the C v. D matter" for "one month of occupancy in Office O in May" and occupies the office. At T_3 (May 2 – May 28) L works three hours for C and earns \$300. At T_4 (May 31) L bills C for \$300. C

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[165] *See Gostin*, 224 Cal. App. 2d at 325 (citations omitted) (emphasis added):

> Under a contingency fee agreement creating an attorney's lien, *the property upon which the lien is a charge is the obligation to pay the amount recovered upon the client's claim*. The "act" for the performance of which that "property" is made security is the payment of an attorney's fee.

[166] *See supra* note 133 and accompanying text.

[167] *See* Prof'l Ethics Comm. for the State Bar of Tex., Op. 467 (1990).

[168] *Id.* The same economic goal sought by a contingent fee attorney could have been sought by a transactional or family law attorney who worked only under an hourly fee arrangement or a fixed fee arrangement.

> has 7 days to pay L $300. At the end of T_5 (June 7) B tenders demand for $300 to C, which C pays.

Since there is no reason to distinguish between the sale of unearned hourly fees or unmatured contingent fees, the transaction that was prohibited in Texas Op. 467 should be permissible under Option Two even if it were restated using exactly the same details contained in the question posed to the committee:

> Accounts in Unmatured Contingent Fees Sold For Use of Real Property. At T_1 (May 1) B buys "30% of L's accounts receivables in May" in exchange for "one month of occupancy in Office O in May" and occupies the office. At T_2 (May 2) L is retained on a contingent fee contract of 33% by C. At T_3 (May 3 – 30) L works on the C v. D case. At T_4 (May 31) D and C settle for $3000 but D has 7 days to satisfy the judgment. At the end of T_5 (June 7) B tenders demand for $300 to C, which C pays.[169]

The key move in the hypothetical examples in this section was to take an advance that was once labeled a loan and turn it into a purchase of a property interest in a right to an undefined sum. It is possible that the committees that rejected the contingent advances described in Section II would resist this move on the grounds that most of these hypothetical examples are too similar to the non-recourse loans they rejected. The problem with this move is that, as argued in Section III, it is hard to imagine these same ethics committees breaking with clear judicial precedent and prohibiting an attorney from trading her unearned but *defined* hourly fees for an advance of funds.[170] The ethics committees would almost certainly take the view that an attorney who traded $280 in exchange for the first three hours of her work for a client whom she will bill at $100/hour is doing something so similar to standard factoring that is a sale of property, and not a scheme to allow a non-lawyer to "directly" benefit from the attorney's future efforts.

In fact, since there is no relevant economic difference between an attorney exchanging a property interest in her fees for money or use of an office, it is extremely likely that the ethics committees that rejected the transaction in Tex. Op. 467 would probably even permit the following:

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[169] It is possible that, as in the "Factoring Earned Contingent Fees" example, D holds the proceeds in escrow and releases $300 to B.

[170] *See* "Factoring Unearned Defined Hourly Fees," *supra* note 130 and accompanying text.

> Accounts in Unearned Defined Hourly Fees Sold For Use of Real Property. At T_1 L is retained on an hourly rate contact of \$100/hour. At T_2 (May 1) B exchanges the accounts receivables of "the first three hours earned by L for work performed for C" for "one month of occupancy in Office O in May" and occupies the office. At T_3 (May 2 – May 28) L works three hours for C and earns \$300. At T_4 (May 31) L bills C for \$300. C has 7 days to pay L \$300. At the end of T_5 (June 7) B tenders demand for \$300 to C, which C pays.

One could say that the foregoing example, although peculiar, shares the following feature with the Factoring Unearned Defined Hourly Fees example in Section III: In both the non-lawyer knows the value of the contingent right if it comes to pass. It must be conceded that the "definiteness" of the contingent right is a difference between the Accounts in Unearned Defined Hourly Fees Sold For Use of Real Property and the Accounts in Unearned Undefined Hourly Fees Sold For Use of Real Property. But why is this significant? There is no difference in the type of interest L is transferring. At T_2 in the Accounts in Unearned Undefined Hourly Fees Sold For Use of Real Property example the property interest the landlord receives from L is a property interest in "C's obligation to pay", and the landlord relies on the security of a lien on that "property" to guarantee that he will receive what he has bought. Furthermore, all of the examples offered in this section are more like each other than Standard Factoring in one very important way: The payment B hopes to receive, whether defined or undefined, may be zero, depending on contingent events that are partially the result of L's expenditures of "skill, experience and time."

The point of going through these variations is not to predict how the North Carolina and Texas bar ethics committees would decide these hypotheticals, which are, in essence, efforts to repackage transactions they already prohibited. It may be that, when confronted with a transaction labeled a "purchase" instead of a "non-recourse loan" that they might permit it. The point is that, if, as Option Two suggests, the line between debt and property determines whether a financial relationship is "direct" or indirect" under the DRT, then these committees would be hard pressed to explain their decision to approve one transaction but not another, or why they don't just approve all of them. The committees would need to rely on a principle more substantive than simply one that says that a non-lawyer is "directly" benefiting when his financial gain is tied to future expenditures of an attorney's "skill, experience and time."[171]

The problem with Option Two, therefore, is that it does not offer a principled interpretation of the DRT. Whatever was motivating the ethics

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171 Prof'l Ethics Comm. for the State Bar of Tex., Op. 576 (2006).

committees that decided the examples in Section II, it was not a concern that the contracts that promised the non-lawyer payment in exchange for the advance of funds had to be based on the sales of some species of property. The discussion of the hypothetical examples in this section supports the conclusion in Section II that the "something else" that drove the committees to make their decisions was an expression of the principle that an attorney cannot pay a non-lawyer for an advance of capital with a promise that the non-lawyer will benefit "directly" from the attorney's exercise of her legal skills.[172] This principle is not captured by Option Two. This leads inevitably to the other prong of the dilemma, Option One.

