

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

FORMAL OPINION 2011 – 2

THIRD PARTY LITIGATION FINANCING

TOPIC: Third-party litigation financing

DIGEST: It is not unethical *per se* for a lawyer to represent a client who enters into a non-recourse litigation financing arrangement with a third party lender. Nevertheless, when clients contemplate or enter into such arrangements, lawyers must be cognizant of the various ethical issues that may arise and should advise clients accordingly. The issues may include the compromise of confidentiality and waiver of attorney-client privilege, and the potential impact on a lawyer's exercise of independent judgment.

RULES: 1.2(d); 1.6(a); 1.7(a); 1.8(e), (f); 2.1; 2.2; 5.4(c)

QUESTION: What ethical issues may arise when a lawyer represents a client who is contemplating or has entered into a non-recourse litigation financing agreement?

OPINION

I. Background

Third party litigation financing first emerged as an industry in the United States in the early 1990s, when a handful of small lenders began providing cash advances to plaintiffs involved in contingency fee litigation. Within a decade, as many as one hundred companies were offering financing to lawyers, their clients, or both.¹ As of 2011, this industry has continued to grow, both as to the number and types of lawsuits financed and financing provided. The aggregate amount of litigation financing outstanding is estimated to exceed \$1 billion.²

This opinion addresses non-recourse litigation loans, *i.e.*, financing repaid by a litigant only in the event he or she settles the case or is awarded a judgment upon completion of the litigation. Under these arrangements, financing companies advance funds that will be reimbursed, if at all, solely from any proceeds of the lawsuit. As compensation, the financing companies are entitled to receive specified fees, often calculated as a percentage of any settlement or judgment.

¹ See Terry Carter, *Cash Up Front: New Funding Sources Ease Strains on Plaintiffs Lawyers*, ABA JOURNAL 34-36 (Oct. 8, 2004), available at http://abajournal.com/magazine/article/cash_up_front/.

² See Binyamin Appelbaum, *Investors Put Money on Lawsuits to Get Payouts*, NEW YORK TIMES (Nov. 14, 2010), available at <http://www.nytimes.com/2010/11/15/business/15lawsuit.html>.

Non-recourse loans are extended most often to plaintiffs in personal injury cases. These loans may be used to pay the costs of litigation, but also may be used to cover the plaintiff's living expenses during the pendency of the lawsuit.

Non-recourse financing of commercial claims is a more recent development, although it has become increasingly common.³ The providers of this financing typically undertake an analysis of the merits of the contemplated claim that is more rigorous than the analysis employed in personal injury cases. If the claim appears meritorious, the financing company will advance amounts to cover attorneys fees and the other costs of the litigation.⁴ These advances typically are made to the claimant or its outside litigation counsel, in return for a percentage of any eventual recovery.

The growing use of non-recourse litigation financing recently has attracted increasing attention, both within and outside the legal profession,⁵ in part because the arrangements are largely unregulated, and, in the view of some critics, may require the payment of relatively exorbitant financing fees that appear usurious, create the potential for expanding the volume of litigation, and raise the specter of reviving the historically reviled practice of champerty, defined broadly as the support of litigation by a stranger in return for a share of the proceeds.

From the legal ethics perspective, perhaps the greatest concern stems from a financing company's involvement in the details of a claimant's case. Because a financing company's decision to fund will hinge on the company's analysis of the merits of the lawsuit, *i.e.*, the likelihood and size of the expected return, the availability of financing necessarily depends on the company's ability to obtain access to information relevant to its assessment of risks of its investment, both before and after a decision to fund has been made. As part of this process, a financing company may contact the claimant's lawyer to obtain confidential and privileged information regarding the case before making any loan commitment. And even after funding has been provided, the financing agreements may require litigation counsel to periodically update the financing company with developments in the case and/or provide the company with direct access to the claimant's file.

³ See Holly E. Loiseau, Eric C. Lyttle, and Brianna N. Benfield, *Third-Party Financing of Commercial Litigation*, ABA IN-HOUSE LITIGATOR (2010), http://www.weil.com/files/Publication/17c770d9-514d-426d-aalf-bbc4c7547c0c/Presentation/PublicationAttachment/cacabd85-lea5-46ac-8657-40ffd9eac8be/IHL_2010_ThirdPartyFinance.pdf.

