Litigation Finance Developments (Part III): Fee Splitting, Control, and Other Issues

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Part I of these articles on litigation finance dealt with the structure of litigation finance transactions, whether such transactions violate the legal prohibition against champerty, and whether disclosure of information from a client or its attorney to the funder results in a loss of the attorney-client privilege. Part II examined the question of discoverability of information exchanged between clients and their attorneys with litigation funders. The article considered in detail the "must read" decision of *Miller UK Ltd. v. Caterpillar, Inc.,* 17 F. Supp. 3d 1711 (N.D. Ill. 2014), which dealt with issues of the relevance of documents related to litigation funding, application of the principle of real party in interest, the common interest exception to waiver of the attorney-client privilege, and application of the work product doctrine to litigation funding materials. This article focuses on two ethical issues that often arise in litigation finance: fee splitting and independent professional judgment.

Fee splitting

Rule 5.4(a) of the South Carolina Rules of Professional Conduct generally prohibits lawyers from sharing legal fees with nonlawyers. Depending on the structure of the litigation finance transaction, the prohibition on fee splitting may be an issue. Third party financing of litigation can occur in a variety of ways:

(1) Purchase by or assignment to funder of all or portion of the claim. In this form of financing the funder either purchases all or a portion of the claimant's claim or takes an assignment of a percentage of the proceeds of the judgment or settlement in the case. The exact form depends on local law regarding the validity of transfers of claims to third parties. Funds may be used for litigation related expenses, such as expert witness fees, costs of document examination or production, or a portion of the legal fees in the case if the case is not being handled on a pure contingency fee. Funds may also be used for nonlitigation related expenses, unless prohibited by local law. **Fee splitting is not an issue when the funder purchases the client's claim because the funder does not receive anything from the lawyers handling the case. The funder's profit comes from the difference between the amount received for the claim and the purchase price of the claim.**

(2) Loan to owner of the claim. Instead of a purchase or assignment of the claim by the funder, the owner and the funder may enter into a loan transaction. Financing may be used for either litigation or nonlitigation related expenses, unless prohibited by local law. The interest rate would be set by negotiation based on the degree of risk the claimant and the funder are willing to assume, subject to any usury restrictions. The loan can be secured by the general assets of the claimant. The loan can also be secured by an interest in the claim itself or the proceeds of the claim, unless prohibited by local law. (See Part I on champerty.) The loan can be recourse or nonrecourse, but claimants who wish to reduce risk generally prefer nonrecourse loans. **Fee splitting is not an issue when the funder makes a loan to the client because the funder does not receive anything from the lawyers handling the case. The funder's profit comes from payments made by the client to the funder.**

(3) Loan to law firm for all or portion of expenses of case. Instead of a loan to the claimant, the funder may make a loan to the law firm that represents the claimant. Of course, this form of transaction requires full disclosure and consent by the claimant. See SCRPC 1.7. **This form of transaction involves an issue of fee splitting because the firm is making payments to the funder.**

(4) Cocounsel relationship with law firm funded by financing entity. If local law is unfavorable for a direct purchase by the funder and if a loan structure is undesirable, it may be possible to structure a cocounsel relationship between the law firm representing the claimant and a law firm funded by the financier. **This form of transaction also involves an issue of fee splitting because the cocounsel firm is making payments to the funder.**

Combinations of these four types of financing are possible. In addition, other transaction structures may develop as the industry matures.

In structures (3) and (4) the law firm that represents the claimant will be making interest and capital payments on loan that it receives from the funder. These payments will come from legal fees earned by the law firm. The mere fact that the financier is receiving payment of interest out of legal fees earned by law firm does not violate the rule against fee splitting. Because all or almost all revenues of a law firm come from legal fees, the rule cannot be applied literally. If it were, it would prohibit firms from making ordinary business payments, such as salaries to nonlawyer employees, rent to landlords, or utilities to providers of such services. In fact, a number of ethics opinions have held that law firms may borrow money from financial institutions and repay the loan out of the firm's revenues. See, e.g., Kentucky Bar Assn., Ethics Op. E-420 (holding that lawyers may borrow money from financial institutions to finance the costs of contingent fee cases); Ohio Supreme Court Board of Commissioners on Grievances and Discipline, Op. 2001-3 (holding that attorneys may obtain loans from financial institutions to underwrite expenses in contingent fee cases and may then deduct the interest and costs of these loans from the final award; opinion cites favorable precedent from Georgia, Illinois, Louisiana, Missouri, New Jersey, and New York City); Pa. Bar Assn. Op. #2000-04 (advising that a law firm may receive a start-up capital loan from a nonlawyer entity that is not a bank or lending institution). See also Douglas R. Richmond, *Other People's Money: The Ethics of Litigation Funding*, 56 Mercer L. Rev. 649, 676-681 (2005) (analyzing and rejecting arguments that litigation financing involves fee splitting with nonlawyers).

