NEW YORK STATE BAR ASSOCIATION
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New York State Bar Association
Committee on Professional Ethics

Opinion 1183 (03/10/2020)

Topic: Designated counsel in financing transactions; payment of fees by a third party; exercise of independent judgment; conflicts of interest

Digest: A lawyer may accept appointments as designated counsel for underwriters, lenders or other funding sources involved in private equity or corporate financing transactions on the recommendation of the counter-party to the transaction, with the lawyer being paid out of the proceeds of the transaction, provided that no interference occurs with the lawyer's exercise of independent professional judgment on the clients' behalf, the lawyer preserves the confidentiality of client confidential information, and the lawyer obtains the clients' informed consent, confirmed in writing.

Rules: 1.0(j), 1.1, 1.2, 1.3, 1.4, 1.6, 1.7(a) & (b), 1.8(f), 4.2, 5.4(c)

FACTS

1. The inquirer is a New York lawyer who represents underwriters, lenders and other financial institutions that participate in large private equity offerings and other corporate financing transactions. The fees for the lawyer and the lawyer's clients are paid out of the proceeds of the transactions. At risk of oversimplification, but for ease of reference, we refer to the lawyer's clients as the "funders" and the counterparties as the "recipients."

2. We are told that, in a growing number of these financing transactions, it is not uncommon for the recipients (or their counsel) to maintain lists of designated counsel to act on behalf of the funders, the use of which counsel is a condition precedent to the recipients' willingness to transact business with the funders. As we understand the circumstances, the recipients' designation of the funders' counsel is made independent of the selection of the funders and is made by the law firm representing the recipients. No provision is made for the funders' consent to counsel other than that implicit in the funders' agreement to participate in the transaction.

3. These financing transactions are not part of a series of offerings, but have different parties for each transaction. The inquirer has been offered the opportunity to have the inquirer's firm included on the list of designated counsel, which the inquirer acknowledges could result in fees comprising a material portion of the income of the firm's financial transactions practice.

4. Recently the inquirer has learned that the recipients have sent a so-called "terms list" to the funder clients with instructions to agree with the proposed terms, or propose counter terms, but to do so without consultation with the funders' designated counsel. According to the inquirer, no opportunity exists for the funders to use their designated counsel to negotiate the term sheet with the recipients. The role of the funders' designated counsel is thus to prepare the financing documents based on the terms negotiated by the funders (without benefit of counsel) and the recipients (with counsel).

5. We are asked to assume that, if the designated counsel fails to abide by the recipients' directives, then the prospect of future designations will disappear, with the attendant loss of income to the lawyer's firm.

QUESTION

6. May a lawyer accept a designation of counsel to represent a client in a transaction when the counterparty in the transaction makes the designation, places restrictions on the lawyer's ability to exercise independent professional judgment on behalf of the lawyer's client, and the designated counsel is paid out of the proceeds of the transaction?

DISCUSSION

7. The inquiry implicates several provisions of the N.Y. Rules of Professional Conduct (the "Rules"). These Rules regulate the lawyer's responsibilities in an attorney-client relationship when factors extraneous to that relationship may imperil the lawyer's fiduciary obligations to a client and the duties of loyalty and care that accompany those obligations. Broadly stated, the Rules forbid a lawyer to allow a stranger to the attorney-client relationship to inhibit the lawyer's faithful discharge of those obligations to a client, at least absent circumstances in which the client is able freely to provide informed consent to the intrusion without impairing the lawyer's ability to fulfill the lawyer's duties to the client.

8. One such provision is Rule 5.4(c), contained in the provision "Professional Independence of a Lawyer," which says that, unless the law otherwise provides, "a lawyer shall not permit a person who recommends, employs or pays the lawyer to render legal service for another to direct or regulate the lawyer's professional judgment in rendering such legal services or to cause the lawyer to compromise the lawyer's duty to maintain the confidential information of the client" that Rule 1.6 safeguards. Comment [2] associated with this Rule explains that the Rule "expresses traditional limitations on permitting a third party to direct or regulate the lawyer's professional judgment in rendering legal services to another." *See generally* N.Y. State 1081 ¶ 16 (2016); N.Y. State 957 ¶¶ 11-12 (2013).