⁴ See Louis M. Solomon, *Third-Party Litigation Financing: It's Time to Let Clients Choose*, N.Y.L.J. (Sept. 13, 2010).

⁵ For articles (in addition to those cited elsewhere herein), *see, e.g.*, Steven Garber, *Alternative Litigation Funding in the United States: Issues, Knowns and Unknowns* (Rand Corp. 2010); Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 Fordham J. Corp. & Fin. L. 55 (2004); Douglas R. Richmond, *Other People's Money: The Ethics of Litigation Funding*, 56 Mercer L. Rev. 649 (Winter 2005); Julie H. McLaughlin, *Litigation Funding: Charting a Legal and Ethical Course*, Vermont Law Review, Vol. 31, No. 3 615-662 (Spring 2007). For ethics opinions, *see, e.g.*, N.Y. State 666 (1994); Utah State Bar Op. 97-11(1997); State Bar of Mich. Op. RI-321 (2000); FL. Bar Op. 00-3 (2002); Virginia Legal Ethics Op. 1764 (2002); N.Y. State 769 (2003); State Bar of Nevada Standing Comm. On Prof'l. Responsibility, Formal Op. 29 (2003).

Providing financing companies access to client information not only raises concerns regarding a lawyer's ethical obligation to preserve client confidences, it also may interfere with the unfettered discharge of the duty to avoid third party interference with the exercise of independent professional judgment. While litigation financing companies typically represent that they will not attempt to interfere with a lawyer's conduct of the litigation, their financial interest in the outcome of the case may, as a practical matter, make it difficult for them to refrain from seeking to influence how the case will be handled by litigation counsel.

II. Analysis

Against this backdrop, we discuss below the ethical issues potentially implicated by non-recourse financing arrangements and examine how lawyers may properly address these issues as they arise.

A. Legality of the Agreement

Whether a particular financing arrangement comports with the law will depend on its terms and governing law, matters outside the scope of this opinion. Nevertheless, under Rule 1.2(d) of the New York Rules of Professional Conduct, if the arrangement is unenforceable under applicable laws, such as those governing champerty and usury, or is otherwise unlawful, an attorney should so advise the client and refrain from facilitating a transaction that is unlawful.

1. Usury

A financing company generally makes its funding determination based on the "merits" of the lawsuit, *i.e.*, on the likelihood of success and the amount of any anticipated recovery. In the same vein, it will seek to set the fee it collects for providing funds based on its assessment of the likelihood of recovery. Fee arrangements vary widely as a result.

Critics have focused on fee arrangements that ultimately require litigants to pay financing companies a substantial portion of any recovery, noting that if the advances made in exchange for these fees were characterized as "loans," the fees could be deemed usurious.⁶ While financing companies generally characterize non-recourse financing arrangements as a "purchase" or "assignment" of the anticipated proceeds of the lawsuit (and therefore not subject to usury laws),⁷ lawyers should be aware that in certain

⁶ See generally Appelbaum, *supra* note 2; Garber, *supra*, note 3 at 10; see also Binyamin Appelbaum, *Lawsuit Loans Add New Risk for the Injured*, NEW YORK TIMES, (Jan. 16, 2011), available at <http://www.nytimes.com/2011/01/17/business/17lawsuit.html?pagewanted=1&emc=eta1>. Usury laws in New York set a maximum allowable rate of interest per annum. See N.Y. BANKING LAW § 14-a (McKinney 2008); see also N.Y. GEN. OBLIG. LAW § 5-501 (McKinney 2001 & Supp. 2011).

⁷ See, e.g., in the personal injury context, Frequently Asked Questions: What percentage of the proceeds do we purchase?, FASTFUNDS, <http://www.fastfunds4u.com/pages/faqs.html> (last visited Apr. 19, 2011) ("We provide funds by purchasing a small portion of the anticipated proceeds. It is not a loan, so there is no

circumstances, courts have found that non-recourse litigation financing agreements violate usury laws.⁸

2. Champerty

Champerty is a form of maintenance in which a nonparty furthers another's interest in a lawsuit in exchange for a portion of the recovery. The law of champerty varies by jurisdiction.⁹ While we are aware of no decision finding non-recourse funding arrangements champertous under New York law, lawyers should be mindful that courts in other jurisdictions have invalidated certain financing arrangements under applicable champerty laws.¹⁰

