Formal Opinion 2018-5: Litigation Funders' Contingent Interest in Legal Fees

TOPIC: Law firm finance; obligation to avoid fee-splitting with nonlawyers.

DIGEST: A lawyer may not enter into a financing agreement with a litigation funder, a non-lawyer, under which the lawyer's future payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters.

RULES: 5.4(a)

QUESTION: May a lawyer enter into a financing agreement with a litigation funder, a non-lawyer, under which the lawyer's future payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters?

OPINION:

This opinion addresses whether the New York Rules of Professional Conduct (the "Rules") permit a lawyer to enter into an agreement with a litigation funder, a non-lawyer, under which the lawyer's future payments to the litigation funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters. For the following reasons, we conclude that such an arrangement violates Rule 5.4's prohibition on fee sharing with non-lawyers.

I. Background on Litigation Funding

In the litigation-finance industry, entities (often referred to as "litigation funders") extend financing to litigators or their litigation clients under which repayments are contingent on the outcome of the litigation. The number of lawyers and clients benefitting from litigation funding has increased substantially over the last several years.[1] It is now common for litigants and their lawyers to contemplate or obtain litigation funding. Without 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 levelling the dispute-resolution field between parties with deep pockets and those with limited resources.[2]

Prior opinions of this and other ethics committees have addressed litigation funding arrangements between the funder and the client. Under typical client-funder arrangements, the funder agrees directly with the lawyer's client to provide funding for a specific matter and the

[1] Nathan Hale, "Litigation Funding Isn't Just for the Little Guy Anymore," Law360 (Apr. 20, 2018).

[2] *See generally* Radek Goral, "Justice Dealers: The Ecosystem of American Litigation Finance," 21 Stan. J.L. Bus. & Fin. 98 at 100 n.2 (2015) (collecting prior literature discussing whether litigation funding "levels the playing field," or "merely encourages frivolous suits").

client agrees to make future payments if the client prevails. When the client is the plaintiff in a civil lawsuit, the amount of the client's future payments to the funder may depend on the amount of the client's recovery. Client-funder arrangements of this nature do not implicate Rule 5.4, which forbids a lawyer from sharing legal fees with a non-lawyer, because the lawyer is not a party to the arrangement and payments are made by the client out of the client's recovery and do not affect the amount of the lawyer's fee. *See* NYCBA Formal Op. 2011-2 (2011) ("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."); *see also* NYSBA Ethics Op. 666 (1994) (lawyer may refer client to lender who will commit to provide financial support during pendency of case).[3]

This opinion, however, addresses litigation funding arrangements between the funder and the lawyer or law firm. Lawyer-funder agreements may take various forms. As discussed below, the fee-sharing rule does not forbid a traditional recourse loan requiring the lawyer to repay the loan at a fixed rate of interest without regard to the outcome of, or the lawyer's receipt of a fee in, any particular lawsuit or lawsuits. That is the case regardless of whether the loan is or is not secured by some kind of collateral. However, the fee-sharing rule forbids two alternative 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 – for example, where the agreement sets a payment rate on a sliding scale based on the total legal fees or total recovery in the case or portfolio of cases.

II. The Rule against Fee-Sharing with Non-Lawyers

Rule 5.4, titled "Professional Independence of a Lawyer," includes four provisions that regulate lawyers' business relations and other interactions with non-lawyers,[4] including provisions forbidding law firms from having non-lawyer partners or owners.[5] Rule 5.4(a) addresses fee-

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[3] As we cautioned in Opinion 2011-2, however, lawyers must still be cognizant of the risks of client-funder transactions, including the risk of compromising confidentiality, any possible waiver of attorney-client privilege, and any potential impact on a lawyer's exercise of independent judgment. *See* NYCBA Formal Op. 2011-2.

[4] *See, e.g.*, Rule 5.4(c) (prohibiting a lawyer from allowing a third party "to direct or regulate the lawyer's professional judgment"); Rule 5.4(d)(3) (prohibiting a lawyer from allowing a non-lawyer to "direct or control the professional judgment of a lawyer"). Other provisions of the Rules are similarly designed to protect lawyers' independence from third parties. *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"); *see generally* Bruce A. Green, "Lawyers' Professional Independence: Overrated or Undervalued?," 46 Akron L. Rev. 599 (2013).

[5] Rule 5.4(b) ("A lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law."); Rule 5.4(d) (forbidding the practice of law in any entity in

sharing with non-lawyers. Subject to three exceptions not implicated here, Rule 5.4(a) provides that "[a] lawyer or law firm shall not share legal fees with a nonlawyer."

