NEW YORK STATE BAR ASSOCIATION

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Committee on Professional Ethics

Opinion 595 - 11/2/88 (22-88)

Clarified and Amplified by N.Y. State 621

Topic: Conflict of Interest; Dual Practice as an Abstract Company

Digest: Improper for law firm that represents real estate clients, and that has formed and is a principal in an abstract company, to refer clients to the title abstract company except for purely ministerial title searches.

Code: DR 1-102(A)(2), 2-106(A), 3-101(A), 3-102(A), 3-103(A) 5-101(A), 5-104(A), 5-105(A),(C), EC 2-17, 3-5, 5-2

QUESTIONS

(1) May a law firm that represents clients engaged in real estate matters form a title abstract company and be a principal thereof with one of its real estate clients?

(2) May the law firm refer clients to the newly formed company for title insurance work and the like after full disclosure to and consent of such client is obtained?

OPINION

This inquiry concerns whether there are any ethical prohibitions against a law firm acting as a principal, with one of the firm's clients, in an abstract company. The inquirer's law firm is considering forming a title abstract company with a client who is engaged in the ownership, development, management and other aspects of real estate. The firm represents a substantial number of clients engaged in real estate matters, including but not limited to

the acquisition of, and borrowing secured by mortgages on, real property. It is likely that title insurance work for certain of the firm's clients would be referred to the new abstract company, but only after the firm makes full disclosure to and obtains the consent of those clients.

Abstract companies perform primarily three valuable services: (1) The so-called ministerial act of "abstracting" or title searching through various indexes and records; (2) preparation of a "title report" drawn from a judgmental analysis of the abstract, which report is, in the ordinary case, used as a basis for underwriting title insurance coverage and negotiating "exceptions" to title; and (3) service as a conduit for the purchase of title insurance, which is either sponsored by the abstract company itself or underwritten by a large title insurance company and obtained by the abstract company for the customer as an agent of the title company. Rifkin, "Search and Examination of Title," in N.Y.S.B.A. Real Estate Titles 35-36, 49-50 (Pedowitz ed. 1984).

A. *Legal Issues*

The inquiry raises several issues. We are constrained to point out, however, that as a matter of policy the Committee does not render opinions on questions of law and thus does not opine on whether this proposal violates any statute or regulation. If the proposed arrangement violates any law (*see e.g.*, RESPA, 12 U.S.C. §§ 2601 *et seq.*; N.Y. Insurance Law § 6408, § 6409; N.Y. Judiciary Law § 479), any association with such an illegal scheme would be, perforce, unethical. N.Y. State 576 (1986).

B. *Forming the Abstract Company: Dual Practice and the Solicitation Problem*

We have previously stated that "it is not improper for a lawyer to engage in a business other than the practice of law provided the lawyer does not violate any ethical or legal rules." N.Y. State 583 (1987) (citing N.Y. State 307 (1973)). One of the ethical rules that is directly implicated in this query proposing a dual practice is the prohibition of unlawful solicitation. In N.Y. State 576 (1986), which involved the dual practice of acting as a lawyer and as a title insurance agent, we "reaffirm[ed] and invite[d] attention to this Committee's . . . [opinion] in N.Y. State 556 (1984) that a lawyer may maintain a dual practice, *e.g.*, as a lawyer and an authorized title insurance representative, 'provided that . . . [the lawyer] does not solicit employment in violation of any statute or court rule or accept employment resulting from

unsolicited advice to a prospective client to seek counsel'.'' N.Y. State 576, p.7 n.3 (quoting N.Y. State 556). The same rule applies to a lawyer engaging in a dual practice as a real estate broker, N.Y. State 493 (1978), or as a certified public accountant, N.Y. State 494 (1978). We believe that, insofar as the solicitation problem is concerned, and quite apart from the several ethical problems discussed below, the same rule would apply to the arrangement proposed here.