B. Option One: Permit Standard Factoring Of Legal Fees and Prohibit the Factoring Of Unmatured Fees

Upon being confronted with the confusion engendered by Option Two, above, it is easy to see why ethics committees might choose to draw the line at the factoring of earned fees, and choose Option One. In addition to avoiding the problems described in Option Two, a rule that permitted lawyers to factor fees only after they have been "earned" would seem to have the advantage of simplicity.

Still, Option One brings with it two new problems that make it as unattractive as Option Two. First, as noted in Section III, the practice of factoring unmatured fees has grown over the past few years, and the practical effect of a categorical prohibition on the factoring of unmatured fees would be huge, given the large number of contingent fee firms that rely upon these transactions. Second, it is not clear that drawing the line at earned fees gives the ethics committees anything more than the advantage of simplicity: the policy goals that the are purportedly served by the DRT are not clearly served by drawing the line at factoring earned fees. This section will focus on the second problem.

The argument for drawing the line at earned fees must be something like this: Since the DRT prohibits non-lawyers from directly benefiting from the efforts of lawyers in the practice of law, non-lawyers may only receive funds from lawyers that are not linked to specific cases; and an earned fee is not "linked" to a case, since it is like cash in the attorney's bank account. But this statement is a non-sequitur, since accounts receivables are always earned in connection with a specific matter, and they are not reduced to money "in the bank" (that is, in the possession of the attorney) until someone (usually the client but sometimes the defendant) pays over an amount of money corresponding to the earned fee in a specific matter. Were the DRT to be taken at face value, it should not permit even standard factoring. This conclusion has been drawn

[172] *See supra* notes 111 - 112 and accompanying text.

by some ethics committees. Recall that, in an informal opinion, Ohio held that lawyers could not factor earned fees.[173] The committee offered this reasoning:

> A lawyer's legal representation of the client does not end upon reaching a settlement agreement, but continues from settlement agreement through the time of receiving and disbursing the settlement money. A lot can happen in that interval. . . . Until the money agreed upon in the settlement is paid and disbursed, the attorney has not completed his or her legal representation of the client.[174]

In a series of opinions that represent a clear break from the mainstream application of the DRT, ethics committees in Utah have prohibited all financing arrangements where an attorney grants a security interest in the attorney's fee to a non-lawyer as a condition for an advance or a loan.[175] For example, a committee prohibited a non-recourse loan where the attorney promised to repay to the non-lawyer the principal advanced and a fixed interest payment (*not* a share of the fee) if the non-lawyer took a security interest in the attorney's unmatured contingent fee.[176] But, in a later ethics opinion, a committee upheld a non-recourse loan (which would "be repaid" by giving the lender a share of the contingent fee) as long as the attorney did not give the non-lawyer a security interest in the fee.[177] In other words, a promise to pay a non-lawyer a share of an unmatured fee is not fee-splitting in Utah as long as the non-lawyer does not have a lien on the attorney's fee. According to the Utah ethics committee:

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[173] *See* Advisory Opinion, Ohio Supreme Court's Board of Commissioners on Grievances and Discipline, Opinion 2004-2.

[174] *Id.* An attorney's obligations to her client may involve extensive legal work after a settlement agreement is secured on behalf of the client. *See, e.g., Cadle Co. v. Schlichtmann*, 267 F.3d 14 (1st Cir. 2001) (case that was settled for $825,000 contingent on approval by the Massachusetts Department of Environmental Protection which took significant post-settlement effort by the attorneys) *and RDLF Fin. Servs.,* 2012 N.Y. Misc. LEXIS at *4 (factor purchased contingent fees that were earned by an attorney in a case settled for "the prospective sum of $607,500" but which required significant post-settlement effort by the attorney).

[175] *See* Utah Ethics Advisory Opinion No. 97-11, Utah Ethics Advisory Opinion No. 02-01, and Utah Ethics Advisory Opinion No. 06-03.

[176] *See* Utah Ethics Advisory Opinion No. 97-11.

[177] *See* Utah Ethics Advisory Opinion No. 06-03 (endorsing a non-recourse loan that obliges attorney to "repay" the non-lawyer the principal and "a negotiated percentage (e.g., 5%) of the net recovery (gross recovery minus litigation expenses)" as long as there is no security interest in the attorney's fee provided to the funder). Presumably the capital advancer was free to take a security interest in the attorney's other property, such as the attorney's furniture or operating account.

