

Conflicts of Interest Under the New MDP Rules

BY ROY SIMON

At the end of last month's overview of the new MDP rules, I noted that "other issues, such as conflicts of interest and confidentiality, lie beneath the surface and remain to be addressed." This article probes some of the conflict of interest issues that lie beneath the surface.

The new rules pose three main conflicts questions: (1) When do the conflict of interest rules in the Code of Professional Responsibility apply to nonlegal services provided by a lawyer? (2) When does a law firm need to check conflicts jointly with a nonlegal professional service firm (i.e., when are conflicts imputed from a law firm to a nonlegal professional services firm, and vice versa)? and (3) How do the personal-conflict of interest rules apply to referrals to or from nonlegal professionals with whom lawyers have a "contractual relationship" as permitted by DR 1-107? This article focuses on only a part of the third question: how does the rule on personal conflicts of interest, DR 5-101(A), apply to referrals between the two parties to the contractual relationships envisioned by DR 1-107? I conclude that DR 5-101(A) applies to these referrals, but that every resulting conflict is now consentable — it will always pass the "disinterested lawyer" test under DR 5-101(A).

"Core values," but . . .

At the beginning of new DR 1-107(A), the courts added language to articulate the "core values of the legal profession" as follows:

The practice of law has an essential tradition of complete independence and uncompromised loyalty to those it serves. Recognizing this tradition, clients of lawyers practicing in New York State are guaranteed "independent professional judgment and undivided loyalty uncompromised by conflicts of interest." Indeed, these guarantees represent the very foundation of the profession and allow and foster its continued role as a protector of the system of law....[Footnote omitted.]

Despite this emotional ode to the rules guarding against conflicts of interest, the main body of DR 1-107(A) provides that a lawyer or law firm may enter into "a contractual relationship with a nonlegal professional or nonlegal professional service firm for the purpose of offering to the public, on a systematic and continuing basis, legal services performed by the lawyer or law firm, as well as other nonlegal professional services, *notwithstanding* the provisions of DR 5-101(A)" (emphasis added), provided the contractual relationship satisfies certain stiff requirements.

What do the courts mean by the phrase "notwithstanding the provisions of DR 5-101(A)"? They mean that contractual relationships with nonlegal professionals are not prohibited by the conflict of interest restrictions imposed by DR 5-101(A), which protects clients against lawyers' personal conflicts. DR 5-101(A) provides:

A lawyer shall not accept or continue employment if the exercise of professional judgment on behalf of the client will be or reasonably may be affected by the lawyer's own financial, business, property, or personal interests, unless a disinterested lawyer would believe that the representation of the client will not be adversely affected thereby and the client consents to the representation after full disclosure of the implications of the lawyer's interest.

How would DR 5-101(A) protect clients if it did prohibit the lawyer-nonlawyer relationships permitted by DR 1-107? To answer that question, we have to consider the character of the contractual relationships envisioned by DR 1-107 and the amended version of DR 2-103(B), which was added by the same joint order that added DR 1-107. Before this year's amendment, DR 2-103(B) provided that (with exceptions not relevant here) a lawyer "shall not compensate or give anything of value to a person or organization to recommend or obtain employment by a client, or as a reward for having made a recommendation resulting in employment by a client..." Under this former version of DR 2-103(B) (which remains in effect until November 1, 2001), it was generally agreed that mutual referral agreements or understandings between lawyers and nonlawyers were improper. A lawyer could not say to a chiropractor, for example: "If you refer legal cases to me, then I will refer clients to you when they need a chiropractor."

The amended version of DR 2-103(B) changes that. The amended rule still provides that a lawyer shall not give anything "of value" to a person or organization to recommend a client, or as a reward for having done so, but the amended rule carves out a new exception, DR 2-103(B)(1), which provides as follows:

A lawyer or law firm may refer clients to a nonlegal professional or nonlegal professional service firm pursuant to a contractual relationship with such nonlegal professional or nonlegal professional service firm to provide legal and other professional services on a systematic and continuing basis as permitted by DR 1-107, provided however that such referral shall not otherwise include any monetary or other tangible consideration or reward for such, or the sharing of legal fees

"Notwithstanding the provisions of DR 5-101(A)"

Now we can begin to understand the full impact of the phrase "notwithstanding the provisions of DR 5-101(A)." The mutual referral agreements or understandings permitted by DR 1-107 and DR 2-103(B) would ordinarily pose serious personal conflicts of interest under DR 5-101(A). The problem under DR 5-101(A) is that a lawyer has an obvious self-interest in referring nonlegal business to those who reciprocate by referring legal business back to the lawyer. When a lawyer faces a choice between referring a client to an accountant who regularly refers legal matters to the lawyer and an accountant who never refers legal matters to the lawyer, the lawyer has a strong financial interest in referring the client to the accountant who will refer business back, even if a referral to the other accountant would better serve the client's interest.