B. Attorney as Advisor

A lawyer may be asked by a client to recommend a source of third party funding or to review or negotiate a non-recourse financing agreement for a client. If the lawyer does so, Rule 2.1 requires the lawyer to provide candid advice regarding whether the arrangement is in the client's best interest.¹¹

In providing candid advice, a lawyer should advise the client to consider the costs and the benefits of non-recourse financing, as well as possible alternatives.¹² With respect to costs, a common criticism of non-recourse financing is that the fees charged to clients

interest, no matter how long it takes for the case to be resolved. Like the claimant and the attorney, we take the risk of a successful resolution. If the case is lost, we lose our money.").

⁸ See, e.g., *Echeverria v. Estate of Lindner*, 2005 N.Y. Slip Op. 50675(u), at 4-5 (Sup. Ct. Nassau County 2005) (finding non-recourse agreement was "loan" because recovery was certain under strict liability statute and interest rate was usurious); *Lawsuit Fin. v. Curry*, 683 N.W.2d 233, 236 (Mich. Ct. App. 2004) (finding same because judgment had already been entered in favor of plaintiff when she entered into financing agreement).

⁹ Twenty-eight states reportedly no longer prohibit champerty. See Ashby Jones, *The Next National Investment Craze: Lawsuits!*, THE WALL STREET JOURNAL LAW BLOG (June 4, 2010), available at <http://blogs.wsj.com/law/2010/06/04/the-next-national-investment-craze-lawsuits/>. The Court of Appeals of New York has recently clarified the law of champerty in New York. See *Trust for Certificate Holders of Merrill Lynch Mortgage Investors, Inc. v. Love Funding Corp.*, 13 N.Y.3d 190, 192 (2009).

¹⁰ See, e.g., *Johnson v. Wright*, 682 N.W.2d 671 (Minn. Ct. App. 2004).

¹¹ See N.Y. State 666 (1994) (attorney may refer client to financing company for living expenses); see also Fla. Bar, Op. 00-3 (Mar. 15, 2002) (same). In addition to Rule 2.1's duty of candor, a lawyer may have other obligations. For example, several financing companies doing business in New York State have entered into a Stipulation with the Attorney General that requires the companies to follow certain guidelines, such as procuring an attorney certification that the lawyer has reviewed the financing agreement with the client. See American Legal Finance Association, ALFA Agreement (Feb. 17, 2005), available at <http://www.americanlegalfin.com/alfasite2/documents/ALFAAgreementWithAttorneyGeneral.pdf>.

Signatories to the Agreement include Plaintiff Support Services, Pre-Settlement Finance, QuickCash, Magnolia Funding, BridgeFunds Limited, Plaintiff Funding Corp. d/b/a LawCash, Oasis Legal Finance, The Whitehaven Group, and New Amsterdam Capital Partners. *Id.* at 9-18. The Stipulation is posted on the website of the American Legal Finance Association (AFLA). Currently, 21 companies belong to the Association nationwide. See American Legal Finance Association, available at <http://www.americanlegalfin.com/index.asp> (last visited Apr. 19, 2011).

¹² See N.Y. State 769 (2003) (attorney should advise the client of costs and benefits of the transaction as well as alternative courses of action); see also Fla. Bar, Op. 00-3 (Mar. 15, 2002).

may be excessive relative to other financing options, such as bank loans, thereby significantly reducing the client's recovery.¹³ A lawyer thus should bear in mind the extent to which non-recourse financing will limit a client's recovery. And before recommending financing companies, a lawyer should conduct a reasonable investigation to determine whether particular providers are able and willing to offer financing on reasonable terms.¹⁴ In addition, if a lawyer assists a client with non-recourse financing, the lawyer may wish to make clear that such assistance itself is not an endorsement of the financing company.¹⁵

With respect to benefits, a lawyer should advise the client to consider whether, absent funding, the client would be unable to cover litigation or living expenses, or prematurely could be forced into a relatively disadvantageous settlement, effectively limiting his or her access to seek redress through the legal system. Commercial claimants also may lack the resources to pursue a claim absent funding, or may be able to deploy resources more effectively for their business needs by financing some or all of their litigation costs.