> Once a security interest in the recovery of contingent fees from a particular case is granted, Rule 5.4 is implicated. Upon that grant, Lender has an interest in the attorney's contingent-fee award, which Lender has the right to attach upon a default in payment on the loan. That particularized interest in the contingent fees of a case could compromise the lawyer's judgment in a number of ways.[178]

The committee's focus was on the rights that a security interest granted the non-lawyer: The right of priority with regard to other creditors and the right to pursue payment directly against the client, if necessary.[179] These are the conventional hallmarks of holding a property interest, as *Core Funding* illustrates. But they are not limited to *just* the property interest that exists in unmatured contingent fees. The same rights vis-à-vis other creditors and the client are held by the non-lawyer when a security interest in unearned hourly fees is assigned (see *PNC Bank*); and the same rights vis-à-vis other creditors and the client at held by the non-lawyer when a security interest in earned hourly fees is assigned (see *Santander*). The same rights vis-à-vis other creditors and the client are held by the non-lawyer when a security interest in fees earned by an attorney who has secured a default judgment is assigned, even though the proceeds (and fee) may not be paid over for a long time.[180] According to Utah's reasoning, if the DRT prohibits non-lawyers from having a property interest in an attorney's fee that is linked to a specific case or legal matter, then the transaction enforced by the court in *Santander* is void, and if the transaction in *Santander* is void, then attorneys cannot engage in standard factoring.

The Utah ethics opinions, like the Ohio opinion, take an unusual approach to the question of how to define the boundary between a direct and indirect interest in an attorney's fee, but they are not necessarily wrong. The view taken by Utah and Ohio is that the incident of property that matters most to legal ethics when it comes to financial relations between lawyers and non-lawyers is the right to exclusive control over any portion of the interest the attorney has in her fee. As long as the property interest held by the non-lawyer affords him unilateral control over a portion of the attorney's fee, fee-splitting occurs, and this possibility is present even in cases of standard factoring. A non-lawyer who owns a portion of an attorney's earned fees can do more than just sue a client for the funds after the legal matter in which the fees were

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178 Utah Ethics Advisory Opinion No. 97-11.

179 *See* Utah Ethics Advisory Opinion No. 06-03, n.13.

180 *See* Germaine, *SEC Sues NJ Atty, Litigation Fund Over Misleading Investors, supra* note 121 (discussing the sale of plaintiffs' attorneys fees in *Peterson v. Islamic Republic of Iran*, 264 F. Supp. 2d 46 (D.D.C. 2003), in which the default judgment was the subject of a turnover action that lasted until 2016).

earned is completed. As the Ohio committee observed, the non-lawyer may have an interest in collecting on the earned fee after a settlement which could lead it to pursue the defendant directly, to the detriment of other long-term interests of the client and the attorney who sold the fees after settlement.[181] The Utah committees may have had some of these concerns in mind as well. Even where there is no property upon which to attach a lien – as is often the case of the sale of an earned hourly fee – the non-lawyer can interfere with the attorney's ability to make judgments in the best interest of the client.[182]

There is one escape route left for an ethics committee that wanted to maintain the line between line between standard factoring and the factoring of unmatured fees and therefore save Option One. One could concede that, as a formal matter, since all factoring involves the transfer of a property interest, all factoring is in theory the sharing of fees between an attorney and non-lawyer, but retreat from the formal application of the rule against fee-splitting and insist that Rule 5.4(a) has to be read functionally, not formally. Under this account, the reason that the line is drawn between standard factoring and the factoring of unmatured fees is that the former transaction does not implicate the various policy concerns described in Section II, while the latter does.

Some bar ethics committees have tried to take this route. In Va. Op. 1783, which was about fee-splitting but did not concern contingent advances, the committee emphasized that the "application of Rule 5.4(a) must move beyond a literal application of language of the provision to include also consideration of the foundational purpose for that provision."[183] The functional approach adopted in Va. Op. 1783 could be applied to the decision to draw a line between earned and unmatured fees.

As noted in Section II, one of the concerns is addressed by the prohibition on fee-splitting, and which the DRT (in theory) addresses is the avoidance

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181 For example, if B purchases "⅓ of L's fee in case C v. D_a" and L settles that case but still is litigating other cases on behalf of C v. D (e.g., C v. D_b; C v. D_c, etc.), then L's ability to delay collection of the settlement, or even reopen the settlement with the consent of C and D if necessary, will be compromised if B insists on collecting his "property" from D immediately.

182 For example, if B purchases the first three hours of L's billable hours after they have been earned by L working on C's legal matter, and C's matter requires another three hours of L's work, C may be hesitant to instruct C to do more work on the matter if B insists on his "property" and C is short of funds.

183 Virginia Legal Ethics Op. 1783 (2003) (attorney could return to client difference between amount owed by a defaulting borrower according to the loan contract's legal fee provision and the actual cost of representing the client against the borrower).

of improper interference by third parties with the conduct of the litigation.[184] As the Virginia ethics committee noted, it had repeatedly emphasized that "[t]he primary purpose of Rule 5.4 is to prohibit nonlawyer interference with an lawyer's professional judgment and ensure lawyer independence."[185] The functional approach would counsel that the DRT adopt an *ad hoc* distinction between transactions where non-lawyers have a property interest in the results produced by attorneys where the fee has already been earned, as opposed to a property interest in those same results where the fee has not yet been earned. The argument for this would be that, as a practical matter, non-lawyers who factor earned fees simply cannot do very much to interfere with the independent professional judgment of attorneys and cannot therefore do very much to harm their clients, compared to factors who purchase unmatured fees of any sort. If this were the question, one might conclude that non-lawyers' ownership of earned fees does not pose a threat to attorney's independence – since all the owner of the fee can do is enforce a lien against the attorney's client, and that threat, even if carried out, is unlikely to yield much leverage over either the attorney or the client.