As the title of Rule 5.4 reflects, the fee-sharing restriction is intended "to protect the lawyer's professional independence of judgment." Rule 5.4 Cmnt. [1]; *see also* NYCBA Formal Op. 2014-1 (2014) ("The purpose of the fee-sharing prohibition is to remove incentives for nonlawyers to interfere with the professional judgment of lawyers in legal matters, and to remove incentives for nonlawyers to engage in other objectionable conduct."); *Jacoby & Meyers, LLP v. Presiding Justices*, 852 F.3d 178, 192 (2d Cir. 2017) (noting that Rule 5.4(a) serves New York's interest in maintaining "independence" in the legal profession); Roy D. Simon and Nicole Hyland, *Simon's New York Rules of Professional Conduct Annotated*, at 1420 ("[t]he purpose of the rule against fee sharing is to remove any incentive for nonlawyers to engage in undesirable behavior such as (1) interfering with a lawyer's professional judgment in handling of a legal matter, (2) using dishonest or illegal methods . . . in order to win cases . . . or (3) encouraging or pressuring a lawyer to use such improper methods.").

The fee-sharing restriction is of long standing. In 1928, drawing on precedent dating back to the 1700s, the ABA adopted Canon 34 of the Canons of Professional Responsibility, which provided that "[n]o division of fees for legal services is proper, except with another lawyer, based upon a division of service or responsibility." Roy Simon, "Fee Sharing Between Lawyers and Public Interest Groups," 98 Yale L.J. 1069, 1079–80 (1989). In 1969, the ABA re-codified this principle as DR 3-102(A) of the Model Code, which provided that "[a] lawyer or law firm shall not share fees with a nonlawyer." *Id.*, 98 Yale L.J. at 1082. New York's implementation inserted the word "legal" before "fees," but otherwise made no changes to the Model Code. *See* NY Code of Prof. Responsibility, DR 3-102(A). The first clause of Rule 5.4(a) is identical to DR 3-102(A).

Rule 5.4(a) has generally been interpreted to forbid business arrangements in which lawyers agree to make payments based on the receipt of legal fees or the amount of legal fees in particular matters. For instance, in NYSBA Op. 917 (2012), the ethics committee opined that a lawyer could not compensate a non-lawyer marketing professional based on the amount of fees paid by clients whom the non-lawyer professional obtained for the firm. In NYSBA Ethics Op. 992 (2013), the committee concluded that a lawyer may not compensate a business owner for marketing services based on a percentage of fees from a particular matter. Its opinion explained: "Payment of a percentage of firm profits for a specific matter is tantamount to fee sharing and is not permitted." The opinion noted that although Rule 5.4(a)(3) permits lawyers to establish retirement plans for nonlawyer employees based on "a profit-sharing arrangement," even nonlawyer employee retirement plans may not be "tied to profit from a particular case or cases."

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which a nonlawyer owns an interest). On the early history of restrictions on lawyer-nonlawyer collaborations, see Bruce A. Green, "The Disciplinary Restrictions on Multidisciplinary Practice: Their Derivation, Their Development, and Some Implications for the Core Values Debate," 84 Minn. L. Rev. 1115 (2000).

Many other opinions reflect the same general principle. *See*, *e.g.*, NYSBA Ethics Op. 1062 (2015) (law firm attempting to raise money on a "crowdfunding" website would violate Rule 5.4 (a) if investors were to receive a percentage of the firm's revenues); NYCBA Formal Op. 2015-1 (2015) (law firm may not pay professional employer organization for administration services based on percentage of fees the firm generates); NYCLA Ethics Op. 697 (1993) (lawyer may not agree to pay landlord percentage of firm's revenues as office rent); NYSBA Ethics Op. 633 (1992) (lawyer may not enter into payment arrangement with non-lawyer based on "percentage of volume of business developed"); NYSBA Ethics Op. 565 (1984) (lawyer may not compensate marketing agency based on "volume of business developed"); *cf. In re Friedman*, 196 A.D.2d 280 (1st Dept. 1994) (attorney violated DR 3-102(A) by agreeing to pay private investigator in part based on success of litigation); *In re Shapiro*, 90 A.D.2d 22 (1st Dep't 1982) (disciplinary proceeding against attorney who, *inter alia*, paid salary to non-lawyer employee contingent on total fees earned); *see generally* Simon & Hyland, *supra*, at 1419 ("If the nonlawyer's income depends in any way on the lawyer's receipt of legal fees in a specific case or cases, then the lawyer is violating Rule 5.4(a).").

