THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK
COMMITTEE ON PROFESSIONAL ETHICS

Formal Opinion 2015-1: ETHICAL GUIDANCE FOR LAW FIRMS CONSIDERING THE USE OF A PROFESSIONAL EMPLOYER ORGANIZATION

TOPIC: Use by a law firm of a Professional Employer Organization.

DIGEST: A New York law firm is ethically permitted to use the services of a professional employer organization ("PEO"), as long as the law firm: (1) does not allow the PEO to interfere with the lawyers' ethical obligations to exercise independent professional judgment or to supervise other lawyers and nonlawyers; (2) does not allow the PEO to access confidential information relating to the firm's clients; (3) complies with the obligation to avoid conflicts of interest; and (4) does not compensate the PEO in a manner that violates prohibitions against sharing fees with nonlawyers.

A New York lawyer may need to consider additional issues, such as whether the arrangement with the PEO complies with relevant substantive laws and the professional conduct rules of other jurisdictions. These additional issues fall outside the jurisdiction of the Committee on Professional Ethics (the "Committee"), which is limited to interpreting the New York Rules of Professional Conduct (the "New York Rules" or "Rules").

RULES: 1.6, 1.7, 1.8, 1.9, 1.10, 2.1, 5.1, 5.2, 5.3, and 5.4

QUESTION: Is a New York law firm permitted to use a professional employer organization?

OPINION:

I. INTRODUCTION

PEOs help small businesses provide employment benefits and human resource services to their employees. PEOs create "economies of scale," allowing companies to offer benefits at lower cost, and in some instances, to provide benefits that law firms could not provide without the PEO relationship. *See* Barry L. Salkin, *Who's The Boss? New York Defines Roles in the Professional Employer Organization Act*, New York State Bar Journal (July/August 2005), 77 AUG N.Y. St. B.J. 34. In addition, PEOs free businesses to focus on their core missions by transferring administrative functions to the PEO. Although designed to address the needs of small businesses (a category into which many New York law firms fall), PEOs were not specifically constituted with the distinctive professional responsibilities of attorneys in mind. The concern for New York lawyers is whether using a PEO is consistent with a lawyer's ethical obligations under the New York Rules, including the duties to maintain professional independence, supervise lawyers and nonlawyers at the firm, preserve confidential information, avoid conflicts of interest, and not share legal fees with nonlawyers. This opinion provides guidance for New York lawyers on utilizing PEOs in conformity with the New York Rules.

II. OVERVIEW OF PROFESSIONAL EMPLOYER ORGANIZATIONS

PEOs typically offer their clients a range of human resource management functions, including payroll, employee training, attendance and time-keeping, employment taxes, health and life insurance benefits, retirement plans, and workers' compensation claims. *See* Nicole Fallon, *Considering Employee Leasing? What You Need to Know About Using a PEO*, Business News Daily (Apr. 1, 2014). According to the National Association of Professional Employer Organizations ("NAPEO"), a "PEO relationship involves a contractual allocation and sharing of employer responsibilities between the PEO and the client." *What is a PEO?* http://www.napeo.org/peoindustry/coemployers.cfm (last visited Nov. 8, 2014) [hereinafter, Napeo.org].[1] This arrangement is referred to as a "co-employment" relationship. *Id.* Generally, the client "directs and controls worksite employees in manufacturing, production, and delivery of its products and services." *Id.* However, the PEO must exercise some control over the employees in order to qualify as a co-employer. Thus, the PEO generally "directs and controls worksite employees in matters involving human resources management and compliance with employment laws." *Id.* The PEO also retains a right to hire, reassign and terminate employees. *See* Napeo.org, *supra; see also* Salkin, *supra*. PEOs use a variety of different pricing models, such as a flat fee for packaged services, a fee per employee or per service, or a fee based on a percentage of overall payroll. *See* Fallon, *supra*.

III. THE STATUTORY FRAMEWORK

New York and other states have adopted statutes governing PEOs. The New York Professional Employer Organization Act has been codified as Article 31 of the New York Labor Law, §§ 915, *et seq.* ("NYPEO Act"). The statute defines a PEO as a business that enters into a written contract with a client to "co-employ all or a majority of the employees providing services for the client" on an "on-going rather than temporary" basis (the "PEO Agreement"). NYPEO Act § 916(3). The NYPEO Act requires that the PEO agreement expressly allocate between the PEO and the client "[e]mployer responsibilities for worksite employees, including those of hiring, firing and disciplining" employees. *Id.* In addition, the PEO Agreement must provide that the PEO:

> (i) *reserves a right of direction and control over the worksite employees. However, the client shall maintain such direction and control over the worksite employees as is necessary to conduct the client's business and without which the client would be unable to conduct its business, discharge any fiduciary responsibility which it may have, or comply with any applicable licensure*;
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> (ii) assumes responsibility for the withholding and remittance of payroll-related taxes and employee benefits for worksite employees and for which the professional employer organization has contractually assumed responsibility from its own accounts, as

[1] NAPEO is a national trade association for the PEO industry.

long as the professional employer agreement between the client and professional employer organization remains in force; and

(iii) *retains authority to hire, terminate, and discipline the worksite employees*.