The problem with this functional argument is that it does not look at the whole picture. The question is not, "Does the sale of earned fees differentially increase the likelihood of the non-lawyer interfering with the attorney's exercise of independent professional judgment *only* through the non-lawyer's efforts to enforce their lien?" It is, "Does the sale of earned fees differentially increase the likelihood of the non-lawyer interfering with the attorney's exercise of independent professional judgment any *more* than the sale of unmatured fees? A functional analysis has to take all the possible effects of a practice into account and it has to be comparative. If we look at the effects of allowing the purchase of earned fees from the widest possible perspective, it is not obvious that non-lawyers are significantly less likely to interfere with attorneys' professional judgment in a world where they are only buying earned fees. The comparison should be analyzed along two dimensions.

First, the risk of interference by non-lawyers in cases of standard factoring extends beyond just the risk that the non-lawyer will begin a collection action for the earned fee. The non-lawyer's interest in the fee earned by the attorney might lead the non-lawyer to influence the attorney before the fee is earned, or to influence the attorney's behavior to the extent that it affects the client's decision to pay before a collection action is initiated. In the case of standard factoring of earned hourly fees, the non-lawyer might be tempted to interfere with the attorney's relationship with the client since the period of time

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[184] *See supra* note 86 and accompanying text.

[185] *Id.* (*citing* Va. Legal Ethics Op. 1744) (no violation of the fee-splitting rule in sharing portion of court-awarded fees with nonprofit organization).

between the attorney earning a fee and the client paying that fee could be quite long, and many things could happen in the meantime.[186] Since the attorney might act in a way which might lead the client to refuse any payment (especially if the client intends to sue for malpractice) or the attorney might act in a way that might cause the client to lose the assets with which the fee was to be paid (especially if the hours were earned in a "bet the company" litigation), the non-lawyer might try to preempt or mitigate the conditions which affect these risks. The non-lawyer might try to use whatever influence he has with the attorney to preserve the attorney-client relationship (even if that is not in the attorney's best interest) or to encourage the attorney to take a conservative approach to litigation that guarantees the non-lawyer's property interest at the expense of the attorney's independent professional judgment.[187]

Second, it may be the case that the incentive for non-lawyers to interfere with lawyers in cases of factoring of unmatured fees is overstated. It is important to recall that the distinction between cases of standard factoring and cases of factoring unmatured fees is blurred in practice. The reason, in *Santander,* that the factor bought the law firm's accounts receivables at a discount is that it assumed the risk that those accounts would not be collectable.[188] That is the same reason, in *Core Funding*, that the funder initially bought $124,000 of the plaintiff attorney's unmatured contingent fee for $100,000.[189] The plaintiff's attorney, Diana MacDonald, had co-counseled with a major plaintiff's firm in an airline crash and after litigating the case for a while, she felt confi-

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[186] Even Wall Street firms are finding the delay in payment of their fees, which are comprised of billable hours, sufficiently problematic that there is an increase in suits by these firms against clients for delinquent fees. *See* Christine Simmons, *Elite Law Firms Increasingly Suing Clients to Collect Fees,* December 2, 2016, N.Y.L.J. at ("we can no longer wait 90 days, 120 days, a year or more to collect fees").

[187] The advantage of restricting factoring to earned fees shrinks even more if fees earned by an attorney who has obtained a default judgment are considered "earned fees". A non-lawyer who buys attorney's fees in a case that has resulted in a default judgment but not proceeds could use his leverage against the interests of the client by enforcing his property rights in the fees, either by demanding that the client pay the assigned fees before the client has received her proceeds, or by exercising others rights of ownership, including demanding a voice in the decision of whether to accept an offer of compromise from the judgment debtor.

[188] The explanation one court gave for the reason a factor buys accounts receivables from physicians applies equally to lawyers: "In exchange for providing immediate cash to Valley Hospital, the medical finance companies received as consideration accounts receivables from Valley Hospital worth an amount sufficient to justify the risk they take that they may never actually collect." *Miller v. J-M Mfg. Co*. 2008 U.S. Dist. LEXIS 9392 at *16 (U.S.D.C. Ore. 2008) (standard factoring of accounts receivables is very common in the medical profession).

[189] *Core Funding,* 2006 Ohio App. LEXIS 1523 at *31-*33.

dent that the case would generate proceeds and wanted to sell those proceeds in advance of the case settling. There is no reason to assume that the type of risk faced by the buyers in *Santander* was any different in kind (as opposed to degree) from the risk faced by the buyer in the *Core Funding* case, even though in *Santander* the fees were fully earned when the accounts receivables were purchased, while in *Core Funding* they were unmatured and contingent. This is true even if we restrict the analysis only to the market for the fees from plaintiffs' attorneys who can only factor their contingent fees. As a functional matter, it is not clear that in most cases where factors have purchased unmatured fees, they actually face a risk of non-payment due to a litigation contingency that is any greater than the risks of non-payment faced by a factor who purchases a matured fee post-settlement.[190]

In terms of providing a practical barrier against interference with the independent professional judgment of attorneys, there is no reason to draw a distinction between earned and unmatured fees. There is no reason based on how law is actually practiced in the United States to believe that the risk of interference, to the extent that it exists (which is itself an empirical question for which little or no evidence has been produced), can be predicted based on whether the non-lawyer factor is purchasing an earned fee or an unmatured fee.