In addition, DR 3-103(A) of the Code of Professional Responsibility provides: ''A lawyer shall not form a partnership with a non-lawyer if any of the activities of the partnership consist of the practice of law.''* The Code provides further that a lawyer shall not, with exceptions not pertinent here, ''share legal fees with a non-lawyer,'' DR 3-102(A), and ''shall not aid a non-lawyer in the unauthorized practice of law.'' DR 3-101(A). *See* N.Y. State 557 (1984). If the firm's association with the non-lawyer client as principals in the abstract company is otherwise allowed (see discussion below), these three disciplinary rules in Canon 3 must be strictly observed.

We draw upon principles articulated in the opinions sanctioning a lawyer office-space sharing arrangement with a private business to stress additional conditions which must be met. See ABA Inf. 1482 (1982). When structuring the relationship, ''care must be taken to leave no doubt as to when th[e] [lawyer-client] relationship exists and when it does not,'' because the confidences and secrets of the firm's clients must be maintained and kept from the non-lawyer abstract company. ABA Inf. 1482. This means, ordinarily, that steps must be taken to ensure that the firm's clients, as well as the customers of the abstract business, ''discern readily whether their dealings are with one acting as a lawyer or with one acting in a private business capacity.'' ABA Inf. 1482 (Part IIA) (''Care also must be taken to separate legal files from those belonging to the business''). This task may be easier if the firm's location is different from that of the business; extra care must be taken in designing the physical layout of the office, door signs, telephone listings and receptionist contacts if an office-sharing arrangement is contemplated. ABA Inf. 1482; Monroe County 87-1 (1987); Kansas Opinion 85-3 (1985), digested in ABA/BNA Lawyer's Manual on Professional Conduct 801:3820.

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* The issue of whether and to what extent the activity of an abstract company constitutes the practice of law, is a question of law upon which the Committee does not pass. *See*, EC 3-5; ABA Opinion 198 (1939). *See also, Surety Title Insurance Agency, Inc. v. Virginia State Bar*, 431 F. Supp. 298, 307-08 (E.D. Va. 1977), *vacated*, 571 F 2d 205 (4th Cir. 1978), *cert. denied*, 436 U.S. 941 (1978).

Finally, to the extent that the proposal contemplates that clients would be entering into partnership with the law firm to form the abstract company, an additional disciplinary rule is applicable to this proposed transaction: DR 5-104(A) provides as follows:

> A lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise his professional judgment therein for the protection of the client, unless the client has consented after full disclosure.

The burden is on the lawyer to show that there is no overreaching and that the client received full and fair terms for performance of the client's side of the bargain. N.Y. State 550 (1983). The disfavor with which the Code holds lawyer-client business dealings is matched by the very liberal judicial approach to subsequent actions for recision by a client-plaintiff. *See Greene v. Greene*, 56 N.Y.2d 86, 92-93 (1982)(Such transactions are "not advisable").

C. *Referral of Clients to the Abstract Company: The Conflict of Interest Problem*

The proposed arrangement, which contemplates a referral of the firm's real estate clients to the new abstract company, carries with it the substantial danger of a conflict between the interests of the law firm's clients and the business interests of firm members resulting from joint ownership of the abstract company in any transactions in which the law firm represents a customer of the company. EC 5-2. Whether the conflict of interest in any particular proposed real estate transaction is disqualifying under Canon 5 of the Code depends upon the nature of the services performed by the abstract company for its customer. We believe that if the services performed involve the purely ministerial function of title abstraction or title searching and if certain conditions are met, the law firm may refer its clients to the abstract company. If the abstract company will in addition prepare title reports or serve as an agent for the company issuing title insurance for the transaction, however, a prohibited conflict of interest arises disqualifying the law firm from representing the client.

(i) *Abstract Company Performing Ministerial Searching Function*

Because the firm may be naturally expected to recommend to its clients the abstract company in which it is a principal, a referral such as the one proposed here would inhibit the market forces available to the firm's clients or otherwise deny the client knowledge of alternative services. *Moll v. US Life Title Insurance Company of New York*, 654 F. Supp. 1012, 1029 (S.D.N.Y. 1987) ("there are elements affecting consumer choice other than price" which would be ignored if clients "relied on their 'tainted' counsel to select their title insurance company for them"). In N.Y. State 576, we stated that a lawyer has a duty to make these alternatives known to the client to the extent they exist.

