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Financing Arrangements Between a Lawyer and Litigation Funder Contingent on Recovery of Legal Fees Violates Prohibition on Fee Sharing with Non-Lawyers in New York Rules of Professional Conduct Rule 5.4(a)

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New York City Bar Association, Professional Ethics Committee, Formal Opinion 2018-5: Litigation Funders' Contingent Interest in Legal Fees (July 30, 2018)

Brief Summary

Litigation funders extend financing to lawyers the repayment of which is contingent upon the lawyer's receipt of legal fees or on the amount of legal fees received. The New York City Bar Association's Professional Ethics Committee ("Committee") concluded that such an agreement with a litigation funder, a non-lawyer, violates New York Rule of Professional Conduct 5.4(a)'s prohibition on fee sharing with non-lawyers.

Complete Summary

Litigation funders extend financing to lawyers and/or their clients to pay litigation expenses during the pendency of the action or prior to receiving settlement proceeds. Such agreements are generally non-recourse with any recovery to the funder contingent upon the outcome of the underlying litigation. As the Committee noted, the litigation financing industry, and the number of lawyers and clients benefiting from litigation funding, "has increased substantially over the last several years."

The opinion addresses only litigation funding arrangements between a funder and lawyer. Prior opinions of the Committee and other ethics committees have found that client-funder agreements do not implicate the fee sharing prohibition of Rule 5.4(a) because the lawyer is not a party to the agreement, and payments are made by the client out of the client's recovery, not the lawyer's fee. *See* NYCBA Formal Op. 2011-2 (2011); NYSBA Ethics Op. 666 (1994).

<u>Rule 5.4(a): The Rule Against Fee-Sharing with Non-Lawyers</u>

Titled "Professional Independence of a Lawyer," New York Rule of Professional Conduct 5.4(a) provides that "[a] lawyer or law firm shall not share legal fees with a non-lawyer." The purpose of the rule is to remove incentives for non-

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lawyers to interfere with the professional judgment of the lawyer on legal matters or to engage in other objectionable conduct, such as using dishonest or illegal methods to win cases or encouraging or pressuring a lawyer to use such improper methods.

The fee-sharing restriction is longstanding and has generally been interpreted to forbid business arrangements in which lawyers agree to make payments to non-lawyers based on received legal fees. The opinions conclude that a lawyer may not (i) pay a landlord a percentage of the firm's revenues as office rent; (ii) compensate a marketing agency based upon the volume of business developed; or (iii) pay a private investigator in part based upon the success of litigation.

Rule 5.4(a) and Litigation Funding

Having established that Rule 5.4(a) has long been understood to apply to business arrangements in which lawyers' payments to non-lawyers are tied to legal fees, the Committee saw no reason why Rule 5.4(a) would not prohibit a financing arrangement where the lawyer will make future payments only if the lawyer recovers fees, or where payment is contingent on the amount of legal fees earned or recovered. Such an arrangement constitutes an impermissible fee-sharing arrangement. Further, Rule 5.4(a) is applicable whether the payments to the funder are based upon recovery of legal fees in a single matter or in multiple matters—such as a portfolio of similar lawsuits. The bottom line was that "[r] ightly or wrongly, the rule presupposes that when non-lawyers have a stake in legal fees from particular matters, they have an incentive or ability to improperly influence the lawyer."

Consequently, the fee sharing rule forbids two alternative funding arrangements: "first, where an entity's funding is not secured other than by the lawyer's fee in one or more lawsuits, so that it is implicit that the lawyer will pay the funder only if the lawyer receives legal fees in the matter or matters; and second, where a lawyer and funder agree, whether in a recourse or non-recourse arrangement, that instead of a fixed amount or fixed rate of interest, the amount of the lawyer's payment will depend on the amount of the lawyer's fees."

Rule 5.4(a), however, does not forbid a traditional recourse loan "requiring the lawyer to repay the loan at a fixed rate of interest regardless of the outcome of, or the lawyer's receipt of a fee in, any particular lawsuit or lawsuits." This includes funding arrangements in which the lawyer's debt obligation is secured by current or future account receivables but not contingent upon the lawyer's receipt of such receivables. Moreover, where legal fees have been earned but not yet been paid, compensating a collections agency based upon a percentage of recovery does not run afoul of Rule 5.4(a). *See* NYSBA Ethics Op. 608 (1975).