V. The Direct Relation Test Revisited

A. The DRT as a Deontological Principle

In Section IV I argued that the DRT cannot provide a functional basis for drawing a distinction between the factoring of earned fees and unmatured fees. The reason for this failure is that the DRT, as currently expressed by ethics committee opinions and commentators over the last few decades, is not based on functional concerns – in other words, the norm it instantiates is not consequentialist but deontological.[191] Of course, deontology is a respected ethical tradition and there may be parts of legal ethics that cannot be explained

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190 It should be recalled that the risk of non-payment to a factor arising from the insolvency of a judgment debtor post-settlement or post-judgment is not insignificant. *See e.g., A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 996 (4th Cir. 1986) (attorneys who won trial judgments against A.H. Robins could not collect fort their clients once it declared bankruptcy).

191 Deontology is "the school of ethics that focuses on the inherent rightness or wrongness of actions themselves, as opposed to the correctness or incorrectness of the consequences of the actions." Deborah Paruch, *From Trusted Confidant to Witness of the Prosecution: The Case Against the Recognition of a Dangerous-Patient Exception to the Psychotherapist-Patient Privilege*, 9 U. N.H. L. REV. 327, 332 (2011) (citation omitted).

except by reference to deontological principles.[192] But to the extent that professional responsibility is governed by norms that should be applied without regard to their consequences, those norms must be instantly recognizable as widely shared. Perhaps the norm behind Rule 1.6 – that confidences belong to the client, not the attorney (even if silence harms others) – is one such norm, but the non-instrumentalist norm identified at the heart of the DRT is neither instantly recognizable nor widely shared. In fact, the norm that undergirds the many applications of the DRT reviewed in this Article does not make much sense once it is isolated and analyzed.

The DRT's deontological injunction is that 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. This injunction can be seen, for example, in the explanation offered by the Texas ethics committee that rejected the non-recourse loans described in Section II. The committee argued that the problem with such arrangements was that the non-lawyer's gain "would be tied directly to the amount of the recovery in the underlying litigation."[193] In a New York case the court said much the same thing: the "prohibition against fee-splitting with nonlawyers is 'intended to bar any financial arrangement in which a nonlawyer's profit or loss is directly related to the success of an attorney's legal business.'"[194] This interpretation of the DRT focuses on the "productive" or "generative" relation between non-lawyer's contribution and the attorney's fee in which the non-lawyer hopes to share. As the ethics committee put it in Texas Op. 576:

> The amount of the recovery in a lawsuit is largely determined by the lawyer's knowledge, skill, experience and time expended. . . . By tying the proposed funding fee to a percentage of the recovery, the lending company would be directly benefiting from the lawyer's knowledge, skill, experience and time expended . . . .[195]

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[192] *See e.g.* Christopher Slobogin & Amy Mashburn, *The Criminal Defense Lawyer's Fiduciary Duty to Clients with Mental Disability*, 68 FORDHAM L. REV. 1581, 1616 (2000) (citing rules 1.2, 1.6 and 1.7 as examples of rules that illustrate a "deontological approach"). Some disgree. *See* Anita Bernstein*, Pitfalls Ahead: A Manifesto for the Training of Lawyers,* 94 CORNELL L. REV. 479, 506 (2009) ("[v]irtually every rule of professional conduct is amenable to [rule-utilitarian] analysis").

[193] Texas Ethics Op. 576 (2006).

[194] *Rodriguez v. City of New York*, 721 F. Supp. 2d 148, 153 (E.D.N.Y. 2010) (citations omitted).

[195] Texas Ethics Op. 576 (2006).

The statement from Texas Op. 576 has two parts. The first assertion, that "the amount of the recovery in a lawsuit is largely determined by the attorney's knowledge, skill, experience and time expended," simply states that outcomes in civil litigation are the product of the application of the attorney's legal skills, and that the resources available to the attorney can help her maximize the effect of those skills.[196] The second assertion is the key move for our purposes. It is that a non-lawyer may not "directly" benefit from the increase of efficacy that his contribution of capital might produce. Two implications follow from this second assertion: First, only the client may *directly* benefit from the attorney's "knowledge, skill, experience and time expended," and second, if anyone else benefits from the attorney's "knowledge, skill, experience and time expended," they may do so only *indirectly*. The second assertion is not, as we saw above, based on any well-grounded policy argument. It is presented as claim about the improper nature of the gain sought by the non-lawyer. The assumption is that only certain persons *should* directly benefit from the application of resources (such as money) to the practice of law – attorneys and clients – but not non-lawyers.

As a deontological norm, the DRT has to be interpreted in ways that make sense of it as an action-guiding norm.[197] "Directly benefit" must mean more than simply a historical correlation between the resources put into a legal matter by the relevant parties (the client, the attorney, and the non-lawyer) and the outcome of the legal work performed on behalf of the client. It must refer to the subjective intent of the parties when the resources were added to the legal matter. In other words, the DRT prohibits a non-lawyer from providing an attorney who has a client matter additional resources with the intent that the client's legal results would thereby be improved and that some of the gains produced as a result of the improvement in the client's legal matter would be returned to the non-lawyer. This principle is not based on a consequentialist concern over the effects of the addition of resources on the client – it is based on a non-consequentialist concern with the non-lawyer's reasons for action. The DRT is a deontological principle that prohibits any act helping the client if it arises from a non-lawyer funder's self-interested motive to profit from the attorney's exercise of her resources on behalf of her client. The DRT is deontological because its reach is not conditioned on a concern for the effects of the prohibition on the client's ends; it is conditioned on a belief that certain ends should simply be unavailable to non-lawyers in connection with legal re-

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[196] *See* Emily S. Taylor Poppe & Jeffrey J. Rachlinski, *Do Lawyers Matter? The Effect of Legal Representation in Civil Disputes,* 43 Pepp. L. Rev. 881 (2016) (review of studies into the efficacy of legal representation).

