Subcommittee Note: This draft is slightly revised from the 12-9-2021 draft to (1) clean up footnotes, and (2) add language to the proposed rule based on a suggestion from an EAC member. The additional language is highlighted in red below and based on language from California's version of ER 1.5(e).

(f) A firm may divide a client's legal fee with another firm, person, or entity outside of the firm under circumstances other than those governed by 1.5(e) if:

(1) the firm discloses to the client in writing how the fee will be divided with the other firm, person, or entity;

(2) the client consents to the division of fees in a writing signed by the client before or within a reasonable time after commencing the representation; and

(3) the total fee is reasonable.

In the Matter of: PETITION TO AMEND RULE 42 (ER 1.5), ARIZ. R. SUP. CT.

Pursuant to Rules 28 and 42.1(b)(2) of the Arizona Supreme Court Rules, the Petitioner, the Arizona Supreme Court Ethics Advisory Committee (the "Committee"), petitions the Court to amend ER 1.5, Fees, to define a lawyer's ethical obligations when dividing a client's fee with a person or entity outside of the lawyer's firm.

I. Introduction and Background.

This rule-change petition addresses gaps and inconsistencies created by the amendment and abrogation of several Arizona Rules of Professional Conduct ("Rules" or "ERs") by Arizona Supreme Court Orders R-20-0030 and R-20-0034. Specifically, this proposed rule change clarifies a lawyer's ethical obligations when dividing a client's legal fee with a person or entity outside of the lawyer's firm.

This petition arises from ethics opinion request EO-21-0001, filed with the Committee on June 16, 2021. The requester sought guidance regarding a lawyer's ethical obligations when dividing a client's fee with another lawyer who provides a referral but otherwise is not involved in the client's representation. The requester noted that the amended Rules

now permit lawyers: (1) to receive referral fees without performing work or being jointly responsible for the client's representation; (2) to pay referral fees to anyone, lawyer or nonlawyer, and (3) to share legal fees with nonlawyers, both within and outside of a lawyer's firm. Moreover, the requester noted the absence of explicit guidance regarding client notice and consent with regard to referral fees and fee sharing.

The Committee evaluated this opinion request in light of the existing Rules, case law, and ethics opinions. The Committee concluded that the absence of guidance created by the abrogation of several ERs would be best addressed by a rule-change petition rather than an ethics opinion. Therefore, the Committee now files this petition to amend the Rules to require client notice and consent anytime a lawyer divides the client's fee with a person or entity outside of the lawyer's firm.[1]

II. Purpose of the Proposed Rule Change.

Prior to January 1, 2021, Arizona lawyers were not allowed to pay for referrals.[2] The only exception was contemplated by ER 1.5(e). This provision allowed lawyers to divide a client's fee with lawyers outside of their firms, typically in situations where a lawyer referred a client to a trial specialist in exchange for a percentage of the fee.[3] However, the referring lawyer had to either accept joint responsibility for the representation or had to be paid in proportion to the work performed.[4] In other words, Arizona lawyers could not pay a referral fee that would allow a referring lawyer to be paid solely for the referral, with no additional work or responsibility to the client.

[1] This petition addresses only situations where a lawyer divides a client's fee with someone outside of the lawyer's firm. The petition does not address a lawyer's ethical obligations when paying referral fees in any other manner, such as a flat payment not tied to the amount of fees the lawyer earns.
[2] ER 7.2(b) prohibited lawyers from providing anything of value in exchange for a recommendation of the lawyer's services. Ariz. R. Pro. Conduct ER 7.2 (b), *abrogated by* Ariz. Sup. Ct. Ord. R-20-0030.
[3] Ariz. R. Pro. Conduct ER 1.5 cmt. 8 ("A division of fee facilitates association of more than one lawyer in a matter in which neither alone could serve the client as well, and most often is used when the fee is contingent and the division is between a referring lawyer and a trial specialist."), *abrogated by* Ariz. Sup. Ct. Ord. R-20-0034.
[4] *Id.* ER 1.5(e), *abrogated by* Ariz. Sup. Ct. Ord. R-20-0034.

