Refunding Unearned Advanced Flat Fees

ISSUES:
How should a lawyer calculate the amount of the unearned fee due to the client where the fee agreement provides for a flat fee paid in advance and the lawyer does not complete all services required under the flat fee agreement?

DIGEST:
(1) A lawyer may agree with client in the attorney fee agreement as to a method of calculating the unearned portion of the fee if services in the flat fee engagement are not completed before the termination of the lawyer’s employment, provided that the methodology results in a fee commensurate with the reasonable value of the lawyer’s services and is not unconscionable.

(2) In the absence of an agreed upon method, the amount of unearned fee that must be returned will depend on a number of factors similar to the factors used in the evaluation of whether the fee paid to the lawyer represents the reasonable value of the lawyer’s services and is not unconscionable.

AUTHORITY INTERPRETED:
California Rule of Professional Conduct 1.5(d)
California Rule of Professional Conduct 1.5 Comment 3
California Rule of Professional Conduct 1.16(e)(2)
California Rule of Professional Conduct 1.15(a) and (b)
California Rule of Professional Conduct 1.15 Comment 2
California Rule of Professional Conduct 1.5(a)
Code of Civil Procedure section 1021

STATEMENT OF FACTS
Hypotheticals
(1) Lawyer enters into written fee agreement with Client to do a specific task for a fixed fee to be paid in advance. The fee agreement recites that the fee is deemed earned when paid, and if the Lawyer’s employment ends before the agreed work is completed, no part of the fee will be refunded to the Client.

(2) Lawyer enters into a written fee agreement with Client to do a specific task for a fixed fee paid in advance. The fee agreement provides that if the lawyer’s employment terminates before the agreed work is complete, the amount of the earned fee will be calculated by multiplying the time spent by an hourly rate of $750. Lawyer typically charges $500 an hour for similar work when charging by the hour but did not disclose this to Client.

(3) Lawyer enters into a written fee agreement with Client to do a specific task for a fixed fee paid in advance. The fee agreement provides that the lawyer’s fee will be deemed earned in one-third increments when progress on the specific task reaches three defined benchmarks described in the fee agreement.

DISCUSSION

While hourly billing has been the most widely used mode of pricing legal services for a number of decades, lawyers in recent years have moved toward the use of flat fees for services. Flat fees contemplate the payment of a fee in a fixed amount that does not increase commensurate with the amount of time spent on matter, in return for a defined set of professional services. California Rule of Professional Conduct 1.5(e) defines a flat fee and authorizes its use:

A lawyer may make an agreement for, charge, or collect a flat fee for specified legal services. A flat fee is a fixed amount that constitutes complete payment for the performance of described services regardless of the amount of work ultimately involved, and which may be paid in whole or in part in advance of the lawyer providing those services.

Flat fees offer the advantage of allowing the client to know exactly how much a given legal service or bundle of legal services will cost in advance. Flat fees also avoid some of the other perceived abuses of hourly billing, such as the incentive to pad bills. For the lawyer, a flat fee offers the security of collecting the entire fee before the work is performed.

Notwithstanding the language of Rule 1.5(e), the flat fee for services is still subject to the requirement that the unearned part of flat fee must be refunded if the lawyer’s employment terminates before all of the services contracted for have been provided. See Rule 1.5, comment 3, citing to Rule of Professional Conduct 1.16(e)(2).

Rule 1.15(a) defines unearned advanced fees as funds held for the benefit of the client and requires that they be placed in trust.

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1 Rule 1.5 was effective November 1, 2018, by order the California Supreme Court. All references to “Rule” or “Rules” in this opinion are to these Rules.
All funds received or held by a lawyer or law firm* for the benefit of a client, or other
person to whom the lawyer owes a contractual, statutory, or other legal
duty, including advances for fees, costs and expenses, shall be deposited in one
or more identifiable bank accounts labeled “Trust Account” or words of similar
import, maintained in the State of California, or, with written* consent of the
client, in any other jurisdiction where there is a substantial* relationship between
the client or the client’s business and the other jurisdiction.

