



ISBA Professional Conduct Advisory Opinion

Opinion 23 – 03

October 2023

SUBJECT: Business Transactions with Clients; Conflict of Interest; Referral Fee and Arrangements.

DIGEST: A lawyer who receives compensation in exchange for the referral of clients to an investment advisor has a conflict of interest and is involved in a business transaction with a client. Whether a lawyer can engage in such a transaction must be analyzed on a case-by-case basis.

REFERENCES: Illinois Rules of Professional Conduct 1.0 (e), 1.1, 1.5, 1.7, 1.8(a), 2.1
ISBA Ethics Opinion 97-04
ISBA Ethics Opinion 99-06
Arizona Advisory Opinion 98-09 (1998)
Connecticut Bar Association Opinion 97-16 (1997)
Maine Prof. Ethics Opinion, Opinion 184 (March 30, 2004)
Michigan Informal Opinion, RI-317 (Feb. 14, 2000)
Utah State Bar Ethics Advisory Opinion 99-07 (Dec. 3, 1999)
In re Schuyler, 91 Ill.2d 6, 424 N.E.2d 1137 (1982)

FACTS

A lawyer is considering referring clients to an SEC-registered Investment Advisor managing assets for others for a fee. The lawyer holds a requisite securities license and would contract with the advisor as an Investment Advisor Representative.

The advisor charges a quarterly fee based on assets under management, generally paid in arrears though in some cases the fees are paid in advance. The lawyer wishes to collect a percentage of the investment advisor's quarterly fee.

QUESTION

1. Does the lawyer's proposed referral arrangement create a conflict of interest pursuant to Rule 1.7? If so, can the lawyer engage in the arrangement?

2. Is the lawyer's proposed arrangement a business transaction requiring that the attorney abide by the requirements of Rule 1.8(a)?

OPINION

The inquiring lawyer wishes to receive compensation from an SEC-registered Investment Advisor, in which the lawyer has no other interest or involvement, in exchange for the lawyer's referral of clients to the advisor for investment management services. For purposes of this opinion, we assume the arrangement is permissible under federal securities law and we will not opine on the lawyer's responsibilities under SEC Rules or other federal or state regulations. However, the proposed arrangement raises serious ethical issues for the lawyer.

First, the arrangement creates a concurrent conflict of interest between the interests of the client and the personal interests of the lawyer in earning a fee as a result of the referral. Pursuant to Rule 1.7(a)(2), a conflict of interest exists "if there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer." Comment 10 provides that "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 interest." It is clear that with the proposed arrangement, the lawyer's representation may be limited by the lawyer's financial interest. The arrangement also creates a substantial risk of interference with the lawyer's independent professional judgment in considering alternatives for the client.

Given that the lawyer does have a conflict of interest, the lawyer then must determine if the lawyer can continue representation, with the informed consent of the client. Some conflicts of interest are nonconsentable; the lawyer must determine consentability on a case by case basis. *See*, Comment 14, Rule 1.7. Pursuant to Rule 1.7(b)(1), the lawyer must analyze whether the lawyer may reasonably believe that the lawyer will be able to provide competent and diligent representation to the client, despite the conflict. *See also*, Rule 2.1 ("In representing a client, a lawyer shall exercise independent professional judgment and render candid advice."). The question is whether a reasonable lawyer would conclude that the lawyer could provide competent and diligent representation even though the lawyer is receiving a benefit from the referral of the client to the investment advisor. If the lawyer concludes that a reasonable lawyer would conclude that competent representation is not compromised by the arrangement, then the lawyer could proceed with the arrangement and the representation of the client, if the lawyer discloses to the client the relationship with the investment advisor, the financial arrangement including the amounts the lawyer expects to receive, the options available to the client, and the ramifications to the client of granting the consent. The lawyer should also disclose that the lawyer will not be able to render legal advice to the client regarding any disputes with the investment advisor and, in the event of such a dispute, the lawyer may be required to withdraw from representing the client in any other matters. *See*, Rule 1.0(e).

