Time To Consider Percentage Rental Agreements For Lawyers

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Many retailers receive variable incomes throughout the year or depending on the year. For example, one could reasonably expect a restaurant in a beach town to earn more revenue in the summer and in years when families can afford to vacation, and for a toy store to earn more before the winter holidays.

In order to alleviate the financial pressures that such variable income creates, the real estate industry frequently uses percentage rental agreements. Under these agreements, the retailer typically pays the landlord a base rate plus a percentage of the revenue received by the retailer.

In this way, part of the business or economic risk can be shifted from the retailer to the landlord: When the retailer earns less, its rental obligations decrease; when the retailer earns more, its rental obligations increase. And the retailer is left to focus more on what will make the business succeed and less on shorter-term issues of cash flow.

One could argue that many lawyers are effectively retailers. But even if one rejects this characterization, many, if not most, lawyers ride the same economic roller coasters as retailers — both within a particular year and over the years.

And it goes without saying that when revenue is tight, the need to make fixed rental payments can put a lot of pressure on lawyers to deviate from their required devotion to client interests. And just as with retailers, this pressure on lawyers could be reduced through the use of the same kinds of percentage rental agreements that real estate lawyers draw for their clients.

Under the American Bar Association's Model Rule 5.4(a) and predecessor rules as adopted throughout the country, however, it has long been the law that even though they can draft such agreements for their clients, lawyers cannot use percentage rental agreements for themselves because doing so would constitute an impermissible sharing of fees with nonlawyers.

In 1993, for example, Formal Opinion 697 of the New York County Lawyer's Association Committee on Professional Ethics observed, "Sixty years ago, it was recognized that percentage lease agreements were absolutely prohibited as an improper division of legal fees with a non-lawyer."

And despite the potential benefits to lawyers in times when the economy is struggling — like now — the prohibition against the use of percentage rental or lease agreements had to remain a part of the prohibition against lawyers sharing fees with nonlawyers:

> Supporting this express prohibition is the concern that a percentage lease agreement creates a built-in financial incentive for the landlord to pressure the tenant law office to increase billings. This could in turn cause the landlord to interfere with the lawyer's exercise of independent professional judgment ..., or to pressure the lawyer

> to charge excessive fees ... or to pay improper referral fees to the landlord .... Whether or not these underlying concerns could be satisfactorily addressed by the terms of the lease is a question that need not be reached, in view of the direct violation of [what is now New York Rule of Professional Conduct 5.4(a)] the proposed arrangement would entail.

And New York is by no means the only jurisdiction to have adopted this position for these reasons.[1]

The point of this article is not to question whether the opinions that reach this conclusion have correctly construed Model Rule 5.4(a), its state variants or its predecessors. The point of this article also is not to question whether lawyers should, more generally speaking, be allowed to practice law in partnerships or other arrangements with nonlawyers.

The question here is far more limited: whether the rules of professional conduct should altogether prohibit lawyers from leasing office space under percentage rental agreements. We submit that they should not.

Starting first on the positive side, percentage rental agreements would help lawyers match expenses with revenues and would therefore place less pressure on lawyers in lean times. Lawyers would therefore be better able to focus on client objectives rather than the lawyers' immediate financial circumstances.

In addition, the field of behavioral economics has shown that any reduction in the level of risk — especially downside economic risk — that lawyers may feel as a result of percentage rental agreements is likely to allow them to exercise independent professional judgment on behalf of their clients more fully than if they are faced with bills in fixed amounts that they must pay.[2]

So what then are the arguments against allowing lawyers to use percentage rental agreements? Looking at NYCLA Opinion 697 and at other similar opinions, there generally are four.

One argument is simply that lawyers have been prevented from using percentage rental agreements for a very long time and that "if it's not broke, don't fix it." With respect, that begs the question of whether, as forward-looking professionals, we should ask what makes sense now rather than what may or may not have made sense a long time ago.

A second argument is that lawyers could thereby be encouraged to charge higher fees. Again with respect, this argument has it backward. It is not our understanding that retailers that use percentage rental agreements increase their prices as a result of pressure from their landlords. With percentage rental agreements in place, lawyers (like nonlawyers) would have less incentive to raise rates in bad times because their expenses would be less.[3]

A third argument is that the landlord may be incentivized to send people with legal problems to its tenant-lawyers and that the tenant-lawyers would feel pressured to take such cases even if they are not competent to do so. While this is a possibility, it is not unique to percentage rental agreements.

Consider, for example, a lawyer who is having trouble paying her rent during a pandemic that has caused massive unemployment among the lawyer's clients and therefore delayed their payments to the lawyer. If the landlord has found the lawyer to be an agreeable

tenant, the landlord would be no less incentivized to send people with legal problems to the lawyer in order to increase her revenue and thus be able to continue the landlord-tenant relationship. And the lawyer is at least as likely to want to stretch the work she accepts to meet a fixed rental payment as to meet a contingent and therefore only potential rental payment.

We turn, then, to the fourth and principal argument against percentage rental agreements — that they would impair the lawyer's exercise of independent professional judgment.

The theory here is that nonlawyers who have an interest in legal fees will force their way into lawyer decision-making and thereby cause decisions to be made in a way that is less favorable to clients because it is less rooted in purely legal considerations. It seems fair to ask, however, how likely an outcome this is.

In the situation discussed in NYCLA Opinion 697, for example, the landlord's proposed percentage rental was to be set at 2%. But even if it were set at 5%, 10% or 20%, how likely is it that landlords will believe that they know better about what to do for clients, that they will insist or even pressure their tenant-lawyers to act in a particular way, and that the tenant-lawyers will do so?

Alternatively, what are the cogent reasons to believe that landlord interference could not be sufficiently prevented by clear contract terms or that the pressures placed on tenant-lawyers by percentage rental landlords are or will be less than the pressures placed on them by fixed-rent landlords, receivables lenders and other creditors?

We understand that the sharing of legal fees with nonlawyers is presently part of a much larger access-to-justice discussion that seeks to authorize new ways of delivering legal services to underserved businesses and individuals. We are raising this issue here, however, because we want to emphasize that regardless of whether or how the fee-sharing or law firm ownership rule may more generally be modified, there is reason to reconsider it entirely within the narrow context of existing law firm economics.

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[1] See, e.g., Pa. Eth. Op. 95-106 (1995); Tex. Prof. Eth. Comm. Op. 467 (1991).

[2] See, e.g., Michael Lewis, The Undoing Project 268–78 (2017) (discussing loss aversion theory); Jonah Lerner, How We Decide 77 (2010) ("As Kahneman and Tversky put it, 'In human decision making, losses loom larger than gains.'").

[3] This anti-percentage rental argument also assumes that legal fees are controlled by individual lawyer rental agreements rather than by overall competitive forces between lawyers and the bargains struck by lawyers and clients.