

ARIZONA SUPREME COURT
ETHICS ADVISORY COMMITTEE

Ethics Opinion EO-24-0006

[Date of Issuance]

**Referral Fees From Financial Planning Firms in Which a Lawyer Has an
Ownership Interest; Required Disclosures**

QUESTIONS PRESENTED

1. May a lawyer receive a referral fee from a nonlawyer financial planning firm in which the lawyer does not have an ownership interest?
2. May a lawyer receive a referral fee from a financial planning firm in which the lawyer has an ownership interest?
3. If yes to Question 2, how much ownership is sufficient to trigger ethical obligations? Is 1% sufficient?
4. Does it matter whether a lawyer receives a one-time referral fee or a continuing referral fee (e.g., a percentage of commissions)?

SHORT ANSWERS

1. Yes. Under specific circumstances, a lawyer may receive a referral fee from a nonlawyer business, provided the arrangement does not create a conflict of interest under ER 1.7, and the lawyer does not disclose confidential client information without informed consent as required by ER 1.6.

2. Yes. However, due to the lawyer's ownership interest, this may be considered a business transaction with a client, and the requirements of ER 1.8(a) may apply in addition to the obligations outlined above.
3. Any ownership interest is sufficient to trigger an analysis of the fee as a business transaction as well as the confidentiality and conflict of interest issues.
4. This analysis must be undertaken for one-time as well as recurring payments. Additionally, the more significant the ownership interest or the duration of the recurring payments, the more rigorous the analysis of these issues must become.

ANALYSIS¹

The abrogation of ER 7.2, which previously prohibited a lawyer from receiving a referral fee, along with the adoption of new rule provisions permitting nonlawyer ownership of law firms, has created uncertainty for lawyers about the circumstances under which referral fees are appropriate.

¹ Throughout this opinion, the terms "lawyer" and "attorney" apply equally to a licensed legal paraprofessional. A legal paraprofessional is bound by the Arizona Rules of Professional Conduct to the same extent an attorney is, and the Committee's analysis of ERs 1.16 and 3.3 therefore governs a legal paraprofessional who faces the same question, within the practice areas for which the paraprofessional is licensed. *See* ACJA § 7-210(J)(1); Ariz. R. Sup. Ct. 31.3(e)(4).

“Referral fee” means a fee that is distinguished from a fee for services rendered by the legal professional. A referral fee is a fee that may be paid by the legal professional or to the legal professional. Referral fees do not come out of client’s portion; this is an amount paid by the lawyer and could be considered overhead. The amount of the referral fee is not typically an amount determined by the client.

I. REFERRAL FEES FROM A BUSINESS IN WHICH THE LAWYER DOES NOT HAVE AN OWNERSHIP INTEREST.²

A lawyer may receive a referral fee from a nonlawyer business provided the arrangement does not create a conflict of interest under ER 1.7 and the lawyer does not disclose confidential client information without informed consent as required by ER 1.6. In circumstances under which a conflict of interest may or does arise, a lawyer must consider whether that conflict of interest is waivable, and if so, may take the steps appropriate under the circumstances to obtain a knowing and informed waiver of that conflict from the client.

A conflict of interest exists if “there is a significant risk that the representation of one or more clients will be materially limited . . . by a

² The question tendered addressed interactions with a financial planning firm, but this opinion is not limited to that particular business and applies to other types of business entities as well.

personal interest of the lawyer.” E.R 1.7(a)(2). Arizona Ethics Opinion 06-02 concluded that referral fees from third parties (e.g., automobile dealers) created a significant risk of materially limiting the lawyer’s judgment due to personal financial interests, thereby triggering ER 1.7 and requiring informed consent. If a lawyer has a regular business relationship with a referral source, that relationship should be disclosed to the client, as it might create the kind of conflict contemplated by ER 1.7 or a substantial risk that a conflict might or arise.

Similarly, Arizona Ethics Opinion 95-10 emphasized that loyalty to a client may be impaired when a lawyer has a financial incentive to make recommendations influenced by something other than the client’s best interests.

Additionally, in providing a referral fee to a nonlawyer business that is calculated as a percentage of a settlement or case proceeds, a lawyer must have informed consent of the client as such a referral fee necessarily involves disclosing confidential information. Likewise, if a referral fee is owed only if the client enters into a lawyer-client relationship, the lawyer must obtain informed consent to disclose that confidential information.

Lawyers must carefully consider whether a conflict of interest exists and, as appropriate, seek informed consent confirmed in writing if they contemplate accepting a referral fee from a nonlawyer business.

II. REFERRAL FEES FROM A BUSINESS IN WHICH A LAWYER HAS AN OWNERSHIP INTEREST.

If a lawyer or lawyer's firm has any ownership interest in the financial planning firm, the referral fee arrangement becomes a business transaction with a client, and the lawyer must comply with ER 1.8(a) in addition to the obligations discussed above.