(emphasis added). At the same time the rule allows this specific type of advanced fees to be
placed in an operating account (and presumably spent) with certain conditions:

(b) Notwithstanding paragraph (a), a flat fee paid in advance for legal services may
be deposited in a lawyer’s or law firm’s operating account, provided:
(1) the lawyer or law firm* discloses to the client in writing* (i) that the client has a right under
paragraph (a) to require that the flat fee be deposited in an identified trust account until the fee is
earned, and (ii) that the client is entitled to a refund of any amount of the fee that has not been
earned in the event the representation is terminated or the services for which the fee has been paid
are not completed; and
(2) if the flat fee exceeds $1,000.00, the client’s agreement to deposit the flat fee in the lawyer’s
operating account and the disclosures required by paragraph (b)(1) are set forth in a writing*
signed by the client.

Accordingly, flat fees for services are not earned on receipt and are only fully earned when all
services have been provided. Moreover, the client is entitled to a refund of the unearned portion
of the fee. But the Rules do not offer any explicit guidance on how the amount of the unearned
fee is to be calculated, except in Rule 1.15, comment 3, which states that “[s]ubject to rule 1.5, a
lawyer or law firm may enter into an agreement that defines when or how an advance fee
is earned and may be withdrawn from the client trust account.”

Flat fees share some of characteristics of contingent fees in that the ultimate amount of the fee is
contingent on the lawyer completing the services that have been defined by the fee agreement.
There is well established California authority that when a lawyer’s services in a contingent fee
case terminate before the occurrence of the contingency, the lawyer is not entitled to the contract
price but only to the reasonable value of the lawyer’s services, Fracasse v. Brent (1973) 6
Cal.3d 784, 786.

Flat fees implicate the client’s right to terminate counsel as well. Flat fees have been abused by
lawyers who charged “non-refundable” fees when not appropriate, collected fees in advance,
provided no legal services of value and then refused to refund the fee, sometimes using the guise
that fees were paid as a true retainer. In the Matter of Lais (Review Dept.1998) 3 Cal. State Bar
Ct. Rptr. 907, 923. A client who has paid a flat fee to a lawyer who is not performing may be
chilled from the exercise of the client’s right to discharge counsel by the prospect of not
receiving any of the fee back.

3 Rule 1.5(d) preserves the availability of the “true retainer” a fee paid for availability as opposed to services that is
earned on receipt while prohibiting the use of the term “non-refundable” in connection with fee.
The State Bar’s Mandatory Fee Arbitration Program (MFA) Arbitration Advisory 1998-003 notes that:

the factors considered under [former] Rule 4-200(B) [superseded by Rule 1.5] are generally identical to the factors considered in analyzing the reasonableness of a fee. Cases which address a determination of reasonable fees in the context of awarding fees to the adverse party have consistently relied upon similar factors to those [factors] [citations].

The MFA Committee-approved form agreement addressing quantum meruit recovery in the context of a contingent fee agreement that terminates before the contingency occurs provides:

In the event of Attorney’s discharge, or withdrawal with justifiable cause, as provided in Paragraph 13, Client agrees that, upon payment of the settlement, arbitration award or judgment in Client’s favor in this matter, Attorney will be entitled to be paid by Client a reasonable fee for the legal services provided. Such fee will be determined by considering the following factors:

(1) Whether the Attorney engaged in fraud or overreaching in negotiating or setting the fee;
(2) Whether the Attorney failed to disclose material facts;
(3) The amount of the fee in proportion to the value of the services performed;
(4) The relative sophistication of the Attorney and the Client;
(5) The novelty and difficulty of the questions involved and the skill requisite to perform the legal service properly;
(6) The likelihood, if apparent to the Client, that the acceptance of the particular employment will preclude other employment by the Attorney;
(7) The amount involved and the results obtained;
(8) The time limitations imposed by the Client or by the circumstances;
(9) The nature and length of the professional relationship with the Client;
(10) The experience, reputation, and ability of the Attorney;
(11) The time and labor required;
(12) The informed consent of the Client to the fee.

These factors mirror the factors listed in Rule 1.5(a) to be used when determining when a fee is unconscionable, except for Rule 1.5(a)(11), whether the fee is fixed or contingent.

