

# AMERICAN BAR ASSOCIATION

STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

**Formal Opinion 499**

**September 8, 2021**

## **Passive Investment in Alternative Business Structures**

*A lawyer may passively invest in a law firm that includes nonlawyer owners (“Alternative Business Structures” or “ABS”) operating in a jurisdiction that permits ABS entities, even if the lawyer is admitted to practice law in a jurisdiction that does not authorize nonlawyer ownership of law firms.<sup>1</sup> To avoid transgressing Model Rule 5.4 or other Model Rules and to avoid imputation of conflicts under Model Rule 1.10, a passively investing lawyer must not practice law through the ABS or be held out as a lawyer associated with the ABS and cannot have access to information protected by Model Rule 1.6 without the ABS client’s informed consent or compliance with an applicable exception to Rule 1.6 adopted by the ABS jurisdiction. The fact that a conflict might arise in the future between the investing lawyer’s practice and the ABS’s work for its clients does not mean that the lawyer cannot make a passive investment in the ABS. If, however, at the time of the investment the lawyer’s investment would create a personal interest conflict under Model Rule 1.7(a)(2), the lawyer must refrain from the investment or appropriately address the conflict under Model Rule 1.7(b).*

### **Introduction**

ABA Model Rule of Professional Conduct 5.4 features a number of prohibitions designed to preserve the professional independence of lawyers. In general, the Rule prohibits a lawyer or law firm from sharing legal fees with a nonlawyer, forming a partnership with a nonlawyer (if any of the activities of the partnership consist of the practice of law), and practicing in a business structure in which a nonlawyer owns any interest in the business or serves as a corporate director or officer.

Model Rule 5.4 or its close equivalent has been adopted in nearly every U.S. jurisdiction; to date only Arizona, the District of Columbia, and Utah have modified their jurisdiction’s Rule 5.4 to permit business structures that allow nonlawyer ownership of law firms and the sharing of legal fees with nonlawyers.<sup>2</sup> Since 1991, the District of Columbia’s version of Rule 5.4 has, in circumstances defined in and limited by that rule, permitted individual nonlawyer partners in law firms, as long as such nonlawyers are providing professional services that assist the firm in delivering legal services. The District of Columbia does not permit passive investment in law firms. In 2020 the Utah Supreme Court launched a two-year pilot legal-regulatory “sandbox” project whereby Court-approved entities may include nonlawyer owners in firms that provide legal

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<sup>1</sup> This opinion is based on the ABA Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2020. The laws, court rules, regulations, rules of professional conduct, and opinions promulgated in individual jurisdictions are controlling.

<sup>2</sup> In 2015 the Washington State Supreme Court authorized Limited License Legal Technicians to share fees and form business structures with lawyers. See WASH. R. OF PROF’L CONDUCT R. 5.9 (Business Structures Involving LLLT and Lawyer Ownership). The United States Patent and Trademark Office permits parent agents to be partners in a law firm practicing before the Office. 37 C.F.R. § 11.1 (definition of practitioner); 37 C.F.R. § 11.504.

services.<sup>3</sup> In 2021 Arizona eliminated Rule 5.4 altogether, substituting a system in which Arizona law firms that include nonlawyer owners or investors may be certified by the Arizona Supreme Court as “alternative business structures” (“ABS”). Given these changes, the question raised is whether a lawyer admitted to practice law in a jurisdiction adhering to Model Rule 5.4 (i.e., a jurisdiction that strictly prohibits nonlawyer ownership of law firms) (hereinafter “Model Rule Lawyer”) may acquire a “passive” investment interest in an ABS?<sup>4</sup>

For purposes of this opinion, a “passive” investment interest means that a lawyer contributes money to an ABS with the goal of receiving a monetary return on that investment. Passive investment does not include scenarios in which the investing lawyer practices law through the ABS, manages or holds a position of corporate or managerial authority in the ABS, or is otherwise involved in the daily operations of the ABS.

Further, passive investment, as used in this Opinion, means that the investing lawyer does not have access to information protected by Model Rule 1.6 without the ABS client’s informed consent.

