Litigation Funding: **Ethical Considerations for the Plaintiff's Lawyer**

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This article addresses some of the ethical concerns a lawyer should consider in connection with funding arrangements between a litigation client and a third party funder. Below is a sample situation.

Your firm appears for Pureheart, Ltd in prosecuting a billion dollar trade secret misappropriation action. Faced with the mounting fees your firm is charging to prosecute its claims in litigation that is increasingly bitter and protracted, the now cash strapped Pureheart contacts Wellspring Capital Group LLP. Wellspring holds itself out as a "specialized commercial litigation financing fund" that will advance a plaintiff's litigation costs, including attorneys' fees, in exchange for a percentage stake in the plaintiff's recovery.

The dollars Wellspring provides will be used to pay the client's outstanding legal fees and expenses, as well as anticipated litigation costs, including expert witness fees. But Pureheart's obligation to repay Wellspring is entirely contingent on its recovery by way of settlement or by judgment. Hence, Wellspring readily acknowledges that in the absence of a recovery, it will lose its entire investment.[1]

Pureheart is about to sign an investment agreement with Wellspring under which Wellspring will advance $750,000 on a non-recourse basis, making its advance in exchange for payment of 40 percent of any recovery paid to Pureheart. No recovery means that Wellspring will be paid zero.

Pureheart—which currently owes your firm approximately $125,000 in fees and advanced costs under the firm's hourly billing arrangement—asks for your advice about the funding deal Wellspring proposes.

Should your firm's representation of Pureheart include giving advice to the client about the funding arrangement? If so, does the contemplated deal trigger any of your firm's obligations under the Rules of Professional Conduct?

Duties of Loyalty and Conflict Free Representation

> Rule 1.7(a)(2) of the Rules of Professional Conduct (RPC) provides in part:
>
> A concurrent conflict of interest exists if . . . there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to . . . a third party person or by a personal interest of the lawyer.

To the extent a lawyer affirmatively advises a litigation client to accept a third-party's funding proposal, the lawyer must consider whether the client might later claim that in encouraging the client to take the deal, the lawyer and his law firm were "materially limited by . . . a personal interest": the firm's own financial position. After all, in the Pureheart case, one obvious impact of the client closing the deal would be an immediate pay down of the client's large account balance with the firm and the likelihood that future invoices likewise will be covered. Thus the deal directly benefits the lawyer and the law firm, a fact that may affect the advice the lawyer gives. And the funding arrangement also may have another consequence: even if the client succeeds in obtaining a favorable judgment or settlement its recovery will be substantially limited by its obligation to pay Wellspring 40 percent of the settlement or judgment (a contingency amount in excess of the one-third fee lawyers customarily charge in contingency cases). In addition, many litigation funders also require the client to pay periodic (sometimes monthly) "service fees."

In addressing a lawyer's obligations in connection with third-party litigation funding, the Connecticut Bar Association's Standing Committee on Professional Ethics specifically cautioned that a plaintiff's attorney who participates in such an arrangement must avoid a "situation in which the lawyer's own interest in collecting a . . . fee materially erodes the undivided loyalty which the lawyer owes to his or her client."[2]

Put another way, the law firm prosecuting the Pureheart action must ensure that the firm's interest in assuring payment of its fees does not "materially impair [its] ability" to advise the client "to consider alternative courses of action that otherwise might be available to" the client.[3]

But even with that concern in mind, a lawyer does not necessarily run afoul of the conflict of interest rules by advising a client about a third-party funding arrangement.

Instead, ethics authorities encourage attorneys who wish to comply with the conflict rules to provide clients seeking advice on third-party funding arrangement with complete disclosure of the various interests at stake in giving such advice (including, if applicable, the extent to which the structure of the loan repayment may favor the firm's interest in payment of its fees over the client's interest in the recovery), as well as the risks and benefits of proceeding with the funding proposal. This is consistent with Rule 1.7(b)(2), which permits representation notwithstanding an otherwise disqualifying conflict so long as: (1) the "lawyer reasonably believes [he or she] will be able to provide competent and diligent representation . . ."; (2) "the representation is not prohibited by law"; and (3) the "client gives informed consent, confirmed in writing."[4]

An alternative, and perhaps safer course for the law firm, is to refer the client to other counsel for an independent assessment of the pros and cons of accepting the funding offer.