On January 1, 2021, several changes took effect to the ERs. The Arizona Supreme Court adopted these changes based on the report and recommendations by the Court's Task Force on the Delivery of Legal Services ("LSTF Report").[5] Changes to ER 1.5(e) eliminated the requirement that a lawyer dividing a fee with another lawyer either take joint responsibility for the representation or be paid in proportion to their work. Instead, the amended ER 1.5(e) now states:

> (e) Two or more firms jointly working on a matter may divide a fee paid by a client if:
>
> (1) the firms disclose to the client in writing how the fee will be divided and how the firms will divide responsibility for the matter among themselves;
>
> (2) the client consents to the division of fees in a writing signed by the client:
>
> (3) the total fee is reasonable: and
>
> (4) the division of responsibility among firms is reasonable in light of the client's need that the entire representation be completely and diligently completed.

Notably, the amended ER 1.5(e) now applies when two or more firms divide fees when "jointly working on a matter." Thus, the language of ER 1.5(e) appears to expressly exclude situations where one firm merely refers a client to another firm, with no further involvement or responsibility. Moreover, ER 1.5(e) applies only to division of fees between "firms," defined in ER 1.0(c) as "a lawyer or lawyers in any affiliation, or any entity that provides legal services for which it employs lawyers."[6] Therefore, ER 1.5(e) does not apply to division of fees between a lawyer and a nonlawyer, or between a lawyer and an entity that does not provide legal services.

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[5] Ariz. Sup. Ct. Task Force on the Delivery of Legal Servs., *Report and Recommendations* (Oct. 4, 2019), https://www.azcourts.gov/Portals/74/LSTF/Report/LSTFReportRecommendationsRED10042019.pdf?ver=2019-10-07-084849-750 [hereinafter LSTF Report].

[6] Ariz. R. Pro. Conduct ER 1.0(c).

Concurrently with the amendment to ER 1.5(e), other changes to the Rules created new possibilities for Arizona lawyers to pay referral fees to nonlawyers. These changes included the elimination of ER 7.2(b)'s longstanding prohibition on paying anything of value to a person who recommends a lawyer's services and the elimination of ER 5.4's prohibition on sharing legal fees with nonlawyers. With these eliminations, Arizona lawyers may now ethically pay nonlawyers for referrals, and may do so by sharing legal fees.

With the abrogation of ERs 5.4 and 7.2, the Rules do not expressly require that a lawyer obtain a client's informed consent to paying a referral fee, nor do the Rules expressly require a lawyer to obtain a client's informed consent before sharing a client's legal fee with a nonlawyer outside the lawyer's firm, whether as compensation for a referral or for another reason.[7]

III. Content and Rationale for the Proposed Rule Change.

The Committee recognizes that ER 1.5(e) was amended for a specific purpose. As stated in the LSTF Report, ER 1.5(e) was amended to specify that its fee-sharing requirements apply to two or more firms jointly working on a client's matter.[8] Therefore, this petition does not seek to amend the current language of ER 1.5(e).

Rather, this petition proposes a new subsection, ER 1.5(f), which states:

(f) A firm may divide a client's legal fee with another firm, person, or entity outside of the firm under circumstances other than those governed by 1.5(e) if:

[7] For example, Arizona Ethics Opinion 20-0003 held that a lawyer may ethically enter into a fee-financing arrangement where a lender retains a portion of the client's fee to cover the lender's collection management costs, as long as the lawyer obtains the client's informed consent to the arrangement. Ariz. Sup. Ct. Ethics Op. 20-0003 (Aug. 25, 2021), https://www.azcourts.gov/Portals/26/AEA%20Committee/Issued%20Opinions/EO-20-0003.pdf?ver=2021-08-30-113057-927.

[8] LSTF Report, *supra* note 5, at 17.

(4) the firm discloses to the client in writing how the fee will be divided with the other firm, person, or entity;
(5) the client consents to the division of fees in a writing signed by the client before or within a reasonable time after commencing the representation; and
(6) the total fee is reasonable.

The proposed ER 1.5(f) would not diminish an Arizona lawyer's ability to pursue innovative business opportunities as contemplated by the LSTF Report.[9] Arizona lawyers may still divide client fees with individual referral sources, commercial lawyer referral services, lead generators, fee-financing lenders, and the like. However, no matter how innovative, the practice of law in Arizona remains a profession and not a "mere money getting trade."[10] Arizona lawyers must still place a client's interests before their own business interests.

