Are verein-style law firms ignoring ethics rules regarding fee-splitting?

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The last nine years have witnessed remarkable developments in national, international and global law firm business operation constructs. Among these, since 2004, are a number of Swiss verein structures, which have been adopted by several firms: Hogan Lovells, Baker & McKenzie, DLA Piper, Squire Sanders and Norton Rose Fulbright.

A verein is an association of independent legal entities for specifically defined purposes—generally, marketing and branding in nature. Financial separation and local entity independence of control for each verein member law firm is confirmed in the verein's governing documents, and reaffirmed in dedicated disclaimer and notice sections prominently featured on the website of every verein member, along with the important note that the verein itself does not practice law anywhere.

Verein structures for law firms are growing rapidly in number, and by lawyer headcount. The majority of law firm vereins have been formed since 2008 and already account for more than 20,000 lawyers worldwide.

In this column we are taking a discerning look at law vereins and serious ethical questions in their operation. We intend a more extensive and detailed review of verein structures and ethics rules in the near future.

So how do verein structures function under the U.S.-based rules of professional conduct and ethics with respect to fee-splitting and referral fees when matters move between member firms?

A primary purpose of the verein business model in law firms is to enhance the development of the revenues for the verein firm members through common branding, marketing, joint business development efforts and referral of matters to members from other members. There may be no motivation to be a verein member more important than the expectation of revenue and profit enhancement through referrals. That expectation is essential because, once joining the brand, the new member firm will lose referral opportunities from sources in competition with the brand. There must be a material net gain expectation to warrant joining the club, and the verein should keep track of those gains to quantitatively demonstrate to its members the benefits of membership and to attract new members.

Ethics rules for financial arrangements between lawyers in separate law firms are simple. The ABA Model Rule 1.5(e) is the source for many of the rules adopted by the various states in various iterations. The fee-splitting requirements provide that a division of fees between separate law firms cannot be made unless a) up-front full disclosure is made in writing to the client; b) the client agrees in writing;

and in some states c) the division is in proportion to the actual services rendered, or the firms assume joint responsibility for the representation.

It should be no surprise that, based on conversations with partners in four different vereins, the standard form client engagements do not contemplate fee-splitting or referral fees, and therefore they do not include any of the elements of full client disclosure and written consent, or satisfaction of reasonableness, or proportional sharing/joint responsibility, let alone all three. Most clients do not concern themselves with law firm structures and are unaware of the applicability of the ethical rules. In such circumstances, the only way a referral can be in compliance with the U.S.-based ethics rules is if there is no fee-sharing between verein member firms.

So how does one reconcile the following two conflicts? The first is the fundamental legal separation and requirement of no sharing of revenue or profits that is at the core of the verein governing charter, with the business objective of enhancing revenues and profits for member firms. The second is compliance with the ethics rules as between the independent verein members forwarding business back and forth.

Let's "follow the money," hypothetically. (This analysis is not based upon a specific law verein. It will apply generally to all U.S. law firms referring or receiving business with direct or indirect fee splitting or referral fees as a part of the effort.)

To promote business behaviors, one needs to reward those behaviors, and one must be specific about what that reward will be. Therefore the first step is to identify and keep track of behaviors that lead to revenue, and to measure them on a uniform basis from all member firm partners. A client or business origination metric is likely to be one of the key components, particularly since that metric is already at the heart of most existing law firm compensation structures.

When the verein keeps track of originations and referrals, the first element of a potential rules problem is clearly present. Not because the verein keeps track, but because it then provides the basis for the verein governing board to reward behavior based on those measurements to each constituent law firm member.

The second step is to collect funds from each member firm in an amount sufficient to build a pool of monies to pay all or some portion of the origination reward for partners. That cannot be done on the basis of revenues or profits pursuant to verein charter and most local regulatory requirements. So instead, it is characterized as "costs sharing." From the perspective of income statements, sharing costs rather than revenues still allows the bottom line to be influenced with a comparable result as revenue-sharing. For example, if the combined enterprises earn \$200 in revenue, subtract \$100 in costs and split the profits 70/30, then X gets \$70 and Y gets \$30. The economic result is no different if the \$200 revenue is split 50/50 between the member firms; then the \$100 cost is shared \$30 to X and \$70 to Y. X still gets \$70 and Y gets \$30.

Where the verein anticipates a dues or tithe payment to the common cause (such as branding, marketing, business development), that should be entirely consistent with its purpose and be acceptable.

Where the cost-sharing concept is expanded to include an adjustment to cost-sharing formulae that is discretionary to verein management; that is intended to influence operating results of independent members, thus allowing for individual partner reward; and that is for an amount that is greater than the aforementioned direct costs, it poses an interesting question as to whether it will stand up to close scrutiny. The cost-allocation approach is at risk of not complying with the U.S. ethics rules on fee-splitting and referral fees.

This is so because the third step is for the verein governing board to allocate monies from the cost contribution pool either directly with transfers or through ledger entries to fund the partner rewards. The money has to come from a commingled or unified approach of money allocations taken by the member firms from their partners. It doesn't matter if it is as a revenue, profits or costs adjustment for purposes of the ethics rules. It is consideration for the referral. No mention of an actual referral program actually needs to be made.

The verein business model also comes with a cost of membership. Without a tangible return to a network member, why be part of the network? Think about it in simple terms, such as a partner with $2 million in originations all worked within that verein member firm. We know how that works; it is totally local. Now change that to $2 million in originations all worked by a different verein member firm. If there is no transfer between network members, then all the reward for origination must be funded from within the referring partner's local firm, diluting the contributions of the other local members, reducing their personal incomes and conflicting with all of their interests.

There is another delicate issue here, and that is the reasonableness of the fee charged the client in the referral process. Depending on how the contribution-rebate scheme works, if the receiving firm charges its standard fee and the referring firm gets a fee on top of that, the total fee will always be more than it would have been without the origination credit. If the receiving network member discounted its fee to the client by as much or more than the amount of the referral fee, then it would be reasonable in that definition, but it still has to be disclosed in detail and consented to by the client in advance.

Putting aside the still-fatal problem of no disclosure, even if there is such a discount, does it actually work to help the client? If the referral is from a high-cost venue such as London, New York, Tokyo or Hong Kong, and the work is going to a low-cost venue, will the rate charged in the receiving venue be much less than in the referring venue, but still higher than the local venue rates? What if the rate is normally $800 an hour in New York and charged at $700, but the local venue rate is typically $300? The mechanism now works to actually charge the client, without disclosure, a rate far above what the client might otherwise have paid outside the verein firm structure. Is there a "dues" feature that takes a portion of the rate spread as a contribution to the verein entity or another member based on revenues? That is precisely what the rules are supposed to prevent.

Compliance with the U.S, ethics rules is not optional. Any U.S. firm that has a compensation system rewarding partners for referrals and employing consideration between separate legal entities to enable such rewards must comply with the advance written notice and consent and other requirements. U.S. firms that are part of vereins must apply great care, supervision and discipline to ensure that they are not inadvertently engaged in a business model structured to comply with verein charter rules while ignoring one of the most fundamental ethical proscriptions embraced by virtually every state bar association in the U.S. Let's be real careful out there.

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