Of course, "You scratch my back and I'll scratch yours" is a way of life in the business and professional world. Lawyers have always referred matters to non-lawyers who refer matters back to them – and this minor conflict has not troubled the profession as long as a lawyer has no obligation to refer matters to a particular nonlawyer. In other words, DR 5-101(A) ordinarily requires that a lawyer remain free to refer nonlegal matters to any nonlawyer appropriate for the client's particular situation. Recommending

appropriate nonlegal professionals is part of a lawyer's job, and those recommendations must be untainted by the lawyer's own financial self-interest.

The application of DR 5-101A(A) to referrals was clearly explained in Nassau County Bar Op. 97-08 (1997). There, a personal injury lawyer asked whether he could ethically refer clients to a medical office that provided "free medical reports." (My impression is that most doctors charge \$150 or more for such reports.) The Nassau Bar Ethics Committee analyzed the situation this way (with emphasis added):

The lawyer's "financial" interests may be implicated by the offer of free medical reports. Under DR 5-103(B), a lawyer may advance or guarantee financial assistance to a non-indigent client for the expenses of litigation (expressly including "expenses of medical examination") "provided the client remains ultimately liable for such expenses." If a lawyer has agreed to advance or guarantee the expenses of litigation, the lawyer may have a financial interest in minimizing his or her own out-of-pocket expenses during the litigation. The client remains ultimately liable for the expenses, but as a practical matter recovering the expenses may be problematic.

Thus, a lawyer who is trying to minimize litigation expenses may have a personal financial interest in referring a client to a group that provides free medical reports. This financial interest may skew the lawyer's professional judgment. ("Referring clients to appropriate experts is part of the lawyer's professional judgment.")

Therefore, if the lawyer believes that his or her professional judgment will be or reasonably may be adversely affected by the lawyer's financial interest in minimizing litigation expenses; the lawyer must not refer the client to a "free report" service without the client's consent after full disclosure. The disclosure should reveal the lawyer's financial interest in referring the client to this service rather than some other service that charges a fee for medical reports, and may also include the lawyer's views on the advantages and disadvantages of referral to the "free report" group.

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This Committee's major ethical concern is to ensure that the lawyer's recommendation of a medical group is intended to serve the client's interests, not the lawyer's own financial interests. If a lawyer determines that the lawyer's financial interests will not adversely affect the lawyer's professional judgment in referring a client to a group that provides free medical reports, or if the client consents to that referral after full disclosure of the lawyer's financial interests and the advantages and disadvantages of using the "free report" group, then a lawyer may ethically refer clients to such groups.

Focus On The Client's Interests

In short, a lawyer making a referral to a nonlawyer professional must focus on the best interests of the client. A lawyer may ethically reap a personal advantage from a referral, but the referral must fully disclose that advantage, and the referral must serve the client's best interests as well.

Mutual referral agreements can shift the focus from the best interests of the client to the best interests of the lawyer. Nevertheless, DR 1-107 and the new exception to DR 2-103(B) recognize that lawyer-nonlawyer mutual referral agreements may benefit clients in most matters even if the lawyer's contractual obligation to refer nonlegal matters to a specific nonlegal professional may adversely affect the lawyer's professional judgment in a particular matter.

How do mutual referral agreements benefit most clients?

They do so in two main ways. First, mutual referral agreements may improve coordination and trust between the lawyer and the nonlawyer, thus reducing duplication of effort and unnecessary time and expense working on the client's matter. Lawyers and nonlawyers who work together regularly develop a good sense of each other's professional strengths and weaknesses. Second, mutual referral agreements tell clients which nonlawyers the lawyer will recommend if the client needs related nonlegal work, much as consumers know that all Dell computers have "Intel inside." This serves the interests of full disclosure, and reduces search costs almost to zero when clients need nonlegal professional services in conjunction with legal work.

Avoiding Threats To Core Values

In addition, allowing mutual referral agreements alleviates the intense pressure to adopt rules permitting partnerships with nonlawyers and fee sharing with nonlawyers. The New York State Bar Association and the New York courts fervently believe that allowing partnerships or fee sharing with nonlawyers would threaten the core values of the legal profession.