Lawyer Independence

Rule 2.1 of the Rules of Professional Conduct ("Advisor") commands a lawyer to ". . . exercise independent professional judgment" in the representation of a client. Similarly, Rule 5.4 ("Professional Independence of a Lawyer") broadly prohibits "permit[ting] a person who . . . pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment" in performing those services. And Rule 1.2(a) ("Scope of Representation and Allocation of Authority Between Client and Lawyer") mandates that the lawyer ". . . shall abide by a client's decision whether to settle a matter."

Like any investor in a "high risk-high reward" deal, the goal of a litigation funder is to increase the odds that the plaintiff it is backing not only prevails, but "hits big." This, in turn, creates a risk that the investor will want to do exactly what the authors' Rule 5.4 prohibit: direct, regulate, and possibly control the course of the litigation. And a provision giving the funder the right to veto the client's decision to accept a settlement agreement, while permissible between funder and client, plainly would not be permitted between lawyer and client under RPC 1.2(a).

In a Florida case, the pre-suit agreement between the plaintiffs and their funder gave the funder the right to "approve the filing of the lawsuit" and "control the selection of the plaintiffs' attorneys." Relying on its agreement, the funder also "recruited fact and expert witnesses; . . . reviewed and approved counsel's bills; and had the ability to veto any settlement."[5] This illustrates the type of agreement that would require the client to surrender to the funder certain protections embodied in the RPC such as the client's unfettered right to accept or reject a settlement offer.[6] Some funders even have sought to prohibit a plaintiff from discharging its current counsel or to substitute a different lawyer without the funder's written consent.[7] Still others effectively restrict the client from abandoning its lawsuit. Others condition their delivery of funds on the client's agreement to assign to the funder all of the client's rights in the cause of action in the event the client does abandon its claim.[8]

Even more potentially punitive to the client: a provision authorizing the funder to refuse further advances in the event the plaintiff's counsel makes certain strategic decisions with which the funder disagrees.

The ethical concern arising from a client's agreement to such funding terms is the risk that the deal may affect the lawyer's obligations under Rule 2.1 and 5.4 to exercise independent judgement, and under Rule 1.2(a) to "abide by" the client's decision to settle.

The Connecticut Supreme Court has long held, consistent with Rules 2.1 and 5.4, that counsel assigned—and paid by—a client's insurer to defend an insured, owes its duty of loyalty exclusively to the insured and not to the insurer. [9]

RPC 1.2(c) does permit a lawyer, with the client's informed consent, to "limit the scope of the representation." But the limitation must be "reasonable under the circumstances." For this reason, a client's assent to a funder's otherwise onerous limitations on the professional judgment of its counsel may be "reasonable" if the client is a sophisticated business entity. Conversely, in the case of significant restraints on the lawyer's customary obligations of diligence and communication in the representation of an unsophisticated client, the scope limitation may not be "reasonable" within the meaning of RPC 1.2(a). Under these circumstances the lawyer may not be able to diligently and competently represent the client, and would be required to terminate the representation. This is because RPC 1.16(a) requires termination if the client's proposed course of action will result in the lawyer's violation of other provisions of the RPC.

As is the case with counsel meeting the duty of conflict-free representation, the lawyer can most effectively meet his or her duty of independent professional judgment by a carefully worded letter to the client confirming the client's specific consent to each arguable limitation on counsel's judgment. Such disclosures should include, at a minimum, an express disclaimer that the lawyer does not, and will not, represent the client in negotiating the terms of the funding deal on the client's behalf.