NYPEO Act § 922(a) (emphasis added).

IV. ANALYSIS

The legal ethics of using a PEO is a question of first impression in New York. However, Ethics Committees in several other jurisdictions have addressed this issue and their opinions are instructive. In 2002, for example, the Connecticut Bar Association concluded that "there is no *per se* violation of the rules in having a PEO 'lease' employees, including lawyers, to a law firm so long as it is clear that the PEO will not interfere with the professional judgment of the lawyers involved and the firm and the individual lawyers will take steps to protect client confidences." Connecticut Bar Ass'n Prof. Ethics Committee, Informal Op. 2002-08 (2002) ("Use of Professional Employer Organizations").

The District of Columbia Bar Association approved the use of PEOs, provided the law firm maintains authority "over the hiring or firing of lawyers or legal assistants" and "the provision of legal services by any employee of the law firm." District of Columbia Bar Eth. Op. ("D.C. Eth. Op.") 304 (2001). The D.C. Bar analogized the use of PEOs to the hiring of temporary lawyers, which the Committee had endorsed in a previous opinion, as long as the hiring firm ensured that the temporary lawyers complied with "the ethical obligations of competence, independent professional judgment, undivided loyalty, and preservation of a client's confidences and secrets." *Id.* (quoting D.C. Eth. Op. 284 (1998)). Opinion 304 also relied on opinions from outside D.C., which "approved similar arrangements, subject to the limitation that the lawyer-owner(s) of the firm, rather than the employee management agency, maintain exclusive control over hiring, firing, and other aspects of the lawyer's employment." *Id.* (citing Ill. Op. 90-23 (1991); Mich. Informal Op. RI-310 (1998); Mo. Informal Op. 990019; N.C. Op. RPC 104 (1991); N.J. Op. 631 (1989)).

D.C. Eth. Op. 304 expressed concern that "some PEOs adhere to published standards of a trade organization known as the Employer Services Assurance Corporation ('ESAC')," which require "that a PEO share with the 'client' (i.e., the law firm), and in some instances exercise exclusively, the power to hire and fire employees (who here would include lawyers and legal assistants as well as clerical and secretarial staff), that the PEO have at least a shared right to direct and control the work of the employees, and that ESAC have access to client (i.e., law firm) work sites and records." *Id.* Complying with those standards would compromise the lawyers' duties to exercise independent judgment on behalf of clients, maintain client confidences and secrets, act zealously on behalf of clients, avoid conflicts and supervise the conduct of those working for the firm, the Committee explained.

Both Connecticut and D.C based their analysis, in part, on prior opinions permitting the use of temporary lawyers or outsourcing. And, indeed, the use of PEOs raises many similar ethical issues. This Committee previously addressed the ethics of outsourcing, stating:

> A New York lawyer may ethically outsource legal support services overseas to a non-lawyer, if the New York lawyer (a) rigorously supervises the non-lawyer, so as to avoid aiding the non-lawyer, in the unauthorized practice of law and to ensure that the non-lawyer's work contributes to the lawyer's competent representation of the client; (b) preserves the client's confidences and secrets when outsourcing; (c) avoids conflicts of interest when outsourcing; (d) bills for outsourcing appropriately; and (e) when necessary, obtains advance client consent to outsourcing.

N.Y. City Bar Ass'n Formal Ethics Opinion ("NYCBA Formal Op.") 2006-03 (2006); *see also* NYCBA Formal Ops. 1989-2 and 1988-3 (discussing the use of temporary lawyers). However, the analogy to temporary attorneys and outsourcing – while helpful – is imperfect. For one thing, the NYPEO Act expressly precludes PEOs from providing temporary employees. Unlike temporary employees, who generally work on discrete, short-term projects – often away from the client's office – PEO employees are permanent employees, who are more likely to work full-time, on-site, and are more integrated with the client's daily operations. As Napeo.org explains "a temporary staffing service recruits and hires employees and assigns them to clients to support or supplement the client's workforce in special work situations, such as employee absences, temporary skill shortages or seasonal workloads." By contrast, "PEOs do not supply labor to worksites. They *co-employ existing permanent workforces and provide services and benefits to both the worksite employer and the employees*." Napeo.org (emphasis added).