The further question arises whether the overall arrangement is entered into for the purpose of originating business for the abstract company in return for a fixed fee, or other remuneration to the abstract company, not geared to services performed by the abstract company. If the arrangement is such a business generating mechanism, we may scrutinize the fee paid to the abstract company by the law firm's clients and conclude that the law firm may have, simply by virtue of its partnership with the abstract company, an impermissible and possibly illegal (*see* RESPA, 12 U.S.C. § 2601 *et seq.*) interest in compensation unrelated to services rendered. As indicated, such an arrangement would be *per se* unethical if illegal. If not illegal, we believe the referral of the client to the abstract company for purely ministerial abstract work is ethically permissible if the firm's clients give an advance, informed consent after full disclosure of the nature of the abstract company's fee structure and the law firm's proprietary interest in the abstract company. DR 5-101(A); N.Y. State 576 p. 10. Indeed, the referral should be accompanied as well with a notice stating the client's entitlement to receive any appropriate credit of a non-service related fee or disbursement related to the abstract company's role in the transaction. *Moll v. US Life Title Ins. Co. of New York*, 654 F. Supp. at 1030 (quoting N.Y. State 576).

(ii) *Abstract Company Preparing a Title Report or Serving as an Agent for the Title Insurance Company*

We believe that, in situations where the abstract company performs service in addition to mere title searching, a prohibited conflict of interest arises that may not be cured by the consent of those concerned with the transaction. Typically this conflict occurs when the lawyer-owned abstract company perpares a title report or serves as an agent for the title underwriter. In either

of these situations, the dual roles are improper because they require a law firm, which as a principal in the abstract company prepares a title report showing exceptions in title and recommending whether a title insurance policy will be issued, to negotiate these issues, as counsel for a party in the underlying transaction, with itself. Furthermore, while we continue to adhere to our views in N.Y. State 576, we believe that the proposed ownership interest in an abstract company sponsoring title insurance goes well beyond the simple agency relationship considered in that opinion. Our conclusion is drawn from our view of the nature of the conflict, and a close reading of our opinions interpreting the Code.*

First, the conflict of interest between the law firm's business interests, and concomitantly its members' personal or financial interests, is crystalline. As stated in N.Y. State 576, "the interests of the client, whether seller, buyer, or mortgagee, and the underwriting interest of the title company inherently conflict on the question of what risks will be insured." The conflict identified becomes far more serious when the interests of a lawyer-owned abstract company, upon which the title insurance company relies, is the protagonist in the conflict of interest inquiry. An abstract company seeks, at the highest profit, to provide the least services (*i.e.*, title work or examination) consistent with good business practices in the trade. On the other hand, the law firm's client, which is often the lender or purchaser in the transaction, requires and seeks greater liability protection at a lower price. Moreover, if the abstract company discovers defects in title, it and the purchaser or lender client have manifestly differing interests in the negotiating process toward which a closing of, or decision not to close, the transaction is made by the parties. Indeed, if the transaction is closed in such a case, and a serious defect in the title is discovered, the law firm's client may wish to learn whether the abstract company in which its lawyers are principals were negligent in the performance of the title search, contrary to the lawyer-owned abstract company's interests in such an event.

Second, our prior interpretations of DR 5-101(A) support the conclusion that the type and kind of conflict posed here is so significant that the provision of consent is inadequate to protect the client interests which converge

* This resolution of the issue renders unnecessary an inquiry into whether the proposal, as it relates to these two abstract company functions, seeks to use the device of a separate company in which the lawyer has a proprietary interest to defeat the requirement in DR 2-106(A) and EC 2-17 that a reasonable service-related fee not clearly excessive be charged. DR 1-102(A)(2). Were we to view the conflict differently, we would scrutinize the fees charged by the law firm and the abstract company in the same manner as described in Part B, above, and in N.Y. State 576.