To ensure that DR 5-101(A) does not block the benefits of mutual referral agreements, DR 1-107 expressly states that such agreements are permitted despite DR 5-101(A), as long as the agreements satisfy the criteria of DR 1-107. If the agreements meet those criteria, then the disinterested lawyer test of DR 5-101(A) does not apply to the contractual relationship. Even if a disinterested lawyer would believe that the representation would be adversely affected by the mutual referral agreement, the mutual referral agreement remains proper as long as it meets the three criteria of DR 1-107(A).

The three criteria of DR 1-107(A) were covered in my article last month. (*See An Overview of New York's New "MDP" Rules*, NYPRR, Sept. 2001, at 1.) The first two criteria are that (1) the nonlegal professionals must belong to a profession on the list to be maintained by the Appellate Divisions; (2) the lawyers must not allow the nonlegal professionals to hold or exercise "any ownership or investment interest" or any "managerial or supervisory" role in the law practice, or to share legal fees with the nonlawyers, or to give or receive "any monetary or other tangible benefit for giving or receiving a referral.;" and (3) the third criterion, DR 1-107(A)(3), is a kind of built-in conflict of interest rule that substitutes, more or less, for DR 5-1-1(A). It mandates that, for a "contractual relationship" to be valid:

...The fact that the contractual relationship exists is disclosed by the lawyer or law firm to any client of the lawyer or law firm before the client is referred to the nonlegal professional service firm, or to any client of the nonlegal professional service firm before that client receives legal services from the lawyer or law firm; and the client has given informed written consent and has been provided with a copy of the "Statement of Client's Rights In Cooperative Business Arrangements" pursuant to §1205.4 of the Joint Appellate Divisions rules.

The disclosure in the “Statement of Client’s Rights In Cooperative Business Arrangements” in §1205.4 is unique. It is a scripted disclosure — like the warning on a cigarette package — that the lawyer must deliver to the client, in writing, before the lawyer obtains the client’s “informed written consent” to the conflict inherent in all mutual referral arrangements. The portion of the Statement of Client’s Rights most pertinent to conflicts of interest provides as follows:

Your lawyer is providing you with this document to explain how your rights may be affected by the referral of your particular matter by your lawyer to a nonlegal service provider, or by the referral of your particular matter by a nonlegal service provider to your lawyer....

Your lawyer has entered into a contractual relationship with a nonlegal professional or professional service firm...Such an arrangement may substantially affect your rights in a number of respects. Specifically, you are advised:

1. A lawyer’s clients are guaranteed the independent professional judgment and undivided loyalty of the lawyer, uncompromised by conflicts of interest. *The lawyer’s business arrangement with a provider of nonlegal services may not diminish these rights....* [Emphasis added.]

The italicized statement is quite odd. Under DR 1-107, a valid contractual relationship trumps DR 5-101(A). If Walter Mitty were explaining DR 1-107, he might say: “Damn DR 5-101(A)! Full speed ahead with the mutual referral agreement!” But 22 NYCRR § 1205.4 tells lawyers who enter into cooperative business arrangements that they must abide by all of the conflict of interest rules. What governs – § 1205.4 or DR 1-107(A)? To me, that’s an easy call – § 1205.4 governs. The courts are telling us that, notwithstanding “notwithstanding,” they will not allow cooperative business arrangements to compromise the core value of “independent professional judgment and undivided loyalty,” whether the conflict comes from another client or from the lawyer’s personal interests.

In sum, DR 5-101(A) appears to be alive and well even in the context of contractual relationships between lawyers and nonlegal professionals. This analysis is consistent with the last sentence of new EC 1-14, which says:

[A]lthough the existence of a contractual relationship permitted by DR 1-107 does not by itself create a conflict of interest violating DR 5-101(A) whenever a law firm represents a client in a matter in which the nonlegal professional services firm is also involved, the law firm’s interest in maintaining an advantageous relationship with a nonlegal professional service firm might, in certain circumstances, adversely affect the independent professional judgment of the law firm creating a conflict of interest.”

It also squares with the last sentence of EC 1-16, which says: “Referrals should only be made when requested by the client or deemed to be reasonably necessary to serve the client.”

So what, after all, does “notwithstanding DR 5-101(A)” mean? Not much. Whatever new leeway was granted by that phrase seems to have been taken away by the new EC’s and by §1205.4. The bottom line is, lawyers who enter into mutual referral agreements with nonlegal professionals must be able to justify

every referral to a nonlegal professional based on the best interests of the client, not the best interests of the lawyer. As the Nassau County Bar Professional Ethics Committee said in Op. 97-08: "In short, the main question is: 'What is in the best interests of the client?'" If lawyers adhere to that principle, the new MDP rules will serve the legal profession and the public alike.

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