[197] For a discussion of action-guiding norms in law, W. Bradley Wendel, *Mixed Signals: Rational-Choice Theories of Social Norms and the Pragmatics of Explanation*, 77 IND. L.J. 1, 28 (2002).

sources; that is, non-lawyers who are not clients cannot act with the intention that they will enjoy the fruits of the productive capacities of lawyers working on behalf of their clients.

B. Some Questions About the Deontological Foundations of the DRT

The argument for abandoning the DRT is not just pragmatic, although the pragmatic consequences of halting the practice of factoring unmatured accounts should not be minimized.[198] The argument for abandoning the DRT is that it relies upon a distinction that is an empty formalism: it is an incoherent and counter-intuitive deontological norm.

The DRT is based on the assumption that positive gains in the actual value of the client's legal matter cannot be given to a non-lawyer if he "directly" enhanced the attorney's legal capabilities by the act of providing some additional resource. This begs the following question. Assuming that it is possible to identify "directly caused" enhancements of legal capabilities – which would be a prerequisite if the DRT were to operate as a conduct-guiding norm – why bar non-lawyers from enjoying gains that are the result of direct enhancement, but allow them to enjoy gains resulting from indirect enhancements?

For purposes of this Article, let us assume that the line between direct and indirect support by the non-lawyer can be drawn along some simple version of the but-for test for causation.[199] So, for example, if there is an advantage (such as an extra $10,000 in the final settlement) that would not have come about *but for* some additional quantum of legal practice made possible by the non-lawyer's contribution to the resources at the attorney's disposal, then, according to the DRT, the non-lawyer was the "direct" cause of the resulting advantage. Under this approach, the gains secured by the non-lawyer in standard factoring are indirect because the attorney's legal judgment or practice cannot be affected by the buyer's contribution of resources to the attorney, since the buyer's advance arrives on the scene *after* the legal resources have been expended. The effect of the exercise of the legal resources on the client's matter is already in the past and therefore the non-lawyer's additional funds are not

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198 *See* the discussion of attorneys' need for capital in Section I, *supra* notes 6 – 8 and accompanying text.

199 The but-for test is has a certain attraction in that it can, in theory, be applied without the employment of value judgments about the merit of the underlying distribution that its application produces. *But see* David Rosenberg, *The Causal Connection in Mass Exposure Cases: A "Public Law" Vision of the Tort System,* 97 HARV. L. REV. 851, 855, n.27 (1984) ("Although "causal connection" determinations focus on the ostensibly "scientific" cause-and-effect relationship, several ambiguities in the 'but-for' causation test necessitate the exercise of value judgments by courts and juries.").

able to affect the matter through the resources that the non-lawyer is ostensibly buying (the hours already expended or the fee already earned).

Ignoring, for the moment, the artificiality of the but-for test as it is applied in cases of standard factoring,[200] what possible ethical reason could be offered for distinguishing between resources that are but-for causes of the exercise of legal resources and those that are not? The "but-for" test for directness has the virtue of clarity but it lacks any normative content. To see why this is so, assume that the deontological claim at the root of the DRT concerns the permissibility of non-lawyers (the capital provider) gaining a benefit in a certain way: through the enhancement of an attorney's capabilities. Why should this matter from the perspective of legal ethics? It cannot be because the benefits that are gained by means the DRT deems direct reflect a reason for action on the part of the non-lawyer that is shameful or unseemly. The motive seems no more or less praiseworthy than the motive behind non-lawyer who engages in standard factoring (or lending, for that matter), where the non-lawyer only indirectly benefits from the enhancement of an attorney's capabilities.

In both types of transactions (direct and indirect) the economic rationale behind the price at which the buyer purchases the attorney's accounts receivables is the same: His greater ability to bear the attorney's risk that earned fees will not be paid. If this is the case, it is hard to see how any feature of the non-lawyer's reasons provides a deontological reason to distinguish between the two transactions.

Perhaps the ground for the deontological distinction does not have to do with the non-lawyer who seeks a benefit drawn from the enhancement of the attorney's legal capabilities, but with the reasons of the attorney who seeks out the enhancement of her capabilities. Perhaps the insight behind the DRT is that attorney ought not to receive resources or capital for the "wrong" reasons. This argument, of course, depends on being able to articulate why the attorney who accepts enhancement of their legal capabilities from a non-lawyer investor is acting is a way that is wrong, when they are not acting wrongfully if those enhancements come from their client or from their own capital.