C. Conflicts of Interest

Within the parameters discussed above, a lawyer may refer a client to a litigating financing company. When making a referral, the lawyer is barred from accepting a referral fee from the company if the fee would impair the lawyer's exercise of professional judgment in determining whether a financing transaction is in the client's best interest and would compromise the lawyer's ethical obligation to provide candid advice regarding the arrangement; even where the fee is permitted, the lawyer may be required to remit the fee to the client.¹⁶ A conflict also may arise in the event the lawyer is asked to advise the client about financing when the client cannot afford to commence or continue litigation absent a third party advance of the lawyer's fees. And the conflict rules may prohibit a lawyer, or possibly a company in which the lawyer has a substantial ownership interest, from extending financing to a client that the lawyer represents in litigation.¹⁷ Lawyers should carefully evaluate these and other potential conflicts when initiating or continuing the representation of a client who contemplates the use of financing for the conduct of litigation.

¹³ See Garber, *supra* note 3, at 10; Appelbaum, *supra* note 2.

¹⁴ See Nev. State Bar Standing Comm. On Ethics and Prof'l Responsibility, Formal Op. 29 (Aug. 7, 2003).

¹⁵ See N.Y. State 769.

¹⁶ See N.Y. Rules of Prof'l Conduct R. 1.7(a), 1.8(f), 5.4(c) (2010); N.Y. State 682 (1996) (lawyer must offer client any referral fee the lawyer receives for standard products and services); N.Y. State 671 (1994) (lawyer "absolutely forbidden" from receiving referral fee where amount of product or service purchased depends on attorney advice); ABA Formal Op. 331 (1972).

¹⁷ See N.Y. Prof'l Conduct R. 1.8(e); N.Y. State 753 (2002) (reiterating that lawyer may not ethically represent a client in a real estate transaction if the lawyer acts as a principal in the title insurance agency that has been engaged for the transaction and that is performing non-ministerial tasks); *see also* N.Y. State 769; 666; Fla. Bar, Op. 00-3 (Mar. 15, 2002); Ohio Sup. Ct. Op. 2000-01 (2000) available at http://www.supremecourt.ohio.gov/Boards/BOC/Advisory_Opinions/2000/Op%2000-001.doc (last visited Apr. 20, 2011); Phila. Bar Ass'n Prof'l Guidance Comm., Ethics Op. 91-9 (May 1991); *cf.* S.C. Bar Ethics Advisory Op. 92-06 (1992) (an attorney may own interest in a non-recourse financing company that provides funding to non-clients).

D. Privilege and Confidentiality

Non-recourse financing arrangements also may result in waiver of the attorney-client privilege or other protection from disclosure. This risk arises from provisions requiring a claimant or his or her lawyer to disclose documents and information to financing companies to enable them to evaluate the strength of the claims in the litigation to be financed.¹⁸ In addition, financing arrangements may require a lawyer to inform the financing company of developments in the case and/or allow periodic reviews of the case file.¹⁹ And for very large claims, some financing companies reserve the right to share information regarding a matter with other companies that may participate in the financing.

This opinion does not address whether such communications between the client or lawyer and a financing company result in a waiver of the attorney-client privilege or other applicable protection. We note, however, that the argument has been made that the common interest privilege does not apply to such communications because the financing company's interest in the outcome of a litigation is commercial, rather than legal.²⁰

With the foregoing in mind, a lawyer may not disclose privileged information to a financing company unless the lawyer first obtains the client's informed consent, including by explaining to the client the potential for waiver of privilege and the consequences that could have in discovery or other aspects of the case.²¹ In making disclosures to the

¹⁸ See, e.g., Frequently Asked Questions: Will my case qualify for an advance?, LAWMAX LEGAL FINANCE, <http://www.fundmycase.com/en/FAQ.php4> (last visited Apr. 19, 2011) ("LawMax considers each request for an advance on a case-by-case basis. We will thoroughly review your case, and our underwriters will make a decision within 48 hours of receiving the required documentation from your attorney."); Frequently Asked Questions: Do we get involved in the case?, FASTFUNDS, <http://www.fastfunds4u.com/pages/faqs.html> (last visited Apr. 19, 2011) ("Our only involvement is to initially review the attorney's file so we can evaluate the claim."); Case Documents for Plaintiff Funding, LawLeaf, www.lawleaf.com/lawsuit-funding/case-documents-for-plaintiff-funding.html (requiring certain documents for evaluation of the claim).