With this background, we consider the ethical issues in the use of PEOs, which we have identified as: (1) exercising independent professional judgment and supervising employees; (2) preserving client confidences; (3) avoiding conflicts of interest; and (4) avoiding improper fee sharing.

A. The Duty to Exercise Independent Professional Judgment and Supervise Employees

The duty to exercise professional independence is a core value of the legal profession. This value is reflected in multiple provisions of the New York Rules. *See, e.g.*, Rule 1.8(f) (prohibiting "interference with [a] lawyer's independent professional judgment"); Rule 2.1 (requiring a lawyer to "exercise independent professional judgment" in "representing a client"); Rule 5.4(c) (prohibiting a lawyer from allowing a third party "to direct or regulate the lawyer's professional judgment in rendering … legal services"); Rule 5.4(d)(3) (prohibiting a lawyer from allowing a nonlawyer to "direct or control the professional judgment of a lawyer"). Accordingly, a PEO must not be allowed to influence decisions that would impact the lawyer's ability to provide independent professional judgment to his or her clients.

Law firms, partners, managers and supervisory lawyers are also ethically required to supervise the conduct of other lawyers and non-lawyers at the firm. *See, e.g.*, Rule 5.1 (Responsibilities of Law Firms, Partners, Managers and Supervisory Lawyers), Rule 5.2 (Responsibilities of the Subordinate Lawyer"), and Rule 5.3 (Lawyer's Responsibility for Conduct of Nonlawyers). Thus, an agreement with a PEO must be tailored so that the PEO does not have the authority to hire, terminate, or discipline employees or otherwise have control over

law firm employees in connection with any aspect of the practice of law. Such an arrangement would interfere with the law firm's supervisory obligations.

A critical question is whether the requirements of the NYPEO Act conflict with a lawyer's obligations of professional independence and supervision. As noted above, the NYPEO Act requires a PEO Agreement to state that the PEO "reserves a right of direction and control over the worksite employees." N.Y. Lab. Law § 922(1)(a)(i). The PEO Agreement must also state that the PEO "retains authority to hire, terminate and discipline the worksite employees." N.Y. Lab. Law § 922(1)(a)(iii). On the other hand, the PEO Act contains a carve-out, which states: "the client shall maintain such direction and control over the worksite employees as is necessary to conduct the client's business and without which the client would be unable to conduct its business, discharge any fiduciary responsibility which it may have, or comply with any applicable licensure." N.Y. Lab. Law § 922(1)(a)(i). It is unclear, however, whether this carve-out applies only to Section 922(1)(a)(i) or to other provisions of the Act, including Section 922(1)(a)(iii). To our knowledge, no New York courts have interpreted the carve-out provision contained in Section 922(1)(a)(i). Assuming the NYPEO Act allows law firms to retain the authority to hire, terminate, and discipline employees, then we believe a PEO Agreement could be constructed that would permit New York lawyers to comply with their ethical duties of independence and supervision.[2] At a minimum, the PEO must not have the authority to hire, terminate, discipline, or otherwise control employees in connection with any aspect of the practice of law.

B. The Duty to Preserve Confidential Information

Rule 1.6 requires a lawyer to preserve confidential information belonging to a client and to "exercise reasonable care to prevent the lawyer's employees, associates, and others whose services are utilized by the lawyer from disclosing or using confidential information of a client," absent an exception. Additionally, under Rule 5.1, law firms, their partners, managers and supervisory lawyers are required to make reasonable efforts to ensure that lawyers working through the PEO do not share with the PEO confidential information of the law firm's clients. *See* Rule 5.1 (providing that law firms and its supervisory personnel "make reasonable efforts to ensure that the supervised lawyer conforms to these Rules"). To comply with these rules, PEO arrangements with law firms must include reasonable safeguards to prevent confidential information belonging to the firm's clients from being shared with the PEO. Any PEO Agreement with a law firm should make clear that the PEO has no right to access client confidential information. In addition, the law firm should instruct lawyers and nonlawyers not to share client confidences with the PEO.

This conclusion is consistent with New York State Bar opinions, which have permitted the use of outside vendors, provided "reasonable safeguards exist" to protect confidential information. N.Y. State Eth. Op. 95 (1969) (approving the use of an outside data processor); *see also* N.Y. State Eth. Op. 934 (2012) n. 3, ("[t]he opinions of this committee have long recognized that a law firm may employ outside service providers).