Under these circumstances, a Model Rule Lawyer who makes a passive investment in an ABS does not violate Model Rule 5.4. However, in some circumstances the Model Rule Lawyer may have a conflict of interest, arising from the Model Rule Lawyer’s own practice. The conflict might arise at the time the investment is made or thereafter. The potential for a conflict does not prohibit a Model Rule Lawyer from making the passive investment, but it does require the Model Rule Lawyer to address a conflict that later materializes. If, however, at the time of the investment the Model Rules Lawyer’s investment would create a personal interest conflict under Model Rule 1.7(a)(2), the Model Rule Lawyer must refrain from the investment or appropriately address the conflict pursuant to Model Rule 1.7(b).

## Analysis

### A. A Lawyer May Have Business Interests Separate from the Practice of Law

In general, a lawyer may own a business or an investment interest that is separate from and unrelated to the lawyer’s practice of law. For instance, a lawyer may have an ownership interest in a restaurant, be a partner in a consulting business, invest in a mutual fund, or buy stock in a publicly traded company (collectively “unrelated personal investments”).

An unrelated personal investment does not intrinsically implicate the Model Rules, except to the extent that the lawyer’s activities vis-à-vis the investment present a conflict of interest under Model Rule 1.7 or 1.8. For example, if a lawyer were to ask a client to invest in the lawyer’s separate business or offer to refer ancillary business services to a client, the lawyer would need to comply with the disclosure and writing requirements in Model Rule 1.8(a).<sup>5</sup>

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<sup>3</sup> In May 2021, the Utah Supreme Court extended the term of the Utah legal-regulatory sandbox to seven years.

<sup>4</sup> This Opinion only addresses “passive investment” in an ABS and is not, at this time, evaluating other scenarios involving a Model Rule lawyer practicing in an ABS.

<sup>5</sup> See ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 484 (2018) (offering litigation funding services to a client when the lawyer has a financial interest in the offered services requires informed consent). See also MODEL RULES OF PROF’L CONDUCT R. 1.7, cmt. [10] (a lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed financial

Similarly, the Rules do not prohibit a lawyer from making unrelated personal investments, albeit in some circumstances the Rules require the client's informed consent. When the lawyer invests in an entity that is a client or accepts an interest in a client's business as a fee, the lawyer must comply with Rule 1.8(a).<sup>6</sup> And if a lawyer owns a significant investment interest in a business that is an adversary of the lawyer's client, that interest could materially limit the lawyer's representation as discussed in Part C, below.

### B. Choice of Law Considerations

If a Model Rule Lawyer is a passive investor in an entity operating in a jurisdiction that permits investment in an ABS, there is a choice-of-law question about which jurisdiction's ethics rules apply to the Model Rule Lawyer's passive-investment conduct: the rules of the Model Rule jurisdiction or the rules of the ABS-friendly jurisdiction. Model Rule 8.5(b) resolves the conflict of laws that arises when a lawyer is potentially subject to more than one set of rules of professional conduct that impose different obligations.

Under Model Rule 8.5(b)(1), the rules to be applied depend on whether the conduct relates to a matter pending before a tribunal, in which case the rules of the jurisdiction in which the tribunal sits apply. In other circumstances, the applicable rules are those of the jurisdiction in which the lawyer's conduct occurred, unless the predominant effect of that conduct is in another jurisdiction.<sup>7</sup>

In the Committee's view, the conflict-of-law issue in the passive investment context is resolved by applying the law of the jurisdiction in which the ABS is authorized to operate because under Rule 8.5(b)(2), the predominant effect of a Model Rule Lawyer's *passive* investment in an ABS would be in the jurisdiction(s) where the ABS would be permitted. That conclusion follows from the fact that the investment is passive and is made in order to fund the activities of an ABS in a jurisdiction that permits such entities.<sup>8</sup> Assuming the Model Rule Lawyer's investment is genuinely passive, the lawyer cannot be deemed to be practicing law in the ABS-permissive jurisdiction, just as a lawyer who is an investor in a mutual fund that includes widget company stock in its portfolio is not deemed to be making widgets. Accordingly, when the Model Rule Lawyer is passively investing, the only relevant "conduct" and the only meaningful "effect" of that conduct occurs in the ABS-permissive jurisdiction. As to that conduct, the Model Rule Lawyer's passive investment does not violate the rules of professional conduct of the ABS-permissive jurisdiction.

