

NEW HAMPSHIRE BAR ASSOCIATION

Ethics Committee Formal Opinion # 1998-99/10

Conflict of Interest: Referral Fees from Investment Advisors

May 10, 2000

Presented to the Board of Governors May 18, 2000

RULE REFERENCE:

- * Rule 1.7 – Conflict of Interest: General Rule
- * Rule 2.1 – Advisor

SUBJECTS:

- * Conflict of Interest
- * Referral Fees
- * Adverse Effect on Professional Judgment

COMMITTEE'S POSITION:

Despite the fact that the Ethics Committee thoroughly examined the issues raised by this proposed referral-fee arrangement over the course of several months, no consensus could be reached.

One group of Committee members believe, based primarily on its interpretation of Rule 1.7(b) and Rule 2.1, that the proposed referral plan is a non-waivable conflict. Members who view the conflict as per se unethical object to the ongoing nature of the referral fee that the attorney would receive for the duration of the relationship between the financial adviser and the client, despite the fact that no legal consultation or legal work (as discussed below) would be involved. Such an ongoing potentially lucrative fee could impair the attorney's objectivity and independent judgment. This group feels that the ethical problems inherent in this referral plan cannot be mitigated or cured by full disclosure of the arrangement to the client and an informed client consent.

A number of Committee members strongly disagree with the first group's reasoning and believe the proposed referral-fee plan could be implemented without violating the rules of professional conduct, although they agree that it could be an ethically perilous path. In each instance, the attorney would have the responsibility to analyze a client's unique situation and could proceed only where appropriate and with great caution following a full disclosure to the client and the client's informed consent.

The Committee is thus not issuing a blanket prohibition against such a referral fee plan but is in agreement that there is the inherent potential for conflict and urges each attorney considering participating in such a plan to proceed warily.

QUESTION PRESENTED:

May an attorney, in exchange for referring clients to an investment advisor, receive a referral fee in the form of an ongoing percentage of the investment advisor's commission derived from the investments made by the investment advisor on behalf of the referred clients?

FACTS PRESENTED:

The inquiring attorney has requested an opinion from the Committee on the application of the rules of ethics to a proposed referral-fee arrangement in which an investment advisor would pay an ongoing referral fee to an attorney for referring clients to the investment advisor.

The inquiring attorney is proposing a program in which the referring attorney would be expected to (a) provide clients with informational materials describing the investment advisor's program, (b) introduce clients to the investment advisor, (c) attend meetings with the client and investment advisor, at which the investment advisor would explain the investment advisor's program and investment advisor would assist the client in making investment choices, and (d) receive periodic investment advisory statements. Through receipt of the client's periodic investment statements, the attorney may, but is not required to, monitor the client's investments. The referring attorney is not expected to provide investment advice.

The investment advisor would be required to be in compliance with all applicable securities laws (about which the Committee is not prepared to comment). The client would be provided a written disclosure statement outlining the investment advisor's background information and the terms of compensation for advisory services. The attorney would provide the client with a separate written disclosure statement outlining the financial agreement between the attorney and the investment advisor; the client would be required to sign a statement acknowledging that the client had received and reviewed the written disclosure statement regarding the financial arrangement between the attorney and the investment advisor.

The referral fee paid by the investment advisor to the referring attorney would be a percentage of the commission/fee paid to the investment advisor by the client. The commission/fee paid to the investment advisor would be in accordance with standard market charges for similar investment services. The investment advisor's commission/fee from the client would not be increased to account for the percentage of the commission/fee being paid to the referring attorney. The referral fee would be ongoing in nature, for the duration of the relationship between the referred client and the investment advisor.

RESPONSE:

Rule 1.7. Conflict of Interest: General Rule.

The Committee finds Rule 1.7 – Conflict of Interest: General Rule to be the pivotal rule to be considered by an attorney in determining whether the proposed plan is a waivable or non-waivable conflict in each specific situation.

Rule 1.7 (b) provides:

A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or **by the lawyer's own interest**, unless: (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation and with knowledge of the consequences.... (emphasis added).

Rule 1.7 (b) requires the referring attorney to evaluate whether his or her representation of the client would be “materially limited” by the lawyer’s own interest. The lawyer can only proceed if, after consideration of the specific facts and prior to seeking the client’s consent, the lawyer “reasonably believes” his or her professional judgment will not be compromised. The attorney must believe, after analyzing the situation, that the pecuniary interest to be gained through this specific referral will not unduly influence his or her advice or interfere with the objective fulfillment of fiduciary duties. The Committee finds that the determination as to whether an attorney’s representation will be materially limited in violation of Rule 1.7 is, in each case, a fact-driven analysis. It is the potential for widely divergent fact patterns which prevents the Committee from issuing a blanket prohibition of the proposed referral plan.