[2] This Committee does not have jurisdiction to interpret the NYPEO Act or any other statute. If our assumptions turn out to be incorrect, that could change the conclusions in this Opinion.

C. The Duty to Identify and Avoid Conflicts of Interest

Lawyers and law firms have an obligation to avoid conflicts of interest arising from current or former client relationships. *See* Rules 1.7, 1.9, and 1.10. They also have a duty to implement an effective conflict checking system. *See* Rule 1.10(e). Given the PEO business model, it is foreseeable that a single PEO would enter into PEO Agreements with multiple law firms. Those law firms, in turn, may have clients that are adverse to one another. It is also conceivable for a PEO to employ the same individual at multiple law firms. In these scenarios, what are the law firm's ethical obligations with respect to conflicts of interest?

The use of a PEO does not alter the law firm's duty to ensure that its legal personnel are free of disqualifying conflicts. Accordingly, PEO employees should be subject to the same conflict-checking procedures that would be appropriate for employees hired directly by the law firm. We conclude, however, that there is no obligation to subject the PEO itself to conflict-checking procedures. As long as the PEO is not interfering with the lawyers' professional independence, controlling or supervising employees, or accessing confidential information, we believe there is no ethical prohibition against the PEO providing similar administrative services to other law firms that represent adverse clients.

The Connecticut Bar reached a similar conclusion, stating that adverse representations of PEO employees who do not work for the law firm do not create conflicts as long as: (1) the PEO has no control over "the professional judgment of the lawyers it 'employs'; (2) the employee lawyers adhere to their obligations to avoid conflicts and protect client confidences, and (3) the law firm "is free to and actually does exercise its supervisory responsibilities." Connecticut Bar Ass'n Prof. Ethics Committee, Informal Op. 2002-08; *see also* South Carolina Bar Ethics Advisory Committee 91-09 (1991).

D. The Prohibition Against Sharing Fees with Nonlawyers

Lawyers are prohibited from sharing legal fees with nonlawyers, except in limited circumstances that do not apply here. *See* Rule 5.4(a).[3] Thus, any payment arrangement with a PEO must be structured so it complies with the rule against fee-sharing. Based on our research, we understand that PEOs typically charge their clients a fee based upon a percentage of total payroll (although other payment arrangements are sometimes used, such as flat fees or fees per employee or service). Factors that contribute to setting the fee include employee turnover rate, riskiness of the industry, and types of services provided by the PEO (e.g., health insurance, workers' compensation insurance, federal and state unemployment benefits, and payroll services).

In an opinion addressing payments to PEOs, the North Carolina State Bar approved the payment of a fee calculated as a percentage of payroll costs. *See* North Carolina State Bar Formal Ethics Opinion 6 (2003) ("Contracting with Professional Employer Organization to Handle Human Resources, Payroll, and Other Functions for Law Firms"). Basing the PEO's compensation on the amount charged to the client, however, would be an impermissible sharing of a fee with a non-lawyer, according to the opinion. *See id.*; *see also* Michigan State Bar

[3] Fee-sharing with nonlawyers is also prohibited by N.Y. Judiciary Law Section 491(1).

Opinion RI-310 (fee paid to leasing company for services of a leased attorney may be billed as a flat rate or an hourly charge, as long as the fee is not based on the amount charged the client).

New York State Bar ethics opinions permit the payment of fees to nonlegal service providers, so long as they are not calculated based on legal fees. Compare N.Y. State Eth. Op. 733 (2000) (lawyer may not pay nonlawyer a commission based on percentage of fees attributable to client matters referred by nonlawyer) and N.Y. State Eth. Op. 565 (1984) (lawyer may not pay marketing company a commission based on fees earned from clients introduced by the marketing company), with N.Y. State Eth. Op. 917 (2012) (lawyer may pay bonus to marketer for advertising services if bonus is not based on fees paid by clients).

In our opinion, a law firm is ethically permitted to compensate a PEO based a percentage of total payroll, flat fee, or fee per employee or service. As long as these payment arrangements are not based on the fees paid by the law firm's clients, they do not violate Rule 5.4(a)'s prohibition against fee-sharing.

V. CONCLUSION

A law firm is ethically permitted to use the services of a PEO, provided the law firm: (1) does not allow the PEO to interfere with the lawyers' ethical obligations to exercise independent professional judgment or supervise other lawyers and nonlawyers at the firm; (2) does not allow the PEO to access confidential information belonging to the firm's clients; (3) complies with the obligation to avoid conflicts of interest; and (4) does not compensate the PEO in a manner that violates prohibitions against sharing fees with nonlawyers.