with the law firm's business as an abstract company. Our opinions recognize that, notwithstanding the lack of an express limitation in DR 5-101(A) of the range of consentable conflicts, the "obviousness" test of DR 5-105(C) or the "substantial probability" test of EC 5-2 should be imported into DR 5-101(A) situations. N.Y. State 516 (1980) (reading DR 5-105(C) as limiting the range of permissible DR 5-101(A) conflicts); N.Y. State 208 (1971) (reading EC 5-2 as limiting the range of consentable conflicts). These opinions are supported by the Comment to ABA Model Rule 1.7 which states:

> Rule 1.7 clarifies DR 5-105(A) by requiring that, when the lawyer's other interests are involved, not only must the client consent after consultation but also that, independent of such consent, the representation reasonably appears not to be adversely affected by the lawyer's *other interests*. This requirement appears to be the intended meaning of the provision in DR 5-105(C) that "it is obvious that he can adequately represent" the client, and was implicit in EC 5-2, which stated that a lawyer "should not accept proffered employment if his personal interests or desires will, or there is a reasonable probability that they will, affect adversely the advice to be given or services to be rendered the prospective client." (Emphasis supplied.) ABA Model Rules of Professional Conduct, MR 1.7 Comment (Code Comparison). *

Therefore, if there was intended by the drafters of the Code to be any more or less deference given to client consent to conflicts arising from the personal or business interests of the lawyer, it is in the difference between the "reasonable probability" standard of EC 5-2 and the "obviousness" test of DR 5-105(C).

In any event, and unlike the situation posed by N.Y. State 576, we do not believe that application of either test would fairly lead to the conclusion that a law firm acting as a principal in an abstract company to which it has referred real estate clients may adequately represent those clients in the same transaction. The simple conflict presented in N.Y. State 576 by the situation in which the lawyer searches title for the real estate client and also as an agent of a title company provides less reason to believe that the lawyer's personal and financial interests will uncompromisingly impinge his or her representation of the client or that the resulting "dual representation" may not be

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* The Model Rules have not been adopted in New York. We believe, however, that the Comment fairly reflects the same concerns expressed herein.

reconciled by full disclosure to the parties together with procurement of a meaningful consent to proceed. In constrast, we are convinced that the dynamics of a real estate transaction in which the abstract company proposed here is a protagonist provides far too great a danger, indeed more than a "reasonable probability," that the representation of the client will be affected adversely. EC 5-2.

While our prior opinions do not suggest a clear line of demarcation between those personal or financial interests that are curable by consent and those that are so substantial that client consent would be ineffective to cure the conflict, those opinions do support our conclusion in this case. In N.Y. State 208 (1971), we stated that a lawyer for a real estate client who is also a real estate broker may not act in both capacities in the same transaction. We reasoned that the "reasonable probability" test of EC 5-2 defeated any claim that the client may consent to the conflict presented by the lawyer's own personal interest.

In addition, in N.Y. State 516 (1980), we were of the opinion that a lawyer employed full time by a life insurance company to prepare estate plans for its customers may not prepare and supervise the execution of a will implementing the estate plan the lawyer has devised. In view of the difficulty a full time insurance company employee would be expected to experience in "exercising independent professional judgment in devising estate plans" for insurance customers, we held: "The possibility that the lawyer might also undertake to draft wills implementing those plans passes beyond the level of a reasonable risk that the attorney's advice will be free from conflict." N.Y. State 516.

The Committee perceives no functional difference between the lawyer's position in the two described opinions and the law firm's proposed position as an abstract company principal in this inquiry when the services of the abstract company go beyond the purely ministerial function of title searching or abstraction. Indeed, it might be successfully argued that the law firm's status as a principal in the company provides a far greater degree of risk that its business interests will intrude on the representation of a client than the simple, but yet prohibitive, employee relationship in N.Y. State 516. By constrast, our recent opinion in N.Y. State 583 (1987) did not involve, absent special circumstances not divulged by the inquirer, a personal or business interest which would probably intrude on the attorney client relationship. *See also*, N.Y. State 536 (1981) (financial planning business).

CONCLUSION

For the reasons stated, the first question is answered, subject to the qualifications stated above, in the affirmative. The second question is answered, subject to qualifications, in the affirmative if the abstract company simply abstracts title. If the abstract company prepares a title report or serves as an agent for the procurement of title insurance, the second question is answered in the negative.