As a contractual provision, the suggested form fee language states the factors found in the law that go into a determination of a reasonable fee. In practice, its approach is cumbersome and it may most appropriate where the flat fee is larger or the client is more sophisticated or both. Rule 1.15, comment 3 suggests that the parties have a degree of flexibility in agreeing on a formula for calculating the amount to be refunded. Rule 1.5(a)(13), informed consent of the client to the fee, may carry more weight in the analysis of whether the earned fee is reasonable, given the benefit of flat fee agreements to both client and lawyer. How Rule 1.5(a)(11), whether the fee is fixed or contingent, is uncertain, but the risk associated with contingent fees is certainly far greater than

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5 http://www.calbar.ca.gov/portals/0/documents/mfa/2015/2015_SampleFeeAgreements2-070115_r.pdf
the risk associated with the flat fee, which is intended in some ways to mitigate risk of non-payment to the attorney.

Refunds Based on Time and Labor Required

One alternative approach to the multiple factor test, is the alternative of an hourly fee. This involves tracking the hours spent on the flat fee matter to termination of employment, and multiplying those hours by an hourly rate, sometimes referred to as a “lodestar” rate. This approach has the benefit of simplicity but can raise unconscionability based on the value of the “lodestar.” An hourly rate that is too high may lead to an unconscionable fee. It may also chill the exercise of the client’s highly valued right to discharge counsel at any time for any reason (see Fracasse, supra, 6 Cal.3d at pp. 788-790.)

Milestones Approach

Another possible approach is the so-called milestones approach. This is a common approach in many areas of practice, including criminal defense. It contemplates that the attorney will charge the total fee in what amount to progress payments as the engagement goes forward area. For instance, in a criminal matter the lawyer may charge $10,000 through the time of the preliminary hearing, with a fee of an additional $20,000 to be paid for work through trial.

Several authorities from other jurisdictions have endorsed the milestones approach. Utah State Bar Ethics Advisory Opinion No. 12-02 (2012 WL 8416318) explicitly endorses the Milestones approach “where keeping time keeping records would be inconvenient” (12-02, at page 3.) The opinion discusses the proof problems in establishing the attorney’s entitlement to the flat fee in light of Utah’s version of Rule 1.5, which requires that attorney fees be reasonable. The Colorado Supreme Court in a discipline matter, Matter of Gilbert (Colo. 2015) 346 P.3d 1018, 1025, 1027, rejected a claim that “an attorney who is discharged by her client to refund the entire advance fee if the agreement is silent about early termination, regardless of whether the attorney has expended time and money on the case” stating that, “[a]lthough attorneys are certainly wise to include benchmarks or milestones in flat fee agreements, the Rules of Professional Conduct do not presently require them.” In another discipline case from the Virginia State Bar, In The Matter of Ivan Yacub, VSB Docket No.14-041-097049, 2014 WL 6450329 (Va. St.Disp. 2014), at *2, the hearing subcommittee interpreting Rule 1.15 in disciplinary action stated:

Flat fees, however, constitute advanced legal fees which remain the client's property until actually earned, and as such must be placed in trust until the entire representation is complete unless the fee agreement specifies otherwise. The fee agreement may provide for certain portions of the flat fee to be earned upon completion of benchmarks which allow an attorney to draw down the flat fee in stages. Respondent's fee agreements did not provide for the drawing down of the fiat fee prior to the conclusion of the representation.
Consistent with the *comment* to California’s version of Rule 1.5 discussed above, we agree with these authorities that providing for agreed benchmarks or milestones in the fee agreement is permissible.

CONCLUSION

The question of how the unearned portion of a flat fee paid in advance should be calculated if the representations ends before all services are completed can be addressed in the initial written fee agreement entered into between lawyer and client. A lawyer may agree with client in the attorney fee agreement as to a method of calculating the unearned portion of the fee if services in the flat fee engagement are not completed before the termination of the lawyer’s employment, provided that the methodology results in fee commensurate with the reasonable value of the lawyer’s services and is not unconscionable. In the absence of an agreed upon method, the amount of unearned fee that must be returned will depend on a number of factors similar to the factors used in the evaluation of whether the fee paid to the lawyer represents the reasonable value of the lawyer’s services and is not unconscionable under Rule of Professional Conduct 1.5(b).

Acceptable contractual methods of calculating the amount of unearned fees to be returned include (1) discussion of those factors as guidelines in calculating the amount of the unearned fees subject to subsequent agreement between attorney and client; (2) a method employing multiplication of the time reasonably spent on the matter by a reasonable “lodestar” hourly rate or (3) the employment of “milestones” which allow payments of portions of the flat fee when significant events occur in the course of the representation.