APPENDIX E

LETTER FROM STATE BAR COMMITTEE TO SUPREME COURT

[University of Houston Law Center letterhead]

May 20, 1998

TO: The Honorable Justices of the
Supreme Court of Texas

FROM: The Texas Disciplinary Rules of Professional Conduct Committee
of the State Bar of Texas

RE: Response to the Court's Request for Information Regarding
Possibly Altering Lawyer Referral Fee Practices in Texas

Last year the Court solicited the opinion of the Texas Disciplinary Rules of Professional Conduct Committee on whether Texas should abandon its traditional position of permitting, subject to certain conditions, the receipt and payment of a pure forwarding fee to a lawyer — that is, a fee paid to a lawyer whose sole contribution to the prosecution or defense of a matter was to refer it to the lawyer or law firm that actually handled it — as permitted by TDRPC Rule 1.04(f)(ii), and join the great majority of states that prohibit that practice. In considering the Court's charge, the Committee has taken the liberty of discussing alternatives to what it considers the polar positions with respect to such fees — outright abolition on the one hand, accomplished by deleting TDRPC Rule 1.04(f)(ii), and maintaining the status quo on the other — so that the Court can have a full range of choices before it. This letter contains the Committee's suggestions in that regard.

I. Discussion

Texas's approach of permitting payment of forwarding fees to lawyers is of long-standing. It was recognized as appropriate under the former Texas Canons of Ethics (Canon 31) and the former Texas Code of Professional Responsibility (DR 2-107(A)) and continues to be proper under the current Texas Disciplinary Rules of Professional Conduct (TDRPC Rule 1.04(f)). The most commonly advanced defenses of that practice are that such fees facilitate delivery of legal services of the best available quality to a client because they remove the temptation of a marginally qualified lawyer to retain a matter in order to receive a fee rather than to refer it to a more qualified lawyer better able to handle it. Moreover, so the argument goes, because forwarding fees usually are calculated as a percentage of the client's recovery, their availability aligns the interests of the referring lawyer with those of her client, because the greater the client's recovery the greater the referring lawyer's fee.

That incentive, coupled with the possibility of an action for negligent referral,[1] it is maintained, facilitate clients getting representation from the lawyer best able to handle their particular situation. Finally, the Texas approach has the additional virtue of being open and above board, the common wisdom being that such fees are actually paid in most states, even though prohibited, pursuant to one subterfuge or another.

On the other hand, the practice is criticized on three principal grounds. First, it rewards lawyers for doing essentially nothing more than the rules of ethics already oblige them to do, namely, to see that the client receives adequate legal

[1] This cause of action has been recognized in some jurisdictions but not in others. The author is not aware of any Texas case on point.

representation. Second, it treats clients like commodities to be marketed to the highest bidder. Third, critics say, the practice is not well suited to its intended purpose, because it does not impose any ongoing professional obligation on referring lawyers once the referral has occurred. This leaves referring lawyers with every incentive to send their clients not to the most able practitioners but instead to those whose referral fees compensate them most generously. Critics of forwarding fees also point out that with the recent liberalization of the standards governing advertising and solicitation, lay persons can receive information concerning lawyers far more readily than they once did, thus lessening the likelihood of damage to the public in the event that compensation for lawyer-to-lawyer referrals were to be prohibited.

Referral fees were utilized in Texas for many years without a great deal of controversy. In recent times, however, concerns over widespread barratry and the development of referral-only law firms and legal practices have called those fees into question. Forwarding fees are seen by their critics as the fuel driving the barratry engine. If they were abolished, the argument runs, there would be no financial incentive to engage in barratry and those practices would wither away.

The Committee is concerned, however, that the outright abolition of lawyer forwarding fees might be not only too extreme but futile as well. With regard to the latter, were forwarding fees as currently structured to be prohibited, the Committee believes it likely that they would be driven underground but continued, albeit with greater protection for clients, either as divisions of fees between lawyers "in proportion to the professional services performed by each," as allowed by TDRPC Rule 1.04(f)(1), or as ones "made, by written agreement with the client, with a lawyer who assumes joint responsibility for the representation," as permitted by TDRPC Rule 1.02(f)(1)(iii).[2] Consequently, the Committee believes instead that consideration should be given to instituting regulatory measures short of outright abolition that would retain the salutary aspects of referrals while curbing abuses.

The principal possibilities are set out below.