It is true that, as between factoring earned fees and factoring unmatured fees, the attorney's reasons for wanting to *sell* the property interest she has may not be the same. But is this difference morally significant? It must be conced-

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200 The assumption that the money provided in standard factoring does not actually assist the attorney in her practice of law in ways that create future gains to the non-lawyer is a bit naïve, given that most factoring is not a one-off arrangement but part of an ongoing arrangement where the money paid for fees today will be used to help the attorney earn fees which will be purchased in the future. *See, e.g. See Santander Bank,* 2016 U.S. Dist. LEXIS 5430 (factor and law firm engaged in serial transactions).

ed that an attorney's rationale for accepting resources from the non-lawyer may differ depending on whether the attorney receives the resource before or after the fee is earned. When an attorney factors an unmatured contingent fee, the attorney could use the money she receives to invest further in the case upon which she is working or she may use it for a purpose entirely independent of that case (and even independent of the practice of law). While the attorney will always be interested in these particulars, the buyer can afford to be indifferent to them; all the buyer cares about is that at the end of the day he receives the proceeds from the case that he purchased.

But why should the bar committees prohibited the transactions reviewed in Section II care about what the attorney intends to do with the resource advanced to her when she sells her accounts receivables to the non-lawyer? Assuming that we have already excluded the functional concerns about interference with independent professional judgment, there may be one remaining possibility: The concern that, by allowing non-lawyers to act with the subjective intent to enhance an attorney's practice of law, the non-lawyer is himself violating the prohibition on the unauthorized practice of law (UPL).[201]

UPL is a poor justification of a categorical prohibition on lawyers accepting resources in circumstances where the resources might enhance their legal capabilities. According to this reasoning, all *ex ante* support of an attorney's practice of legal skill and judgment is the practice of law. This is a conceptual argument that cannot possibly be defended. The refutation is easy to demonstrate. Let us assume, for the sake of argument, that a "direct" relation between the a capital advance and the attorney's fee exists when the capital affects the attorney's exercise knowledge, skill, experience and time expended by making her more effective, or efficient. But the enhancement of a professional's exercise of *professional* knowledge, skill, experience and time expended is not necessarily itself the exercise of professional skills. When non-lawyer staff enhances an attorney's exercise of professional skills, no one says that the non-lawyer staff is necessarily practicing law.[202] When a bank, through a conventional recourse loan secured by assets unrelated to any specific case, enhances an attorney's exercise of professional skills, no one says that bank is practicing

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[201] *See* Koppel, *Under Siege From Within and Without, supra* note 46 ("Once a close relationship develops between lawyers and non-lawyers, it is easy for non-lawyers to wittingly or unwittingly become involved in the unauthorized practice of law.") (*citing Emmons, Williams, Mires & Leech v. State Bar,* 6 Cal. App. 3d 565, 573 (1970)).

[202] UPL by staff and paralegals has to be proven by showing that their efforts did not "merge into the attorney's completed work product". Unauthorized Practice of Law Advisory Opinion No. 192, 1999 Va. LEXIS 88 (July 13, 1999) at *7.

law (although in reality, the bank may impose covenants that may do just that).[203]

There is no plausible argument for adopting a deontological norm against non-lawyers benefitting from directly enhancing lawyers' legal capabilities. The argument lacks any intuitive appeal, and to the extent that it is justified as a necessary prophylactic to protect against the unauthorized practice of law, it is very unlikely that the "necessity" upon which this argument relies can be demonstrated.

VI. Conclusion

This Article began with a description of the anxiety over capital expressed by attorneys over the past thirty years.[204] The other half of the story, which is equally important, and perhaps better known, is the anxiety that the bar has felt over the pressures imposed on it to become more like a business.[205] This latter anxiety is based on the reasonable fear that, as a general matter, efforts to allow non-lawyers to engage in profit-making activities with attorneys will erode the legal profession's core values and independence.[206] Still, it is important to recognize that not every move to allow non-lawyers to pursue profit-making activities with attorneys will result in a descent down a slippery slope towards turning law into a "swashbuckling" market in which legal ethics plays no role, and attorneys no longer are expected to "have special responsibilities and special roles to play in our society."[207] As this Article has argued, there are at least four different ways that non-lawyers could invest in modern American legal practice.[208] Debate over the formation of professional partnerships with non-lawyers and the sale of equity in an attorney's practice have dominated the bar's attention. This Article tries to lower the temperature of the

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[203] *See supra* notes 23 - 25 and accompanying text.

[204] *See supra* notes 6 – 8 and accompanying text.

[205] *See* Lawrence J. Fox, *MDPs Done Gone: The Silver Lining in the Very Black Enron Cloud*, 44 ARIZ. L. REV. 547, 556 (2002) (the MDP reform effort "depends on the invidious notion . . . that lawyers really are just another set of service providers, that there is nothing special – in the sense of special responsibility – about being lawyers, that our rules of professional conduct are not all that important, and that the sooner we lawyers got off our high falutin' horses the better off we will be").

[206] *See id.* ("Nor should anyone doubt that lawyer regulation by the judiciary would be one of the first casualties of lawyer MDPs . . . and these enterprises [will] be regulated just like any other for-profit enterprise.").

[207] Lawrence J. Fox, *Dan's World: A Free Enterprise Dream; An Ethics Nightmare*, 55 BUS. LAW. 1533, 1563 (2000).

[208] *See supra* notes 28 - 43 and accompanying text.

debate and address the anxieties on both sides by asking everyone to turn their attention to a different reform – passive investment in legal practice by allowing attorneys to sell their unmatured fees.