E.R. 1.8(a) prohibits a lawyer from entering into a business transaction with a client unless certain conditions are met:

- Full written disclosure of the transaction and its terms;
- Advice to the client to seek independent legal counsel and a reasonable opportunity for the client to do so; and
- Written informed consent signed by the client.

An ownership interest, regardless of the percentage of that interest, in the financial planning firm becomes a financial transaction with the client because of the compensation to the financial planning firm that flows to the lawyer. This is sufficient to trigger ER 1.8(a)'s obligations. The lawyer must also assess whether the conflict is waivable under ER 1.7(b), as described above. If it is not objectively reasonable that the lawyer could provide competent and diligent representation despite the conflict, the lawyer must decline representation.

This principle is supported by Opinion 06-02, which found that referral fees tied to a lawyer's financial interest in a business (even indirectly) must be treated as a business transaction under ER 1.8(a). Further, a lawyer faces a substantial burden in showing the ER 1.8(a) requirements are met. *See* Ariz. Ethics Opinion 99-09 (1999).

In the context of a lawyer providing investment-related services to an existing client, the lawyer must show that each such transaction is fair and reasonable. *Id.* Among other things, the lawyer will bear the burden of showing that the lawyer's compensation is reasonable under the circumstances and that the "client was not taken advantage of in any way." *Id.* (quoting State Bar of Cal., Standing Comm. on Pro. Resp., Formal Op. 1995-140 (1995)).

The transaction must also be fully disclosed to the client in a manner the client can reasonably understand. Such disclosure must include all facts relating to the lawyer's relationship to any particular investment advisory firm whose products the lawyer might sell, including the amount and manner in which the lawyer will receive commissions or fees. The lawyer must also disclose the availability of comparable products or services from other sources, their relative costs, and all reasonably foreseeable adverse consequences of the transaction. *See* Ariz. Ethics Op. 99-09.

ER 1.8(a) also requires the lawyer to advise the client in writing of the desirability of seeking the advice of independent legal counsel in the transaction, and the client must have a reasonable opportunity to seek such advice. Thus, a lawyer who contemplates providing investment advisory services to existing clients must affirmatively encourage them to obtain the advice of independent counsel and not merely casually suggest that they consult with another lawyer. *See id.*

The final requirement under ER 1.8(a) is that the client provide, in a writing signed by the client, informed consent to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction. A client's consent is not informed unless the lawyer adequately explains both the material risks of the proposed transaction and reasonably available alternatives. *See* ER 1.0(e); ER 1.8, cmt. 2.

III. AMOUNT OF OWNERSHIP INTEREST NECESSARY TO TRIGGER ETHICAL OBLIGATIONS.

Any ownership, even 1%, is sufficient to trigger the conflict analysis and disclosure requirements. While 1% may seem *de minimus*, any compensation creates a financial relationship between lawyer and client. In addition to the financial benefit, there are other incidental benefits to the

owner of the business, including personal benefits, which are sufficient to create a potential conflict between the lawyer's own interest and the fiduciary duty to the client.

IV. AMOUNT AND TYPE OF REFERRAL FEES.

Higher referral fees or recurring referral fees require a more rigorous conflict of interest analysis.

A. Recurring Fees.

A recurring fee, even with a minimal lawyer ownership interest, would trigger the requirement for disclosure and informed consent. As even a 1% interest may result in significant financial benefits to a lawyer with an ownership interest, we find that disclosure and informed consent are necessary.

In Arizona Ethics Opinion 20-0003, the Committee addressed fee-financing arrangements and emphasized that recurring financial benefits to the lawyer must be disclosed, and informed consent obtained, especially when the arrangement affects the client's financial obligations.

B. The Lawyer May Not Require the Client to Use the Referred Business.

While not addressed by the requesting lawyer, we note that lawyers may not require clients to use a referred financial planning firm as a

condition of representation. Such a requirement would violate the lawyer's duty to act in the client's best interest and, under certain circumstances, could constitute coercion or undue influence. This principle is consistent with the duties of loyalty and independent judgment outlined in ER 1.7 and reinforced in Opinion 95-10, which cautioned against arrangements that interfere with the client's freedom of choice.

CONCLUSION

Lawyers may receive referral fees from financial planning firms, but must carefully evaluate the arrangement under ERs 1.6, 1.7, and 1.8(a). Even when not required by the ethical rules, disclosure of the arrangement may be pertinent to the client's understanding of the relationship formed with the lawyer. In some circumstances, the arrangement may need to be disclosed under ER 1.4(b) to give the client the information necessary to make informed and prudent decisions.