A. Strengthen Disclosure Requirement With Respect To Forwarding Fees

Currently TDRPC Rule 7.04(1) requires advertising attorneys who know that they will be forwarding some or all of the clients responding to that advertisement to another lawyer to say so in the advertisement itself. In addition, TDRPC Rule 1.04(f) requires lawyers to advise their clients of any division of legal fees between attorneys not in the same firm to the client. Neither of these rules, however, mandate disclosure of the *terms* of the referral. Were those terms disclosed, the client would be in a better position to bargain with the lawyer who would be handling the matter (or some other lawyer) over the terms of any engagement, because s/he would realize the true value of the case to the handling attorney.

B. Strengthen The Substantive Terms Of Any Referral Arrangement

Under current TDRPC Rule 1.04(f), at least one court has concluded that rule does not require client consent in advance to any proposed referral but only that the client be advised of and not object to the referral fee at some point before it is paid. *See Polland & Cook v. Lehman*, 832 S.W.2d 729, 736 (Tex. App.—Houston [1st Dist.] 1992, writ denied). Although there is a strong argument that the court is mistaken in that regard,[3] whether or not that is true, the practice the

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[2] This feature is not likely to restrain the particular division settled upon by the forwarding and handling lawyers, as most cases conclude that any agreement by the lawyers in that regard should be enforced. *See* Stissi v. Interstate & Ocean Tr. Co. Of Philadelphia, 814 F.2d 848 (2nd Cir. 1987); Oberman v. Reilly, 66 A.2d 686, 687, 411 N.Y.S.2d.23, 25 (1st Dept. 1978); Fitzgibbon v. Carey, 70 Or. App. 127, 137, 688 P.2d 1367 (1984), *rev. denied*, 298 Or. 553, 695 P.2d 49 (1985).

[3] *See* comment 10 to TDRPC Rule 1.04, which now provides in pertinent part:

> Because the association of additional counsel normally will require further disclosure of client confidences and have a financial impact on a client, *advance disclosure of the existence of that*

Polland & Cook court endorses is not in clients' best interests. To provide a greater degree of accountability and client protection, TDRPC Rule 1.04(f) could be amended to require one or more of the measure set out below:

1. That any forwarding fee arrangement would have to be furnished to the client *in writing*.

2. That for any such arrangement to be valid, the client would have to *advised* of it *prior to* the referral being made.

3. That no referral fee agreement could be enforced without the client's *written* consent.

4. That a client's consent to a forwarding fee arrangement, whether sought before or after the referral occurs, would not be effective unless the client had been advised that:

a. The client has a right to withhold consent;

b. If the client were to withhold consent, no contractual forwarding fee could be paid to the forwarding lawyer.[4]

5. If the client's consent had not been sought prior to the referral, the client would have to be advised that it would be advisable for the client to consult with independent counsel before deciding whether or not to ratify the tendered arrangement.

C. Alter The Economic Incentives Surrounding Referral Fee

At present, the economic incentives surrounding referral fees have two substantial flaws. The first is that they encourage the lawyers involved to tell the client as little as possible about their arrangement. The second is that they encourage forwarding lawyers to refer cases to the handling lawyer paying the most generous referral fee rather than to the handling lawyer best qualified to handle the matter. These incentives could be change to align them more with the interests of referred clients in one or more of the following ways:

1. Require both the forwarding lawyer and the handling lawyer to comply with the requirements surrounding forwarding fees, as set out in Rule 1.04(f) and in section B above;

2. Provide that any lawyers who do not comply with paragraph 1, may not rely on their contract of employment to recover a fee but instead must justify any compensations based on *quantum meruit*;

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proposed association and client consent generally are required.

The clear import of this language is that the client should be advised of any proposed referral prior to its occurrence.

[4] Possible dispositions of any unpaid fee are discussed in sections C.2 and C.3 below. Section C.2 provides that a noncomplying lawyer would lose any *contractual* right to a fee but might be entitled to some compensation on a *quantum meruit* basis. Subsection C.3 says that any difference between the *quantum meruit* and contractual fees would either be paid to the client or allocated between the client and any complying lawyer(s) on a *pro rata* basis. Whatever measures were adopted in that regard also would have to be communicated to the client prior to any consent for it to be effective.

3. Provide that any difference between a noncomplying lawyer's contractual fee and that awarded in *quantum meruit* pursuant to paragraph 2 would be either paid to the client (rather than the other lawyer as currently is the case), or shared among the client and any lawyer(s) complying with paragraph 1 *pro rata*.[5]

Some of these reforms probably could be accommodated through amendments to currently disciplinary rules, but others (most notably paragraphs 2 and 3) would probably require legislation. All are apt to be quite controversial.

