

Percentage Fees: Available *and* Ethical

by Michael Franck

Lawyer referral and information services are not immune from economic reality. They too must cope with the twin pressures of less generous sources of income and escalating expenses. The traditional funding sources of sponsor subsidy plus client and panelist fees are increasingly inadequate. Additional income must be generated if referral and information service components are to maintain the quality standards essential to properly serving the public.

The most equitable source of additional funding for the service is obviously the lawyer who benefits financially from its operation. Why shouldn't that lawyer's contribution be directly proportionate to the monies earned as the result of a referral? Many services have forgone this potential source of funding because they regard it as fee-splitting, which is prohibited by the ethical standards of the profession. Careful analysis of that concern suggests that it is misplaced.

The long-standing prohibition against fee-splitting reflects the concern that a third party sharing in a legal fee would interfere in the lawyer-client relationship, by seeking to influence the lawyer to conduct the representation with an eye toward maximizing the fee to be earned, rather than to benefit the client. This concern first manifested itself in prohibitions against nonlawyer solicitation of claims in exchange for a percentage of the lawyer's fee (see *Mequire v. Corwine*, 101 U.S. 108 (1879)) and in prohibitions against the practice of law by corporations (see *In re Cooperative Co.*, 198 N.Y. 479 (1910)).

The prohibition against lawyers paying laypersons for soliciting cases was incorporated in the original Canons of Professional Ethics adopted by the American Bar Association in 1908. Other forms of fee-sharing with nonlawyers were originally prohibited only by statutes and case law. In 1928, the American Bar Association adopted Canon 34 of the Canons of Judicial Ethics which prohibited the sharing of legal fees

entirely, except with another lawyer based upon a division of service or responsibility. But, as Gilbert and Sullivan's *Little Buttercup* remind us in *H.M.S. Pinafore*, things are seldom what they seem.

In 1956, the ABA Committee on Professional Ethics issued an opinion as to whether a referral service sponsored by a local bar association could require those lawyers utilizing the service to assist in its financing, either by a flat fee or sliding-scale charge based on the fees derived by the lawyers from the cases referred to them. The Committee opined that registrants could be required to contribute to the expense of operation the referral service by a reasonable registration charge or by a reasonable percentage of fees they collected. The latter appeared to clearly be a division of legal fees with a nonlawyer. Nevertheless, the Committee concluded the arrangement would not constitute a violation of Canon 34.

The Ethics Committee gave absolutely no reason for its conclusion that the proposed percentage fee conformed to the existing Canon provision. We can only speculate that the Committee was determined not to impede the then-recent development of the lawyer referral service by the application of an ethical standard which had not anticipated that means of providing legal services to the public.

In 1969, the ABA Canons of Ethics were replaced by the ABA Model Code of Professional Responsibility. The Code retained the prohibition against a lawyer or law firm sharing legal fees with a nonlawyer, with exceptions only for death benefits payable to the estate of a deceased lawyer, compensation for services rendered prior to death payable to the estate of a lawyer, and the inclusion of nonlawyer employees in a firm retirement plan, even though the plan may be based on a profit-sharing arrangement (DR 3-102(A)). However, the Code also incorporated the lawyer referral service exception first sanctioned in Opinion 291. DR –103(B) prohibited the giving of compensation by a lawyer to a person or organization for having recommended or secured the lawyer's employment, or as a reward for having made a recommendation resulting in the lawyer's employment by a client, except that the lawyer was permitted to pay the usual and reasonable fees or dues charged by any of the organizations listed in DR 2-103(D). That subsection permitted the lawyer to

be recommended by, among others, a lawyer referral service operated, sponsored, or approved by a bar association. The percentage fee now had formal Code sanction.

In 1970, a law firm unsuccessfully sought a declaratory judgment that its agreement to pay one-third of an attorney fee of almost \$48,000 in a medical malpractice case referred by the lawyer referral service of a local bar association violated public policy against fee-splitting and was unenforceable. In *Emmons, Williams, Mires & Leech v. State Bar of California*, 6 Cal. App. 3d 565 (1970), the California Court of Appeals, citing criteria for the operation of a lawyer referral service adopted by the State Bar of California which had been premised on standards promulgated by the American Bar Association, as well as the Opinion 291 of the ABA Committee on Professional Ethics, held that the percentage fee did not violate the public policy underlying the prohibitions against fee-splitting and was, therefore, enforceable.

The court summarized the dangers to be avoided by the fee-splitting prohibition as competitive solicitation, potential control by the layperson interested in personal profit rather than the client's fate, and the lay intermediary's tendency to select the most generous, not the most competent, attorney. The court concluded that none of these dangers or disadvantages characterizes a local bar association's referral service. "The bar association seeks not individual profit but the fulfillment of public and professional objectives. It has a legitimate, nonprofit interest in making legal services more readily available to the public. When conducted within the framework conceived for such facilities, its reference service presents no risk of collision with the objectives of the Canons of fee-splitting and lay interposition." The lower court decision requiring the law firm to pay the referral service a percentage of the fee it had earned as the result of the referral was upheld.

Although the *Emmons* decision was not predicated upon the specific provisions of the Code of Professional Responsibility but upon similar regulations adopted by the State Bar of California, it is fully consistent with the philosophy underlying the parallel Code provisions.

The Code was replaced in 1982 by the ABA Model Rules of Professional Conduct. Model Rule 5.4(a), which prohibits a lawyer or law firm from sharing legal fees with a nonlawyer, is identical to DR 3-102(A) of the Model Code. Model Rule 7.2(c) generally prohibits a lawyer from giving anything of value to a person for recommending the lawyer's services. One express exception is that the lawyer may pay the usual charges of a not-for-profit lawyer referral service or legal service organization. The term "usual charges" incorporated the various methods for compensation lawyer referral services then in existence and included flat enrollment charges as well as percentage fees. The Model Code requirement that the referral service be sponsored by a bar association was dropped from the Model Rules. That change reflected significant doubt as to the constitutionality of lawyer ethical standards which advantaged referral service mechanisms sponsored by bar associations over similar services established by not-for-profit organizations to further ideological goals arguably protected by the First Amendment against discriminatory limitations applicable to them and not to others. Even the Model Rule exception, limited to not-for-profit organizations, may be subject to constitutional challenge.

The percentage fee is now a well-established method of funding lawyer referral services (see generally the ethics opinion set forth in the *ABA/BNA Lawyers' Manual on Professional Conduct* 41:804. The files of the ABA Standing Committee on Lawyer Referral and Information Service indicate that more than forty percent of the referral services in existence are so funded in whole or in part.

The size of the percentage fees charged varies greatly. They range up to one-third, the percentage fee at issue and enforced in the *Emmons* case, *supra*.

Although no specific limitation on the size of the referral fee charged by a referral service has been expressly formulated, it seems obvious that some standard of reasonableness must apply. The outside limits of that standard may be defined as the point at which a further deduction from the fee left to the lawyer handling

the matter may well affect the quality of the representation by adversely affecting the enthusiasm the lawyer brings to the matter and the ultimate result the lawyer seeks to achieve.

The purpose for which the proceeds of the referral fee charged by the service are used also raises ethical concerns. The lawyer referral concept was developed to further the profession's obligation to make legal services widely available. Consequently, it would not be appropriate to use the income generated to subsidize the normal operating expenses of the bar association or other sponsor of the referral service. Those proceeds should be devoted to funding the reasonable operating expenses of the service. Any balance remaining should fund public service activities of the service or its sponsoring organization, including the delivery of pro bono legal services.