In addition, the lawyer should obtain the client's written acknowledgement that in the event the lawyer winds up holding proceeds of any recovery, the lawyer may be duty bound not to deliver funds to the client if the funder demands the funds under its agreement with the client.

Moreover, the prudent plaintiff's counsel also will write a letter to both the client and to the funder confirming, among other things, that it is the client and not the funder, from whom the lawyer will take direction on key strategic decisions, including most importantly, the decision on whether to accept a settlement offer.

Duties of Confidentiality and Protecting the Attorney-Client Privilege

Not surprisingly, as part of its underwriting process, a litigation funder typically will require the client to authorize its counsel to release information otherwise protected by the attorney-client privilege, and/or the work product doctrine, as well as by the lawyer's duty of confidentiality under RPC 1.6 ("Confidentiality of Information"). For plaintiff's counsel, the concern is obvious: the likelihood the lawyer's adversary will argue that by sharing confidential litigation information with a funder, the client has voluntarily waived such protections.

Some courts have found waiver under such circumstances, rejecting a plaintiff's claim that information provided to a funder to assist the funder's due diligence is protected by the attorney-client privilege under the so-called "common interest" exception to waiver principles.[10] Other courts have held the opposite: that litigation related disclosures to the funder are privileged under the common interest doctrine because the information shared by the plaintiff's counsel was for the "limited purpose of assisting" both the client and the client's designated funder in their "common cause" to maximize a recovery.[11]

Should a plaintiff's counsel ever facilitate

such a potential waiver of confidentiality?

Here, again, the most effective tool to manage the risks for plaintiff's counsel is a detailed confirmatory letter to the client. In such a letter counsel should explain all the risks to the client in counsel's compliance with the client's direction to respond to the funder's requests for information.

Ideally, the lawyer will confirm each specific category of information the client has voluntarily authorized counsel to disclose to the funder, including ongoing reports to the funder of material developments in the prosecution of the action.

Some courts have protected exchanges with a funder where the plaintiff's counsel has taken steps to shield, and to limit the distribution of, such disclosures. Thus, plaintiff's counsel should also confirm in writing—to both the client and the funder—that counsel's agreement to make the requested disclosures to the funder is expressly conditioned on the funder's pledge to strictly safeguard all such information as well as its acknowledgment that it in fact does share a "common interest" with the client. The client also should be asked to acknowledge in writing that its counsel has fully explained the risk that a court ultimately might conclude that otherwise protected information, including assessments of the strengths and weakness of the claims and defenses and likely verdict ranges, is not protected and thus discoverable by the defendant.

In its 1999 opinion, the CBA Ethics Committee warned that "to avoid violating Rule 1.6(a)" the plaintiff's lawyer "would necessarily have to have a significant conversation with the client" about whether the disclosures required by a potential a funder "might constitute a waiver of the attorney-client privilege or render discoverable otherwise undiscoverable information."

Conclusion

The emerging capital market in litigation funding reflects the demands of both individual tort plaintiffs as well as well heeled, but budget conscious, corporate litigants. An individual plaintiff seeking damages under a contingency fee arrangement may be in need of cash to pay living or medical expenses. Such clients realize that "the most valuable asset against which they can obtain capital is a contingent share of an eventual judgment of settlement."[12] And a large corporation prosecuting big dollar commercial claims through a law firm historically adverse to contingency fee deals may have discovered that utilizing third party financing provides an attractive hedge against an uncertain result while minimizing the enormous, and frequently unanticipated, outlays necessary to fund complex litigation in the 21st century.