Conflicting Case Law

The opinion is in conflict with two earlier New York Supreme Court cases, both rejecting Rule 5.4 as a defense to enforcement litigation funding agreements. *See Hamilton Capital VII, LLC v. Khorrami, LLP*, 48 Misc.3de 1223(a), 22 N.Y. S.3d 137 (Sup.Ct. N.Y.Cty. 2015); *Lawsuit Funding LLC v. Lessoff*, 2013 N.Y.Misc.LEXIS 5685, 2013 NY Slip Op. 33066(U) (Sup.Ct. N.Y.Cty. Dec. 4, 2013). In enforcing the litigation financing agreements at issue, each court recognized the benefits of allowing "lawsuits to be decided on their merits, and not based on which party has the deeper pockets or stronger appetite for protracted litigation."

In *Lawsuit Funding LLC*, the law firm defendants entered into a litigation financing agreement entitled "Sale of Contingent Proceeds Agreement," whereby the litigation funder was to receive a portion of the contingent legal fees if five specially named lawsuits were adjudicated in favor of defendants' clients. Defendants failed to pay and the litigation funder sought to enforce the agreement in arbitration. The parties settled the arbitration, providing for re-payment based upon legal fees defendants expected to receive in eight named lawsuits and a percentage of legal fees received from unrelated cases.

After defaulting a second time, the litigation funder commenced an action; defendants raised Rule 5.4, among other defenses, to enforcement. The court disagreed, relying upon an earlier Delaware case that concluded that "there was no real "ethical" difference whether a security interest is in contract rights (fees not yet earned) or accounts receivable (fees earned) in so far as Rule of Professional Conduct 5.4 . . . is concerned."

Similarly, in *Hamilton Capital VII, LLC*, the funding challenged was line of credit that entitled the litigation funder to a percentage of the law firm's gross revenue in consideration of money loaned to the firm. The court, citing *Lawsuit Funding LLC* and *PNC Bank, Delaware*, enforced the agreement over defendants' Rule 5.4 defense, reasoning that "[p]ermitting investors to fund firms by lending money secured by the firm's accounts receivable helps provide victims their day in court. This laudable goal would be undermined if the [funding agreement] were held to be unenforceable."

Significance of Opinion

Litigation funding has been embraced by law firms of all sizes. Sources in early 2018 estimated that it represents a $5 billion market in the U.S. alone. Despite arriving at a contrary conclusion to *Lawsuit Funding LLC* and *Hamilton Capital VII, LLC*, the Committee cited similar public policy grounds for the enforcement of funding arrangement:

> "[w]ithout litigation funding, some lawsuits arguably could not be filed or maintained. In this respect, litigation funding may expand access to the courts to litigants who would otherwise be financially unable to pursue their legitimate claims. Litigation funding may also advance fairness by leveling the dispute-resolution field between parties with deep pockets and those with limited resources.

Yet, even in the face of the benefits of litigation funding, these arrangements have been under increasing scrutiny by ethics committees and the courts. (*see* Client Alert: "In Permitting the New York AG Case Alleging Consumer Law Violations by Litigation Financier to Proceed, Court Comments on Distinctions in Litigation Funding Arrangements," July 3, 2018). While an ethics opinion is not binding upon the courts, and has been criticized, it will be interesting to see if, and how, the Committee's opinion will influence future court decisions and impact litigation funding arrangements in New York.

NOTE: This topic was also addressed by Anthony Davis in a recent *New York Law Journal* column titled "New Ethics Opinion on Litigation Funding Gets it Wrong."

Such arrangements between funder and client may raise other risks such a compromising confidentiality, possible waivers of attorney-client privilege, and impacting a lawyer's exercise of independent judgment. *See* NYCBA Formal Op. 2011-2. The Committee noted that several other states have reached the same conclusion with respect to litigation funding, citing opinions in Maine, Nevada, Utah and Virginia.

See Lawsuit Funding LLC, 2013 N.Y.Misc.LEXIS 5685 at *6 (citing ABA Comm. on Ethics 20/20, *Informational Report of the House of Delegates*, Feb. 2012).

PNC Bank, Delaware v. Berg, 1997 Del. Super.LEXIS 19 (Del.Super.Ct. 1997).