D. Direct Economic Regulation Of Forwarding Fees

One particularly feasible and perhaps less controversial approach to regulating forwarding fees would be to have a separate disciplinary standard covering them. Several different approaches are possible. The first would be to hold forwarding fees to a stricter standard than the "unconscionable" benchmark of current TDRPC Rule 1.04(a), requiring instead that they not exceed a "reasonable" fee as described in Rule 1.04(b). This makes sense, because the many variables normally involved in deciding upon a fee are absent from typical pure forwarding fee settings, where the forwarding lawyer's principal contributions to the representation are concluded once that lawyer decides upon an appropriate handling attorney and makes the referral. Since the presence of the most of Rule 1.04(b)'s standards serve to justify higher fees, their absence from prototypical forwarding fee arrangements should exert a substantial downward pressure on forwarding fees. On the other hand, where forwarding lawyers actively participate in the resolution of the forwarded matter, Rule 1.04(b)'s factors would serve to justify that lawyer receiving a large share of the total fee. For example, a forwarding lawyer who assumed joint responsibility for the representation of the forwarded client and devoted a considerable amount of time to the client's matter would be entitled to a greater fee than would a wholly passive forwarding lawyer. *See* Rule 1.04(b)(1), (4), (). More direct regulation could be attempted, such as limiting forwarding fees to a certain percentage of a total fee or recovery or to a particular dollar amount, or prohibiting the increasingly prevalent practice of payment of a forwarding fee upon receipt of the client by the handling lawyer rather than upon conclusion the matter.[6]

The principal concern these approaches raise for the Committee is whether they are proper topics for inclusion in disciplinary rules. To date, the rules have not attempted to regulate the economic side of the practice of law. Any effort to do so, even through legislation, is bound to be very controversial.

A slightly different approach, however, might be worth considering: repeal of the rule of *Mandell & Wright v. Thomas*, 441 S.W.2d 841 (Tex. 1965). That case held that when a client, without good cause, discharges an attorney before the attorney's engagement has been completed, the attorney may recover the full amount owed under the contract of employment. *Id.* at 847. This rule, which as been partially abrogated by TDRPC Rule 7.03(d) with respect to cases acquired as a result of barratry, provides both referring and handling lawyers with an extremely potent weapon to wield against clients who become dissatisfied with their representation. The case permits those attorneys to threaten their clients credibly with the prospect of having to pay full attorney fees to two different sets of lawyers in the event that they discharge original counsel, as occurred in *Mandell & Wright*. That result has been the subject of pungent and telling criticism.[7] The Court might want to give consideration to adopting a disciplinary standard limiting attorneys discharged

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[5] In a sense, payment of any forfeited fee to either the other lawyers involved or to the client results in a windfall to them, as they will be receiving more for their services or recovery as the case may be than provided for in the agreement between them. The recent case of *Arce v. Burrow*, 958 S.W.2d 239 (Tex. App.—Houston [14th Dist.] 1997, n.w.h.), however, establishes the right of a client to recovery of some or all of the attorneys fees paid to a lawyer who breaches his or her duty to the client. *Id.* at 246. There also is some authority in federal court for a *cy pres* remedy in such circumstances, in which the forfeited amount escheats to the government or is awarded to selected charities.

[6] The reason this practice is troublesome is that it removes the normal incentive for a referring lawyer to refer a matter to the best lawyer rather than to the most generous one.

[7] *See* Johnston v. California Real Estate Investment Trust, 912 F.2d 788, 789 (5th Cir. 1990).

without just cause to the reasonable value of their services under a *quantum meruit* rationale, as is done in most other jurisdictions by case law.

II. Conclusion

If the discussions in our Committee are any indication, the question of what measure if any should be taken with respect to attorney referral fees raises many issues over which reasonable persons will differ. The proper resolution of those issues involves both political and public policy questions that go well beyond the ethical concerns that are the purview of this Committee. Those broader questions need to be debated at length in a more open and more representative forum than our committee provides. The views of attorneys and others who are most knowledgeable about current practices and who stand to be most directly affected by any changes in those practices are especially important.

Once that debate has occurred, it will be time to undertake those actions that appear to be in the best interests of the Bar and the public it serves. At that time, should the Court request that it do so, the Texas Disciplinary Rules of Professional Conduct Committee will be prepared to assist in drafting nay amendments to the disciplinary rules found to be desirable.

Sincerely,

Robert P. Schuwerk, Chair for the
Texas Disciplinary Rules of Professional Conduct Committee