Dividing a client's fee with someone outside of the firm creates a risk to clients. A lawyer may increase overall billings as a means of compensating for the fee-sharing arrangement. In a contingent fee representation, a lawyer may be influenced by the fee-sharing arrangement in counseling a client to accept or reject offers of settlement. These risks are further enhanced by a client's lack of specialized legal knowledge and inability to monitor the lawyer's actions.[11]

Transparency mitigates this risk. A client who knows that her legal fee will be divided with someone outside the firm will be better equipped to evaluate settlement offers and the overall reasonableness of the lawyer's fees. Requiring client notice and consent strikes an appropriate balance between the client's interests and the lawyer's. The

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[9] *Id.* at 10 (identifying former ER 5.4's prohibition on sharing fees with nonlawyers as "a barrier to innovation in the delivery of legal services").
[10] *In re Swartz*, 141 Ariz. 266, 273 (1984).
[11] In economics, this is known as the principal-agent problem. The agent may act in the agent's best interest rather than the principal's; this problem is exacerbated when the agent has more information than the principal. The problem may be mitigated in several ways, such as by decreasing asymmetry of information and allowing the principal opportunities to monitor the agent. *E.g.*, Bengt Holmstrom, *Moral Hazard and Observability*, 10 Bell J. Economics 74-91 (Spring 1979), https://www.gwern.net/docs/economics/1979-holmstrom.pdf.

requirements of ER 1.5(f) impose a minimal burden on Arizona lawyers, who can obtain client consent as part of their written fee agreement with the client.[12]

Furthermore, the proposed ER 1.5(f) comports with national ethical norms. Every U.S. jurisdiction permits fee sharing to some degree. Many jurisdictions have adopted verbatim American Bar Association Model Rule 1.5(e), which permits fee sharing among lawyers not in the same firm only when the lawyers divide the fee in proportion to work performed or share joint responsibility for the representation.[13] Others, such as California, Kansas, and Michigan, permit fee sharing among lawyers *without* a concurrent requirement of proportional work or joint responsibility, thereby allowing lawyers to pay each other solely for referrals.[14] Nonetheless, all jurisdictions require the lawyer to obtain the client's agreement to the fee-sharing arrangement.[15]

Lastly, informing the client of the fee-sharing arrangement ensures the client's right to legal representation of her choice. Even in fee-sharing arrangements where the total fee is reasonable, the client may end up paying a higher fee than she would have to a lawyer who was not dividing her fee with someone else.[16] As noted in the Restatement (Third) of the Law Governing Lawyers, "[t]he remedy of the client . . . lies in rejecting the arrangement and retaining a single lawyer at a lower fee."[17] This remedy is available only when clients are informed that the lawyer intends to divide their fee with someone outside the firm.

IV. Conclusion.

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[12] Ariz. R. Pro. Conduct ER 1.5(b) (requiring written fee agreements).
[13] Model Rules of Pro. Conduct r. 1.5(e) (Am. Bar Ass'n 2021).
[14] *See* Am. Bar Ass'n Ctr. for Pro. Resp. Pol'y Implementation Comm., *Variations of the ABA Model Rules of Professional Conduct, Rule 1.5: Fees* 7, 18, 27 (current as of August 2021), https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/mrpc-1-5.pdf.
[15] *Id.* For example, California requires client consent; Kansas requires that the client "not object to the division," and Michigan requires the client "not object to the participation of all the lawyers involved." *Id.*
[16] Restatement (Third) of the Law Governing Lawyers § 47, *Fee-Splitting Between Lawyers Not in the Same Firm*, cmt. f (Am. L. Inst. 2000) (noting that "there will usually be a range of total fees satisfying the reasonableness requirement . . . .").
[17] *Id.*

The Petitioner respectfully requests that the Court adopt the proposed rule. In the alternative, Petitioner requests that the Court refer the matter back to the Committee with directions. Attached are EO-21-0001 and clean/redlined versions of the proposed rule.

RESPECTFULLY SUBMITTED this ____day of_____, 2022.

/s/ Judge Christopher Staring