In addition, the proposed arrangement constitutes a business transaction with a client and also implicates Rule 1.8(a). In relevant part, Rule 1.8(a) provides:

(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 in a manner that can be reasonably understood by the client;

(2) the client is informed in writing that the client may seek the advice of independent legal counsel on the transaction, and is given a reasonable opportunity to do so; 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.

We have previously opined that two slightly similar referral arrangements constituted business transactions with a client, but were not per se prohibited. In ISBA Opinion 97-04, the lawyer sought to refer clients to an investment adviser and securities broker in exchange for a portion of the management fee generated by the investment of the client's funds. In ISBA Opinion 99-06, the lawyer inquired whether he could obtain fees as a trust administrator from a trust company to whom he referred clients. In each situation, we concluded that the lawyers were required to abide by the requirements of both Rule 1.7 and 1.8(a). In addition, as we noted in Opinion 99-06, "[U]nder pertinent Illinois case law, a presumption of undue influence arises where a lawyer benefits from a business transaction with a client. The presumption may be rebutted only by clear and convincing evidence. Generally, this requires a showing of full disclosure of all relevant information, a transaction that was fair and reasonable, and that the client had the advice of independent counsel, or the opportunity for such advice, before entering into the transaction." *See, e.g., In re Schuyler*, 91 Ill.2d 6, 424 N.E.2d 1137 (1982); Franciscan Sisters Health Care v. Dean, 95 Ill.2d 452, 448 N.E. 2d 872 (1982).

Other states have considered similar arrangements. Some states have prohibited similar arrangements. *See, e.g.,* Maine Prof. Ethics Opinion, Opinion 184 (March 30, 2004)(arrangement violated the rule prohibiting an excessive fee and the terms of the arrangement were not fair and reasonable to the client); Arizona Advisory Opinion 98-09 (1998)(arrangement interfered with the client's ability to be candid with the lawyer and created a conflict of interest). Other states, like Illinois, have opined that while the arrangements raise serious ethical considerations, the lawyer may engage in such arrangements provided the lawyers comply with their ethical obligations under Rules 1.7 and 1.8(a). *See, e.g.,* Michigan Informal Opinion, RI-317 (Feb. 14, 2000)(lawyer may enter into a referral arrangement with an investment provider provided the lawyer complies with Rule 1.7 and 1.8(a)); Connecticut Bar Association Opinion 97-16 (1997)(lawyer may accept referral fee if client gives informed written consent); Utah State Bar Ethics Advisory Opinion 99-07 (Dec. 3, 1999)(not per se unethical for a lawyer to refer a client to

an investment advisor and take a referral fee from the commission paid to that advisor, although the lawyer has a heavy burden to insure compliance with applicable ethical rules).

Accordingly, if the lawyer here concludes that the lawyer can obtain informed consent under Rule 1.7, we believe the lawyer must also follow the requirements of Rule 1.8(a) by confirming that the arrangement is fair and reasonable to the client, fully disclosing in writing the terms of the arrangement, advising the client in writing to seek the advice of independent counsel, and obtaining the client's informed consent in writing.

In determining whether the transaction is fair and reasonable to the client and in obtaining informed consent to the conflict of interest, we note that the lawyer is obligated to conduct some amount of due diligence with respect to the investment advisor. The lawyer may also want to check with their malpractice carrier to determine if the carrier covers claims arising out of business transactions with clients. In providing full disclosures under Rule 1.8(a), the lawyer should reveal the complete extent of the relationship with the investment advisor, the terms of the referral arrangement, the formula for determining the lawyer's fee, the available options to the client to retain other investment advisors, and the right to seek services from other investment advisors.

CONCLUSION

A lawyer who agrees to refer a client to an investment advisor in exchange for a referral fee has a conflict of interest and is involved in a business transaction with a client. This type of referral arrangement is not per se prohibited by the Illinois Rules of Professional Conduct. However, prior to engaging in the transaction, the lawyer must proceed with caution by analyzing the conflict of interest under Rule 1.7, determining whether the attorney can provide competent and diligent representation despite the conflict, and if so, obtaining informed consent. In addition, the lawyer must abide by the requirements of Rule 1.8 (a) governing business transactions with the client.

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