Committee members are concerned by the type of pecuniary interest acquired by the referring attorney in the proposed scheme. The acquisition of a pecuniary interest, without more, is not a per se violation of the rules. See e.g. Rule 1.8 (a). However, when a lawyer acquires a pecuniary interest during the course of representing a client, the Committee emphasizes that other factors should be examined, including (a) whether the client sought and received tangible/material benefit from the attorney acquiring a pecuniary interest, (b) whether the benefit was in the nature of or as a result of legal services or advice or ancillary to such services or advice, (c) whether the interest is ongoing or a single, discreet interest, and (d) whether the circumstances are ripe for abuse with little or no opportunity for oversight. Another factor in the analysis may be the sophistication level of the client.

In this matter, the client receives the benefit of a referral to an investment advisor, but nothing beyond that. Second, the benefit to the client is not in the nature of or as a result of legal services or advice by the inquiring attorney nor does it appear to be ancillary to the services the attorney provided. No legal work is performed in exchange for the referral fee. The pecuniary interest gained by the attorney is ongoing in nature, based on the success of the client’s investments; and, finally, there is no oversight of the transaction such as disclosure to an agency

or oversight or supervision by an independent third party. Still, a client may find such a plan to be acceptable after full disclosure because there is no additional fee to the client for the lawyer's participation in the arrangement; in other words, the client does not pay more in commissions for agreeing to the referral plan.

An additional consideration is the referring attorney's appearance of involvement in the investment process, particularly when the attorney attends meetings, receives periodic statements, and is given the opportunity to provide assistance in investment choice. The client's perception of the attorney involvement in the investment decision-making process could be misleading and could, at some point, provide grounds for substantial malpractice claims that may not be protected against in a standard legal malpractice policy.

Each case involving the acquisition of a pecuniary interest by an attorney must be examined on its unique facts and circumstances. However, the Committee recognizes the potential for abuse in such a referral plan and urges careful analysis by an attorney when considering participating in a referral plan of this nature. The Committee finds that a reasonable, disinterested person could view the referring attorney's pecuniary interest unduly influencing his or her decision-making. Clients must not become a commodity to an attorney to be traded for the acquisition of a pecuniary interest which requires no investment of time or effort on the part of the attorney. It is possible that the attorney's independent judgment, as well as loyalty to the client, could be compromised by the allure of pecuniary gain.

The Committee recognizes that many conflicts are waivable based on the client's informed consent under 1.7(b)(2). Although Rule 1.7(b)(2) provides that clients can waive a potential conflict after consultation and with knowledge of the consequences, there are situations in which, even if the client consents to representation, a lawyer should decline to represent that client. Kelley's Case; Cahalin's Case, 137 NH 314, 319 (1993).

The New Hampshire Supreme Court has also held that "when a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances, the lawyer cannot properly ask for such agreement or provide representation on the basis of the client's consent." Boyle's Case, 136 N.H. 21,24 (1992). Neither the facts of Boyle's Case or Kelley's Case are dispositive of the inquiry. However, the Supreme Court states in both cases that while a client may waive certain conflicts after full disclosure and consent, there is a whole other class of conflicts for which the attorney may not even request a waiver. Only the specific facts of each situation will determine if it is appropriate for the attorney to request a particular client to consent to such an arrangement. It may be immediately evident in representing a particularly vulnerable or less sophisticated client that the attorney should not request the client's consent. Other situations may be more difficult to assess, in which case the attorney should consider the "disinterested lawyer" standard: what would a disinterested lawyer conclude about the attorney's request of this particular client to consent to an on-going referral-fee plan? Will there be the appearance, in hindsight, to a disinterested lawyer that the attorney's objectivity and independent judgment were affected by the potential of personal financial gain?

To participate in a referral plan such as the one outlined would require specific and detailed disclosures in order to satisfy the informed consent provision. The Committee can envision circumstances where the informed consent would not be adequate, but is inclined to rely on the judgment of each attorney in each factual scenario.

Rule 2.1. Advisor.

Rule 2.1 applies to an attorney's role as advisor and states:

In representing a client, **a lawyer shall exercise independent professional judgment** and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation. (emphasis added.)

The first requirement articulated in Rule 2.1 is that a lawyer shall exercise independent judgment. The ongoing pecuniary interest acquired by the referring attorney may be perceived by a disinterested third-party as affecting the attorney's independent judgment. The Committee believes each attorney considering participation in such a referral plan must analyze the impact such a pecuniary interest could potentially have on objective professional judgment. Therefore, the Committee advises an attorney considering participating in such a referral plan to give serious thought as to whether or not his or her independent judgment would be affected in any way by potentially lucrative financial gain.

CONCLUSION:

The Committee, unable to reach a consensus, looked to other jurisdictions for guidance and found a split of authority among states that considered a similar proposed referral-fee arrangement. The states split along lines similar to the Committee, with a majority (Arizona, Kentucky, Maryland, Nevada, and New York) finding the proposed plan per se unethical and a minority of states (Connecticut, Missouri, and Utah) allowing each attorney to make the determination in each unique set of circumstances. All jurisdictions share a concern about the inherent potential for conflicts in the proposed referral-fee plan, and those jurisdictions not prohibiting the plan urge practitioners to proceed only with great caution.