¹⁹ See, e.g., The Funding Process, LAWMAX LEGAL FINANCE, <http://www.litigationfinancing.com/FundingProcess.htm> (last visited Apr. 19, 2011) ("We . . . ask . . . that we be kept aware of any developments in the case."); see also Del. State Bar Ass'n Comm. On Prof'l Ethics, Op. 2006-2 (Oct. 6, 2006) ("Th[e] information [requested] includes police/accident reports, medical records, witness statements, expert reports, and information relating to the defendant's insurance carrier and its policy limits."); Complaint, *S&T Oil Equip. & Mach. Ltd. v. Juridica Invests. Ltd.*, (S.D. Tex. Filed Feb. 14, 2011) (alleging that claimant's counsel "was required to place all information regarding the strategy, public profile, factual or legal developments regarding the [arbitration] on [the] internal website [of the law firm associated with the funding company]. This included key substantive pleadings, key documents, settlement documents and any scheduling orders.").

²⁰ See, e.g., *Leader Techns., Inc. v. Facebook, Inc.*, 719 F. Supp. 2d 373 (D. Del. 2010) (compelling disclosure of documents shared with financing companies during discussions about potential financing); see also *Abrams v. First Tenn. Bank Nat'l Ass'n*, No. 3:03-cv-428, 2007 WL 320966, at *1 (E.D. Tenn. Jan. 30, 2007); see also Nate Raymond, *Litigation Funders Face Discovery Woes*, Nat'l L.J., Feb. 21, 2011 (reporting that in at least one case, the initial conversations between a funding company and the client were not protected from disclosure by the attorney client privilege).

²¹ See N.Y. Prof'l Conduct R. 1.6(a) (2009).

financing company, a lawyer should take care not to disclose any more information than is necessary in his or her judgment.²²

E. Control Over the Legal Proceeding

Non-recourse financing agreements often require the claimant's lawyer to keep the financing company apprised of any developments in the litigation or to seek the company's consent when taking steps to pursue or resolve the lawsuit, such as making or responding to settlement offers. These notice provisions raise the specter that a financing company, armed with information regarding the progress of the case, may seek to direct or otherwise influence the course of the litigation.²³ For example, to protect its own interest in maximizing the fee it may earn, a financing company may object to steps calculated to advance the client's interests, such as pursuing a promising line of additional discovery at a cost the company would prefer to avoid, or accepting a settlement offer that does not meet the company's expectations regarding the return on its investment. While a client may agree to permit a financing company to direct the strategy or other aspects of a lawsuit, absent client consent, a lawyer may not permit the company to influence his or her professional judgment in determining the course or strategy of the litigation, including the decisions of whether to settle or the amount to accept in any settlement.²⁴

III. Conclusion

Non-recourse litigation financing is on the rise, and provides to some claimants a valuable means for paying the costs of pursuing a legal claim, or even sustaining basic living expenses until a settlement or judgment is obtained. It is not unethical *per se* for a lawyer to advise on or be involved with such arrangements. However, they may raise various ethical issues for a lawyer, such as the potential waiver of privilege and interference in the lawsuit by a third party. A lawyer representing a client who is party, or considering becoming party, to a non-recourse funding arrangement should be aware of the potential ethical issues and should be prepared to address them as they arise.

²² See N.Y. State 769.

²³ See Garber, *supra* note 3, at 18.

²⁴ See N.Y. Rules of Prof'l Conduct 1.7(a), 1.8(f), 5.4(c) (2010). After a settlement or judgment has been obtained, a lawyer may turn over to a funding company a portion of a client's recovery pursuant to the terms of that client's non-recourse financing agreement. See N.Y. State 666; Fla. Bar, Op. 00-3 (Mar. 15, 2002); S.C. Bar Ethics Advisory Op. 92-06 (1992); Phila. Bar Ass'n Prof'l Guidance Comm., Ethics Op. 91-9 (May 1991). We do not reach the issue, but note the potential conflict, where a lawyer is a signatory to a financing agreement and is instructed by the client not to pay over to the financing company the contractually-specified portion of the settlement or judgment.