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interest); MODEL RULES OF PROF'L CONDUCT R. 5.7, cmt. [5] (noting that when a client-lawyer relationship exists with a person who is referred by a lawyer to a separate law-related service entity controlled by the lawyer, the lawyer must comply with Rule 1.8(a)).

<sup>6</sup> See MODEL RULES OF PROF'L CONDUCT R. 1.8, cmt. [1].

<sup>7</sup> See MODEL RULES OF PROF'L CONDUCT R. 8.5(b)(2).

<sup>8</sup> Cf. NY State Bar Ass'n Comm. on Prof'l Ethics Op. 1093 (2016) (predominant effect of New York-admitted lawyer practicing in England was in the latter jurisdiction). The analysis does not change if the passive investment funds, in whole or in part, litigation before a tribunal. In order for Rule 8.5(b)(1) to apply, instead of Rule 8.5(b)(2), the conduct at issue must be before a tribunal. A lawyer making a passive investment in an ABS-firm is not engaged in "conduct in connection with a matter pending before a tribunal." See MODEL RULES OF PROF'L CONDUCT R. 8.5 cmt. [4] (conduct by litigating lawyer "in anticipation of a proceeding not yet pending before a tribunal" is governed by Rule 8.5(b)(2).)

This outcome is, from a policy standpoint, consistent with this Committee's earlier opinion on cross-border fee dividing between lawyers. In ABA Formal Opinion 464 (2013), the issue was whether a lawyer in a Model Rules jurisdiction could serve as co-counsel in a matter and divide legal fees with a Washington, D.C. lawyer who practiced in a firm that included a non-lawyer partner as permitted under the District of Columbia's Rule 5.4(b). The Committee concluded that such a fee division did not violate the Model Rules because the lawyer would be dividing a legal fee only with "another lawyer," and a lawyer may divide legal fees with a lawyer admitted in another jurisdiction. In the Committee's view, the possibility that the District of Columbia firm might eventually "share" some fraction of that firm's portion of the fee with a nonlawyer because a portion of it becomes part of that firm's overall revenues was not a basis upon which to expose the lawyer in the Model Rules jurisdiction to discipline. Just as the Committee previously concluded that a Model Rule Lawyer can jointly represent a client and ethically divide a fee with a lawyer practicing in a firm whose structure is not permitted by Model Rule 5.4 but allowed by the local jurisdiction's rules, so too the Committee concludes that a Model Rule Lawyer's passive investment in such a firm is likewise allowed where ABS's are permitted by a jurisdiction's rules.

### **C. Conflict of Interest Risks Presented by Passive Investment**

A passive investment in an ABS, without more, does not mean that the Model Rule Lawyer is practicing law through the ABS. To avoid any appearance of practicing law through the ABS, the investing Model Rule Lawyer must ensure that the ABS does not identify the Model Rule Lawyer as a lawyer or hold out the Model Rule Lawyer as a lawyer associated with the ABS.

A passive investment does not create an "of counsel" relationship where conflicts are imputed to other lawyers. Nothing about a passive investment necessarily creates the "close, regular and personal relationship" characteristic of "of counsel" arrangements.<sup>9</sup>

As a result, the mere fact of a passive investment by a Model Rules Lawyer in an ABS does not require imputation of conflicts under Model Rule 1.10 between the Model Rule Lawyer (or that lawyer's firm) and the ABS.

However, even if a Model Rule Lawyer is only a passive investor with no other relationship to the ABS, that Model Rule Lawyer still must consider the possibility of the concurrent conflicts of interest that could arise from the Model Rule Lawyer's representation of clients in the Model Rule jurisdiction.