9. This same Comment [2] directs attention to Rule 1.8(f), of special pertinence here, which says that a "lawyer shall not accept compensation for representing a client from one other than the client unless (1) the client gives informed consent; (2) there is no interference with the lawyer's independent professional judgment and (3) information relating to the representation of the client is protected as required by Rule 1.6." "Simply put, Rule 1.8(f) means that a lawyer owes a client the same duties owed to a client without regard to the source of the fees the lawyer is paid, with the added proviso that a client must give 'informed consent' to the arrangement." N.Y. State 1000 ¶ 5 (2014) (allowing a lawyer to be paid by an adverse party subject to Rule 1.8(f)). As Comment [11] to this Rule explains, and as our Opinion 1000 attests, "[t]hird-party payors frequently have interests that may differ from those of the client." But this fact does not unburden the lawyer of the duty to comply with obligations to a client, including, among others, the duties of competence set out in Rule 1.1, of diligence set out in Rule 1.3, of communication set out in Rule 1.4, of confidentiality set out in Rule 1.6, and of attention to conflicts of interest set out in Rule 1.7.

10. N.Y. State 818 (2007) is instructive in applying these principles to this inquiry. That opinion was issued under the N.Y. Code of Professional Responsibility (the "Code"), the precursor of the Rules, but the relevant provisions of the Code and the Rules are interchangeable for our purposes. There, the inquirer was designated counsel for an underwriter of a series of municipal security offerings by the same issuer. The lawyer was "selected for this work by the

issuer," which paid the designated counsel's fees. In Opinion 818, we recognized that "there may be competing interests when negotiating the underwriting agreement" and that disagreements could arise about what is 'material' for the purposes of disclosure in offering documents." *Id.* ¶ 5. We continued: "The Code explicitly requires that a lawyer whose fees will be paid by a third party obtain the consent of the client, after full disclosure of all relevant facts and circumstances, before accepting such compensation." *Id.* ¶ 8. Included in the disclosures are "any material facts or circumstances – beyond the selection of Designated Underwriters' Counsel by the issuer and what that normally entails – that might bear on the lawyer's ability to exercise independent professional judgment on behalf of the client (the underwriter) or otherwise interfere with the lawyer's ability to adequately represent the client." *Id.*

11. Although some facts in Opinion 818 vary from those here – for instance, here each transaction is unique and involves different financial instruments and participants – these variances do not affect the controlling principles. Among other things, the competing interests and the potential for disagreement over disclosure and material terms persist, and thereby engender the same concerns animating Opinion 818. There, as here, these concerns included that the designating counterparty might impose conditions on the lawyer's exercise of independent professional judgment and also that the prospect of future designations comprising a significant source of income to the lawyer could affect lawyer's exercise of that judgment. *Id.* Accordingly, there, we concluded: "A law firm selected to serve as Designated Underwriters' Counsel by a company must carefully consider its relationship with the company selecting it, and assess whether a disinterested lawyer would conclude that the law firm can competently represent the interests of the underwriters in light of its relationship with the company, and if so, ensure that the underwriters appropriately consent to its representation of them." *Id.* ¶ 14.

12. Apparent from Opinion 818 is that a conflicts analysis under Rule 1.7 may be an integral part of appraising the ethical limitations of accepting the role of counsel designated by an adverse party and paid by other than the counsel's own client. The Comments associated with each Rule refer to the other. Thus, Comment [12] under Rule 1.8(f) says that a conflict under Rule 1.7(a) may exist if "there is a significant risk that the lawyer's professional judgment on behalf of the client will be adversely affected by the lawyer's own interest in the fee arrangement or by the lawyer's responsibilities to the third party payer." Likewise, Comment [13] under Rule 1.7(a) says that a lawyer "may be paid from a source other than the client, including a co-client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty or independent judgment to the client. *See* Rule 1.8(f). If acceptance of the payment from any other source presents a significant risk that the lawyer's exercise of professional judgment on behalf of a client will be adversely affected by the lawyer's own interest in accommodating the person paying the lawyer's fee . . . then the lawyer must comply with the requirements of [Rule 1.7] (b) before accepting the representation, including determining whether the conflict is consentable and, if so, that the client has adequate information about the material risks of the representation." Our prior opinions frequently refer to each Rule in describing a lawyer's duties when the source of the lawyer's fee is other than the client. *See, e.g.*, N.Y. State 1162 (2019); N.Y. State 1155 (2018); N.Y. State 1086 (2016); N.Y. State 1063 (2015).

13. The lessons for this inquiry from these Rules and the opinions construing them are readily apparent. A lawyer may not ethically accept a representation of a client if the lawyer accepts compensation or "anything of value" (including inclusion of an approved list of designated counsel), nor a recommendation to serve as counsel, if the lawyer thereby allows a stranger to the attorney-client relationship to interfere with, among other things, the lawyer's exercise of independent professional judgment on behalf of the client. To us, this means that a lawyer may not allow counsel for an adverse party to dictate the limits the lawyer's role in service of a client's interests absent a client's informed consent confirmed in writing.