Ownership interests, the structure of the fee, and the potential impact on the client's interests all impact whether the arrangement is ethically permissible. When the ethical rules require a lawyer to disclose the arrangement to the client, full disclosure and informed consent are essential. Above all, lawyers must avoid any arrangement that compromises their independent judgment or the client's freedom of choice.

RELEVANT ETHICAL RULES

ER 1.0 Terminology

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(e) “Informed consent” denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.

* * * *

(n) “Business transaction,” when used in reference to conflicts of interests:

(1) includes but is not limited to:

- (i) the sale of goods or services related to the practice of law to existing clients of a firm's legal practice;
- (ii) a lawyer referring a client to nonlegal services performed by others within a firm or a separate entity in which the lawyer or the lawyer's firm has a financial interest; or
- (iii) transactions between a lawyer or a firm and a client in which a lawyer or firm accepts nonmonetary property or an interest in the client's business as payment of all or part of a fee.

(2) does not include:

- (i) ordinary fee arrangements between client and lawyer; or
- (ii) standard commercial transactions between a lawyer and a client for products or services that the client generally markets to others and over which the lawyer has no advantage with the client.

(o) “Personal interests,” when used in reference to conflicts of interests, include but are not limited to:

- (1) the probity of a lawyer's own conduct, or the conduct of a nonlawyer in the firm, in a transaction;
- (2) referring clients to a nonlawyer within a firm to provide nonlegal services; or
- (3) referring clients to an enterprise in which a firm lawyer or nonlawyer has an undisclosed or disclosed financial interest.

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Comments

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[4] Many of the Rules of Professional Conduct require the lawyer to obtain the informed consent of a client or other person (e.g., a former client or, under certain circumstances, a prospective client) before accepting or continuing representation or pursuing a course of conduct. See ERs 1.2(c), 1.6(a), 1.7(b), 1.8(a), and 1.9(b). The communication necessary to obtain such consent will vary according to the Rule involved and the circumstances giving rise to the need to obtain informed consent. The lawyer must make reasonable efforts to ensure that the client or other person possesses information reasonably adequate to make an informed decision. Ordinarily, this will require communication that includes a disclosure of the facts and circumstances giving rise to the situation, any explanation reasonably necessary to inform the client or other person of the material advantages and disadvantages of the proposed course of conduct and a discussion of the client's or other person's options and alternatives. In some circumstances it may be appropriate for a lawyer to advise a client or other person to seek the advice of other counsel. A lawyer need not inform a client or other person of facts or implications already known to the client or other person: nevertheless, a lawyer who does not personally inform the client or other person assumes the risk that the client or other person is inadequately informed and the consent is invalid. In determining whether the information and explanation provided are reasonably adequate, relevant factors include whether the client or other person is experienced in legal matters generally and in making

decisions of the type involved, and whether the client or other person is independently represented by other counsel in giving the consent. Normally, such persons need less information and explanation than others, and generally a client or other person who is independently represented by other counsel in giving the consent should be assumed to have given informed consent.

[5] Obtaining informed consent will usually require an affirmative response by the client or other person. In general, a lawyer may not assume consent from a client's or other person's silence. Consent may be inferred, however, from the conduct of a client or other person who has reasonably adequate information about the matter. A number of Rules require that a person's consent be confirmed in writing. See ERs 1.7(b) and 1.9(a). For a definition of "writing" and "confirmed in writing," see paragraphs (n) and (b). Other Rules require that a client's consent be obtained in a writing signed by the client. See, e.g., ERs 1.5(e)(2), 1.8(a) and (g). For a definition of "signed," see paragraph (n).

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ER 1.6 Confidentiality

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted or required by paragraphs (b), (c) or (d), or ER 3.3(a)(3).

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Comments:

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[2] A fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, the lawyer must not reveal information relating to the representation. See ER 1.0(e) for the definition of informed consent. This contributes to the trust that is the hallmark of the

client-lawyer relationship. The public is better protected if full and open communication by the client is encouraged than if it is inhibited. The client is thereby encouraged to seek legal assistance and to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter. The lawyer needs this information to represent the client effectively and, if necessary, to advise the client to refrain from wrongful conduct. Almost without exception, clients come to lawyers in order to determine their rights and what is, in the complex of laws and regulations, deemed to be legal and correct. Based upon experience, lawyers know that almost all clients follow the advice given, and the law is upheld.

[3] The principle of client-lawyer confidentiality is given effect by related bodies of law: the attorney-client privilege, the work product doctrine, and the rule of confidentiality established in professional ethics. The attorney-client privilege and work product doctrine apply in judicial and other proceedings in which a lawyer may be called as a witness or otherwise required to produce evidence concerning a client. The rule of client-lawyer confidentiality also applies in such situations where evidence is sought from the lawyer through compulsion of law. The confidentiality rule, for example, applies not only to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source. A lawyer may not disclose such information except as authorized or required by the Rules of Professional Conduct or other laws.