III. The Application of Rule 5.4(A) to Certain Litigation Funding Arrangements

Lawyer-funder arrangements do not necessarily involve impermissible fee sharing under Rule 5.4(a). The rule is not implicated simply because the lawyer's payments to a funder come from income derived from legal fees.[6] But Rule 5.4(a) forbids a funding arrangement in which the lawyer's future payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters. That is true whether the arrangement is a non-recourse loan secured by legal fees or it involves financing in which the amount of the lawyer's payments varies with the amount of legal fees in one or more matters.[7] Rule 5.4(a) has long been understood to apply to business arrangements in which lawyers' payments to nonlawyers are tied to legal fees in these types of ways. *See* Part II, *supra*.

No New York ethics committee has yet addressed the rule's application specifically to litigation funding arrangements. However, we see no meaningful difference between payments for financing, on the one hand, and payments for goods and services, on the other, that would call for a different interpretation of "fee sharing" when a lawyer's payments to a provider of funding,

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[6] The Rules do not define what it means to "share" a "legal fee," but the cases and opinions cited herein leave no doubt that Rule 5.4(a) does not forbid payments from income derived from legal fees. An interpretation to the contrary would be unrealistic, since all or virtually all of lawyers' income ordinarily derives from legal fees and therefore all payments they make for nonlawyer salaries, services, etc., ordinarily derive from legal fees. *See* Preamble [6] ("The Rules of Professional Conduct are rules of reason. They should be interpreted with reference to the purposes of the legal representation and of the law itself.").

[7] Further, a litigation-funding arrangement involves impermissible fee sharing where the arrangement in effect makes the lawyer's payments contingent on the receipt or amount of fees, regardless of how the arrangement is worded. For example, Rule 5.4(a) applies equally regardless of whether the lawyers' future payments are explicitly contingent on the receipt of fees or are contingent on the client's success which in turn will result in legal fees.

rather than a provider of goods or services, are contingent on the lawyer's receipt of fees in a particular matter.[8] Rule 5.4(a) must therefore be read to foreclose a financing arrangement whereby payments to the funder are contingent on the lawyer's receipt of legal fees.[9] A non-recourse financing agreement secured by legal fees in a matter – i.e., an arrangement in which it is contemplated that the lawyer will make future payments only if the lawyer recovers fees – constitutes an impermissible fee-sharing arrangement regardless of how the lawyer's payments are calculated. Likewise, a financing arrangement constitutes impermissible fee sharing if the amount of the lawyer's payment is contingent on the amount of legal fees earned or recovered. Further, Rule 5.4 is equally applicable when the lawyer's payment to the funder is based on the recovery of legal fees in multiple matters (*e.g.*, a portfolio of lawsuits against the same defendant or involving the same subject matter) as opposed to a single matter.

For purposes of Rule 5.4, a non-recourse funding arrangement in which the lawyer's payments are contingent on the lawyer's receipt of legal fees, or a funding arrangement in which the lawyer's payments depend on the amount of legal fees received in a matter, is different from the traditional "recourse" loan agreement described above in which a lawyer's payments are *not* contingent on the receipt or amount of legal fees in particular matters.[10] To be sure, the lawyer in both scenarios will pay the lender from the firm's revenues (i.e. legal fees). But, given the long line of prior opinions, it matters that in the former scenario the lawyer's payments are tied to the lawyer's receipt of fees in one or more matters. Rightly or wrongly, the rule presupposes that

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[8] Several other states have also reached a similar conclusion. *See* Prof'l Ethics Comm'n Me. Bd. of Overseers of the Bar, Op. 193 (2007) ("[P]ayment on a non-recourse loan to finance litigation in a contingency fee case, where the lawyer is obligated to repay the loan only if a fee results in the case, constitutes sharing legal fees with a non-lawyer in violation of the rule."); State Bar of Nevada Op. 36 (2007) ("Any loan obtained for purposes of litigation funding must be a 'recourse' loan that counsel is obligated to pay."); Utah Bar Ass'n Adv. Op. 97-11 (1997) ("[A]n attorney may not finance the costs of a contingent-fee case in which a non-recourse promissory note is secured by the attorney's interest in the contingent fee."); *see also* Va. State Bar Standing Comm. on Legal Ethics, Advisory Op. 1764 (2002) ("not[ing] a basic ethical problem" in a proposed financing agreement that called for a "finance company to receive a portion of the attorney's legal fee").