Thus, the source of a payment to a nonlawyer is not determinative as to whether the payment involves improper fee splitting. Instead, it is necessary to determine whether a particular fee payment to a nonlawyer violates the policies on which the prohibitions against fee splitting with nonlawyers are based.

Comment 1 to Rule 5.4 states the following policy: "The provisions of this Rule express traditional limitations on sharing fees. These limitations are to protect the lawyer's professional independence of judgment" (emphasis added). The Restatement of the Law Governing Lawyers provides a similar discussion of the policy underlying the fee splitting rule: "Those limitations are prophylactic and are designed to safeguard the professional independence of lawyers." Restatement (Third) of the Law Governing Lawyers §10, comment *b*. As discussed in the next section, the loan to the firm representing the claimant can be structured to protect the professional independence of the lawyers involved in the plan. The loan can be structured so that neither the funder nor any of its agents or affiliates will have the right to control the activities of the law firm representing the claimant or any of its lawyers in the handling of any case.

In addition, the transaction can be arranged to reduce the likelihood that a claim of fee splitting will be sustained. The transaction can be structured so that the funder will not have any direct interest in the fees from any case nor will it have a security interest in the proceeds of any particular case until funds are actually received by the law firm or the law firm has defaulted on the loan.

Ethics opinions in some jurisdictions have imposed limitations on the security for loans from financial institutions. Some opinions have held that a financial institution may not have a security interest in a lawyer's contingent fee. See, e.g. Kentucky Bar Assn., Ethics Op. E-420 (2002). The rationale for this limitation seems to be that the existence of such a lien may interfere with the lawyer's independent professional judgment on behalf of the client. Other opinions disagree and have held that it is ethically proper for a lawyer to participate in a transaction to finance litigation in which the lawyer pledges potential fees from the representation. See State Bar of Nevada Standing Committee on Ethics & Prof. Resp. Op. #36 (2007). Some opinions have decided that a financial institution may not obtain a security interest in the client's settlement or judgment. See, e.g. Ohio Supreme Court Board of Commissioners on Grievances and Discipline, Op. 2001-3. The rationale for this limitation is that a lender which has such an interest has a direct interest in the proceeds of the case and therefore engages in sharing of fees with a lawyer. Other authorities disagree with this limitation. See *Lawsuit Funding LLC v Lessoff*, 2013 N.Y. Misc. LEXIS 5685 (Sup. Ct. 2013) (finding that a security interest in lawyer's fees did not constitute sharing of legal fees and citing numerous authorities in support of this proposition).

Regardless of whether these limitations are sound as a matter of policy, they would not apply if the funder does not take a security interest or have any other legal right in the underlying case, in any prospective settlement or judgment, or in any contingency fee unless permitted by applicable ethics rules, and until such time as there is a default under the lending agreement. However, it should be possible for the funding agreement to provide that the amounts received by the lawyer from designated cases must be deposited in a trust or special account and may only be withdrawn with the permission of the funder. It may also be possible for the funder to be a cosigner or to have a security interest in the account.

Interference with professional judgment

South Carolina Rule of Professional Conduct 5.4 expresses a general principle of professional independence: Nonlawyers should not control or interfere with the professional judgment of lawyers, except when the relationship is one of attorney and client. In particular, Rule 5.4(c) states: "A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services."

To comply with this ethical requirement, the loan agreement between the funder and the attorneys for the claimant must incorporate provisions to protect the independent professional judgment of the attorneys who represent the claimant. The claimant and its attorneys must retain control over all decisions affecting the case, including how discovery will be conducted, the strategy and tactics of negotiation, and whether to accept or reject any settlement offers.

While the claimant and its attorneys must retain control of the case, the loan agreement could incorporate a number of provisions allowing the financier to protect its investment without interfering with the independent professional judgment of the claimant's lawyers. The loan agreement could require the claimant and its attorneys to keep the funder and its attorneys informed on a periodic basis of the status of the case and to notify the funder and its attorneys of any settlement offers. It should be proper for the loan agreement to require the claimant and its attorneys to seek the advice of the funder and its attorneys regarding whether to accept or reject settlement offers, so long as the claimant retains the right to make the ultimate decision whether to accept or reject an offer. If the loan agreement provides for periodic rather than lump sum advances, it should be proper for the agreement to condition advances on the happening of certain events or benchmarks in the case, so long as the claimant and its attorneys retain decision making authority. Particular provisions or conditions should be reviewed by qualified ethics counsel for compliance with the ethical requirement of independent professional judgment.

In these three articles I have tried to cover a number of major issues both legal and ethical that lawyers face when considering litigation funding for their cases. However, the articles are not exhaustive. Other issues to consider, depending on the applicable law and ethics rules, are usury, conflicts of interest, fees, and business transactions with clients. For a comprehensive analysis of these issues and other issues see American Bar Association, Commission on Ethics 20/20, Information Report to the House of Delegates on Litigation Finance.