For example, a Model Rule 1.7(a)(2) concurrent conflict of interest based on the Model Rule Lawyer's personal interest in the investment in the ABS would likely exist if, when the Model Rule Lawyer made the investment the Model Rule Lawyer also represented a client whose interests were adverse to a client of the ABS. Such a conflict would exist if the Model Rule Lawyer were to act as an advocate against a client of the ABS or represent a business in a transactional matter requiring negotiation with a client of the ABS. In these situations, among others, the Model Rule Lawyer's investment interest in the ABS could "create a significant risk" that the Model Rule

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<sup>9</sup> See ABA Comm. on Ethics & Prof'l Responsibility, Formal Ops. 90-357 & 94-388.

Lawyer's representation of the client would be "materially limited" by the lawyer's investment interest in the ABS.<sup>10</sup>

In most circumstances, such a conflict will only preclude the investing Model Rule Lawyer from representing the client, because personal interest conflicts are generally not imputed to other lawyers in the same firm unless those interests create a significant risk of materially limiting the representation of a client by the remaining lawyers in the Model Rule Lawyer's firm.<sup>11</sup>

The fact that a conflict might arise in the future between the Model Rule Lawyer's practice and the ABS firm's work for its clients does not mean that the Model Rule Lawyer cannot make a passive investment in the ABS. If, however, the Model Rule Lawyer's investment in an ABS will create a conflict of interest at the time of the investment, the Model Rule Lawyer would need to refrain from the investment unless the conflict can be resolved appropriately under Model Rule 1.7(b).<sup>12</sup>

#### **D. ABS Client Confidential Information**

While it is hard to assess what information might be requested by investors or potential ABS investors, it is unrealistic to assume that there will be no investor requests for information about the ABS operations or revenue. The issue of disclosure of confidential information by an ABS is a developing area of the law and beyond the scope of this opinion; when investing in an ABS, the Model Rule Lawyer should exercise due care to avoid exposure to confidential client information held by the ABS or other associations that could result in a determination that the Model Rule Lawyer is part of the ABS "firm."

#### **Conclusion**

A lawyer admitted to practice law in a Model Rule jurisdiction may make a passive investment in a law firm that includes nonlawyer owners operating in a jurisdiction that permits such investments provided that the investing lawyer does not practice law through the ABS, is not held out as a lawyer associated with the ABS, and has no access to information protected by Model Rule 1.6 without the ABS clients' informed consent or compliance with an applicable exception to Rule 1.6 adopted by the ABS jurisdiction. With these limitations, such "passive investment" does not run afoul of Model Rule 5.4 nor does it, without more, result in the imputation of the ABS's client conflicts of interest to the investing Model Rule Lawyer under Model Rule 1.10. The fact that a conflict might arise in the future between the Model Rule Lawyer's practice and the ABS firm's work for its clients does not mean that the Model Rule Lawyer cannot make a passive investment in the ABS. If, however, at the time of the investment the Model Rules Lawyer's investment would create a personal interest conflict under Model Rule 1.7(a)(2), the Model Rule Lawyer must refrain from the investment or appropriately address the conflict pursuant to Model Rule 1.7(b).

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<sup>10</sup> See ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. R. 1.7, cmt. [10] (a "lawyer's own interests should not be permitted to have an adverse effect on representation of a client").

<sup>11</sup> ABA MODEL RULES OF PROF'L CONDUCT R. 1.10(a)(1).

<sup>12</sup> The potential inability of the Model Rule Lawyer to redeem or liquidate her investment at any time may create difficulties in resolving conflicts that arise post-investment. The Model Rule Lawyer may not be able to withdraw from the passive investment at any time, absent simply giving up the interest, and that leaves informed consent from the Model Rule Lawyer's client or withdrawal from the representation of that client as the only options.

**Abstaining:** Norman W. Spaulding

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**AMERICAN BAR ASSOCIATION STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY**

321 N. Clark Street, Chicago, Illinois 60654-4714 Telephone (312) 988-5328

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