14. Other Rules compel this conclusion. Rule 1.2(a) provides that a "lawyer shall abide by a client's decisions concerning the objectives of representation," and by necessary implication not abide by the dictates of others. Rule 1.3 says that a lawyer "shall act with reasonable diligence and promptness in representing a client." Rule 1.4 imposes obligations on a lawyer promptly to inform the client of material developments in the matter and, among other things, reasonably to consult with the client about the means by which the client's objectives are to be achieved and to explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation. To fulfill these responsibilities requires the unfettered ability to exercise independent professional judgment on the client's behalf unless the client otherwise agrees.

15. In addition, in these circumstances, if a "significant risk" exists that a disinterested lawyer would conclude that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's "own financial, business, property or other personal interests," then a conflict of interest is present. In light of the inquirer's acknowledgement that a failure to abide by the third party's directives could endanger a material portion of the lawyer's business and property interests, it is likely that a disinterested lawyer would find such a significant risk. Fortifying this conclusion is that Rule 1.8(f), which addresses specific conflicts that Rule 1.7 addresses more generally, identifies situations involving third-party payors as ones in which conflicts are inherently present. So, too, does Rule 5.4(c).

16. This leaves the question – applicable under Rule 1.7(a) and Rule 1.8(f) – whether the conflict is subject to informed consent. We think the answer is yes. Rule 1.0(j) defines "informed consent" as "the agreement by a person to a proposed course of conduct after the lawyer has communicated information adequate for the person to make an informed decision, and after the lawyer has adequately explained to the person the material risks of the proposed course of conduct and reasonably available alternatives." The expectation of informed consent to the representation is found within Rule 1.8(f) and, save for the requirement of a writing, is no different from that required under Rule 1.7(a)(2). On our view, "informed consent" cannot be adequate without disclosing to the client the lawyer's business and personal interest in carrying out the representation.

17. This is nothing new. We have followed these principles in other areas, most notably in insurance defense when the existence of third party payment of fees did not alter the primary obligations owed to the client. *See* N.Y State 721 (1999). For instance, in N.Y. State 1154 (2018), we said that, if the "lawyer depends on an insurance carrier for a regular flow of business," then the inquirer needed to resolve whether this relationship created a conflict of interest. If the inquirer concluded that it did, then the inquirer had to determine whether the inquirer reasonably believed that the inquirer could nevertheless provide "competent and diligent" representation to the affected client. If yes, then the inquirer needed to obtain the client's informed consent confirmed in writing, including by disclosing "the inquirer's relationship with the insurer." *Id.* ¶ 16. Applying that statement to the present inquiry would suggest that the inquiring counsel disclose to the funder clients the nature of the inquirer's relationship with recipients and their counsel.

18. Similarly, in N.Y. State 942 (2012), another inquiry involving a third-party payor, the client would not be told material facts concerning the fee arrangement. There, we said: "Informed consent can occur only after the lawyer has adequately explained the risks and provided enough information for the client to make an informed decision." We concluded, "That standard may not be satisfied here, given the apparent limits to the planned disclosure to the client." So, too, here. The analysis of adequate consent is heavily fact-dependent, including clarification that the duty runs solely to the client, the sophistication of the client, the risks

flowing from the representation, and the ability to exercise independent judgment on the client's behalf. Nevertheless, we are confident that the funder's willingness to participate in the transaction does not alone constitute "informed consent" within the meaning of the Rules.

19. Nothing in this opinion is intended to criticize or discourage use of designated counsel, a common practice that often provides efficiencies of great benefit to the clients and other parties. Nor is there anything wrong with principals negotiating the material terms of a transaction without benefit of counsel on each side and then enlisting lawyers to prepare the needed documents, subject to the requirements of Rule 4.2 regulating a lawyer's right to communicate with a person known to be represented by counsel. And a client is free to give informed consent, as defined above, to limit the scope of a representation if the limitation is reasonable in the circumstances. Rule 1.2(c) & Rule 1.2, Cmt. [6A]. But a lawyer is not free to undertake a representation of a client when a counter-party dictates the terms of the lawyer's exercise of independent professional judgment.

CONCLUSION

20. A lawyer may accept appointments as designated counsel for underwriters, lenders or other funding sources involved in a private equity or corporate financing transaction on the recommendation of and paid for by the issuer, borrower or other lead entity from the transaction proceeds if the lawyer concludes the third party will not interfere with the lawyer's independent professional judgment and the lawyer obtains the informed consent confirmed in writing to the representation from the lawyer's client.

(33-19)