The advantages of the reform proposed in this Article are threefold. First, unlike the reform most frequently debated, the formation of professional partnerships between attorneys and non-lawyers, the sale of unmatured fees does not formally allow non-lawyers to become involved with an attorney's practice. The concerns raised by critics of MDPs over UPL, interference with attorney's independent professional judgment and violation of client confidences are thereby reduced if all the non-lawyer is doing is advancing capital.[209] The concerns raised by critics of the Australian or U.K. reforms, which would allow law firms to sell equity in their practice (either controlling or non-controlling shares), which is that the firms would be driven to "practice to the share price," while genuine, would not be reproduced if all that the non-lawyer could purchase was an interest in a future, contingent fee.[210] Since the non-lawyer buying the unearned fee can only profit if the attorney earns her fee, the attorney's original interest in her client's recovery and the non-lawyer's interest when he bought the fee are aligned.[211]

Second, the advantages to attorneys and society of allowing the purchase of unmatured fees, while hard to quantify, are potentially significant. As shown in Section I, the size of the legal market in the United States is large, and the need for capital is demonstrable. Finally, as documented in Section II, attorneys and financiers are willing to engage in factoring transactions involving unmatured fees.[212] It is not the intention of this Article to oversell the ad-

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[209] *See, e.g.* Carson, *Under New Mismanagement, supra* note 55 at 615 – 33 (describing risks to clients of MDPs) *and* Joseph E. Neuhaus*, Comments of the New York State Bar Association Committee on Standards of Attorney Conduct on Ethics 20/20's Issue Paper Concerning Alternative Business Structures* (June 9, 2011) (same). *See also* L. Harold Levinson, *Independent Law Firms That Practice Law Only, supra* note 209 (arguing that admitting non-lawyers into legal partnerships will impair the independence and decisional autonomy of lawyers and the legal profession).

[210] *See* MacEwen et al., *Law Firms, Ethics, and Equity Capital*, *supra* note 38 at 70.

[211] This is why the state bar ethics committee in Utah Ethics Advisory Opinion No. 06-03 upheld a proposed transaction involving the purchase of an unmatured contingent fee. Where an attorney is obliged to give only a portion of every dollar that she earns to the non-lawyer, the "litigation-funding Agreement does not present the potential that the lawyer will have a financial incentive not to obtain a recovery for the client." Utah Ethics Advisory Opinion No. 06-03. The committee assumed that the interests of the non-lawyer aligned with the attorney and that the interests of the attorney aligned with the client.

[212] *See supra* notes 134, 135, and 139.

vantages of allowing the purchase of unmatured fees – they are not designed to provide clients with the additional efficiencies that MDPs and ALPS might provide.[213] In 2011 the ABA's 20/20 Commission received unsolicited comments about passive investment from two very different perspectives, and the contrast between them is revealing.[214] One comment, which came from Consumers for a Responsive Legal System, urged the ABA to consider reforms of Rule 5.4 that would include passive investment.[215] The other comments, which came from the United States Chamber of Commerce, objected to any "loosening of Model Rule 5.4's restrictions on non-attorney investments in law firms."[216] America's law firms, it argued, complain "about their ability to raise money [but] there is no evidence that U.S. law firms lack sufficient capital."[217] To the extent that one accepts that these comments demonstrate the interests that would be served if attorneys were allowed to sell unmatured fees, there is reason to believe that consumers would benefit from this reform.

Third, the adoption of the reform proposed in this Article would not require changing Rule 5.4. As argued in Section IV, the current state of the law with respect to contingent advances is in a state of confusion. The state bar ethics committee opinions which prohibit fixed-return contingent advances and percentage-return contingent advances are based on a principle, the DRT, which either excludes too many or too few transactions. This article views these ethics committee opinions as too unreliable to provide guidance in the future and their reasoning should be ignored. This is not to say that all of the opinions arrived at the wrong conclusion. It is to say, however, that the principle produced by these opinions, the DRT, is not a valid interpretation of Rule 5.4. This Article recommends that bar ethics committees and courts begin with the

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[213] Dzienkowski & Peroni, *Multidisciplinary Practice and the American Legal Profession, supra* note 47 at 170 (on "coordination" benefits to clients of MDPs).

[214] Cobb, *Have Your Cake and Eat It Too!, supra* note 42 at 786 – 89 (The ABA 20/20 Commission chose not to invite public comments on passive investment).

[215] Comments to the ABA Commission on Ethics 20/20 Working Group on Alternative Business Structures, Consumers for a Responsive Legal System, May 31 2011, available at http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20110627_abs_issues_paper_comments_for_posting.authcheckdam.pdf. (last visited on February 21, 2017).

[216] Letter from John H. Beisner, U.S. Chamber Institute for Legal Reform, to Natalia Vera, Senior Research Paralegal, Commission on Ethics 20/20 (June 1, 2011), available at http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20110627_abs_issues_paper_comments_for_posting.authcheckdam.pdf. (last visited on February 21, 2017).

[217] *Id.*

assumption that the sale of unmatured fees is not fee-splitting, and prohibit transactions that involve such sales only if it can be shown that the transactions would lead to any of the concerns which have led committees to prohibit fee-splitting in the past: namely UPL, interference with attorney's independent professional judgment and violation of client confidences. Rule 5.4 should not be read as requiring a *per se* prohibition of a market in unmatured fees. This Article, therefore, calls for reform in how the profession thinks about allowing attorneys to raise capital by selling their fees to non-lawyers, and not in Rule 5.4 itself.