[9] This opinion does not read Rule 5.4(a) to forbid funding arrangements in which the lawyer's debt obligation is secured by current or future accounts receivable but repayment is not contingent on the receipt or amount of fees. For example, a recourse debt that is not contingent on the amount of legal fees – e.g., a promise to repay a loan with interest over a particular period of time – does not constitute impermissible fee sharing simply because the debt is secured by accounts receivable in one or more matters. In the case of a recourse loan, there is no implicit or explicit understanding that the debt will be repaid only if legal fees are obtained in particular matters, and the creditor may seek repayment out of all of the law firm's assets. Nor do we believe the fee-sharing rule forbids funding arrangements in which the timing of the lawyer's payments is determined by the resolution of a matter – e.g., where the lawyer's payment obligation does not begin until a matter is resolved – but the amount of lawyer's payment obligation does not itself depend on whether, or in what amount, legal fees are obtained.

[10] It is important to note that this opinion does not address legal fees that have been earned and that are subject to collection but that have not yet paid. We do not question the State Bar ethics committee's conclusion in NYSBA Ethics 608 (1975) that a lawyer employing a collections agency to collect earned but unpaid legal fees may compensate the collections agency based on a percentage of the recovery.

when nonlawyers have a stake in legal fees from particular matters, they have an incentive or ability to improperly influence the lawyer.[11]

There is room to argue whether the prohibition on fee sharing is overbroad. One might argue that the rule sweeps more broadly than necessary to serve its purpose of protecting lawyers' independence, or whether there are adequate contractual means or other alternative means of preventing litigation funders from encroaching on litigators' exercise of independent professional judgment. But that is a matter to be decided by the state judiciary, which periodically reviews the Rules, or by the state legislature. Nothing in the language, history or prior interpretations of Rule 5.4(a) supports an interpretation carving out litigation funding arrangements.[12]

IV. Conclusion

Under Rule 5.4(a), a lawyer may not enter into a financing agreement with a litigation funder, a non-lawyer, under which the lawyer's future payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters.

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[11] Of course, even under a recourse loan, a law firm that receives no legal fees and therefore has no income may be unable to make payments to a funder or to others to whom the law firm is in debt. Likewise, a law firm whose debt exceeds its incoming legal fees and other assets may be unable to meet its financial obligations. One might therefore argue that any creditor has an incentive to encroach on lawyer independence and that there is no reason to single out those particular creditors who have a stake in lawyers' fees in particular matters. But 90 years of ethics rules and opinions interpreting them have at least implicitly assumed either that there is a meaningful difference or that the distinction has another justification (such as that rules cannot realistically prevent lawyer insolvency).

[12] We recognize that several New York courts have upheld litigation funding agreements in the face of public-policy challenges. *See Hamilton Capital VII, LLC, I* v. *Khorrami, LLP*, 2015 N.Y. Slip Op. 51199(U) (Sup. Ct. N.Y. County Aug. 17, 2015) (distinguishing between fee-sharing agreements and a credit facility giving lender a security interest in law firm's accounts receivable); *Lawsuit Funding, LLC* v. *Lessoff*, 2013 WL 6409971 (Sup. Ct. N.Y. County Dec. 4, 2013) (refusing to use Rule 5.4(a) to invalidate a settlement agreement on public policy grounds where lawyer agreed to repay lender a set amount from lawyer's fees in eight other lawsuits); *see also Heer* v. *North Moore St. Developers, L.L.C.*, 140 A.D.3d 675, 676 (1st Dep't 2016) (rejecting law firm-defendant's argument that N.Y. Judiciary Law barred collection agency's motion to intervene, as § 474 permits "litigation loans obtained by law firms and secured by their accounts receivable"). However, insofar as the lawyers' payments to funders in these cases depended on the receipt of legal fees in particular matters, the judicial decisions enforcing the lawyers' contracts do not necessarily establish that Rule 5.4 applies differently to litigation funding arrangements than to other business arrangements. Regardless of whether the funding arrangements were forbidden by Rule 5.4, New York courts could be expected to enforce the arrangements, because lawyers who violate the Rules cannot ordinarily invoke their own transgressions to avoid contractual obligations. *See Marin* v. *Constitution Realty, LLC*, 28 N.Y.3d 666, 672 (2017) (rejecting lawyers attempts to "use the ethics rules as a sword" to render an agreement unenforceable).