This means that lawyers and law firms will, of course, need to respond to the broad array of clients turning to non-traditional means of financing litigation such as the non-recourse funding described above. But as in any emerging trend in the legal services marketplace, lawyers must pay particular attention to the ethical pitfalls that accompany such changes. CL

Notes

1. Apparently those funders investing in commercial litigation search for cases in which they predict the claim value is likely to exceed the amount of their investment by a margin of at least 5:1. Agee, "Litigation Financing: A Business Development Opportunity," Law Practice at 105 (Nov.-Dec. 2014). Some funders offer litigation financing to defendants in exchange for a set percentage of the savings relative to the amount of the claim or demand.
2. CBA Informal Op. 99-42 (1999) "Advance of Funds to Client by Third Party"
3. Restatement (Third) of the Law Governing Lawyers §125 ("A Lawyer's Personal Interest Affecting the Representation of A Client") comment c (2000).
4. The authors of Rule 1.7 define "informed consent" as "the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks and reasonably available alternatives to the proposed course of conduct."
5. Abu-Ghazaleh v. Chaul, 36 So. 3d 691, 693 (Fla. Ct. App. 2009)
6. According to the CBA Professional Ethics Committee, a lawyer who includes a provision in a client engagement agreement that alters the fee arrangement in the event the client rejects a settlement offer the attorney recommends the client accept (by converting a contingency based fee into an hourly one) violates the command of Rule 1.2(a) of the RPC that a "lawyer shall abide by a client's decision whether to settle a matter." CBA Informal Op. 99-18 (1999) "Contingency/Hourly Fee Agreement."
7. Michigan Advisory Op. RI-321 (2000).
8. Agreements that impose such restrictions on a litigant's autonomy, or otherwise require the assignment of the client's rights to collect on a judgment, also may be deemed unenforceable (as between a plaintiff and a funder) for reasons unconnected to the lawyer's professional obligations; namely, the public policy embodied in the ancient prohibition against champerty. In the context of an objection to a Chapter 11 bankruptcy trustee's request for approval of a litigation funding agreement, a Bankruptcy court judge – applying Connecticut law – rejected a claim by potential defendants that the arrangement was champertous and thus enforceable. In re Complete Retreats, LLC, 2011 WL 1434579 (Bankr. D. Conn. April 14, 2011) (Shiff, J.) But in so doing, the court specifically relied on, among other things, the facts that the client had not: (1) assigned to the funder its rights to pursue the claims; or (2) delegated control of the litigation to the funder "including the right to" seek "approval of any settlement." Id. at *3. See also, Justinian Capital SPC v. WestLB AG, 2016 WL 6270071 (N.Y. Oct. 27, 2016) (statutory prohibition on champerty barred a plaintiff from collecting on promissory notes where it had acquired the notes for the "sole purpose" of suing on the notes in place of the original note holder).
9. Metropolitan Life Insurance Co. v. Aetna Casualty and Surety Co., 249 Conn 36, 61 (1999) (". . . even when an insurer retains an attorney . . . to defend a suit against an insured, the attorney's only allegiance is to the client, the insured."; the attorney's ". . . duty of loyalty . . . remains exclusively with the insured.'") (emphasis in original; citation omitted).
10. Miller UK Ltd. v. Caterpillar, Inc., 17 F. Supp. 3d 711 (N.D. Ill. 2014); Leader Technologies, Inc. v. Facebook, Inc., 719 F. Supp. 2d 373 (D. Del. 2010). In January 2017, the U.S. District Court for the Northern District of California became the first court in the nation to adopt a policy permitting defendants to discover the iden-tity of any outside funder of a plaintiff's claims. However, the new rule (embodied in the District Court's "Standing Order" on discovery in civil actions) is limited to class actions.
11. In re International Oil Trading Co., LLC, 548 B.R. 825 (Bankr. S.D. Fla. 2016). Most courts have rejected, as not calculated to lead to the discovery of evidence admissible at trial, a defendant's demand a plaintiff disclosure ". . . the amount of money sought or received" from the funder "the details of the [funding] agreement . . . or how much the funder will receive" in the event of a recovery. Miller UK Ltd. v. Caterpillar, Inc., 17 F. Supp. 3d at 742.
12. ABA Commission on Ethics 20/20 "Informational Report to The House of Delegates" (ABA "White Paper") (Feb. 2012) at 27.