[4] Paragraph (a) prohibits a lawyer from revealing information relating to the representation of a client. This prohibition also applies to disclosures by a lawyer that do not in themselves reveal protected information but could reasonably lead to the discovery of such information by a third person. A lawyer's use of a hypothetical to discuss issues relating to the representation is permissible so long as there is no reasonable likelihood that the listener will be able to ascertain the identity of the client or the situation involved.

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ER 1.7 Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

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(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyers responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

Comments:

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[2] Resolution of a conflict of interest problem under this Rule requires the lawyer to: 1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentable; and 4) if so, consult with the clients affected under paragraph (a) and obtain their informed consent, confirmed in writing. The clients affected under paragraph (a) include both of the clients referred to in paragraph (a)(1) and the one or more clients whose representation might be materially limited under paragraph (a)(2).

* * * *

[8] Even where there is no direct adverseness, a conflict of interest exists if there is a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests. For example, a lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer's ability to recommend or advocate all possible positions that each might take because of the lawyer's duty of loyalty to the others. The conflict in effect forecloses alternatives that would otherwise be available to the client. The mere possibility of subsequent harm does not itself require disclosure and consent. The critical questions are the likelihood that a difference in

interests will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.

* * * *

[14] A lawyer may be paid from a source other than the client, including a co-client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty or independent judgment to the client. See ER 1.8(f). If acceptance of the payment from any other source presents a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's own interest in accommodating the person paying the lawyer's fee or by the lawyer's responsibilities to a payer who is also a co-client, then the lawyer must comply with the requirements of paragraph (b) before accepting the representation, including determining whether the conflict is consentable and, if so, that the client has adequate information about the material risks of the representation.

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ER 1.8 Conflict of Interest: Current Clients: Specific Rules

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing a manner that can be reasonably understood by the client;

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

* * * *

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) the client gives informed consent;

(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

(3) information relating to representation of a client is protected as required by ER 1.6.

* * * *

Comments:

[1] The risk to a client is greatest when the client expects the lawyers to represent the client in the transaction itself or when the lawyer's financial interest otherwise poses a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's financial interest in the transaction. Here the lawyer's role requires that the lawyer must comply, not only with requirements of paragraph (a), but also with requirements of ER 1.7. Under that Rule, the lawyer must disclose the risks associated with the lawyer's dual role as both legal adviser and participant in the transaction, including when lawyers refer clients for nonlegal services provided in the firm by either the lawyer or nonlawyer in the firm or refer clients through a separate entity in which the lawyer has a financial interest, such as the risk that the lawyer will structure the transaction or give legal advice in a way that favors the lawyer's interests at the expense of the client. Moreover, the lawyer must obtain the client's informed consent. In some cases, the lawyer's interest may be such that ER

1.7 will preclude the lawyer from seeking the client's consent to the transaction.

[2] If the client is independently represented in the transaction, paragraph (a)(2) of this Rule is inapplicable, and the paragraph (a)(1) requirement for full disclosure is satisfied either by a written disclosure by the lawyer involved in the transaction or by the client's independent counsel. The fact that the client was independently represented in the transaction is relevant in determining whether the agreement was fair and reasonable to the client as paragraph (a)(1) further requires.

* * * *

[14] Paragraph (i) states the traditional general rule that lawyers are prohibited from acquiring a proprietary interest in litigation. Like paragraph (e), the general rule has its basis in common law champerty and maintenance and is designed to avoid giving the lawyer too great an interest in the representation. In addition, when the lawyer acquires an ownership interest in the subject of the representation, it will be more difficult for a client to discharge the lawyer if the client so desires. The Rule is subject to specific exceptions developed in decisional law and continued in these Rules. The exception for certain advances of the costs of litigation is set forth in paragraph (e). In addition, paragraph (i) sets forth exceptions for liens authorized by law to secure the lawyer's fees or expenses and contracts for reasonable contingent fees. The law of each jurisdiction determines which liens are authorized by law. These may include liens granted by statute, liens originating in common law and liens acquired by contract with the client. When a lawyer acquires by contract a security interest in property other than that recovered through the lawyer's efforts in the litigation, such an acquisition is a business or financial transaction with a client and is governed by the requirements of paragraph (a). Contracts for contingent fees in civil cases are governed by ER 1.5.

RELEVANT ETHICS OPINIONS

Arizona Ethics Opinion 95-10

Arizona Ethics Opinion 99-09

Arizona Ethics Opinion 05-01

Arizona Ethics Opinion 06-02

Arizona Ethics Opinion 04-02

Arizona Ethics Opinion 20-0003