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Pitfalls to avoid with litigation funding

WHETHER A THIRD-PARTY LOAN IS MADE DIRECTLY TO THE CLIENT OR THE ATTORNEY BORROWS THE MONEY, THERE ARE ETHICAL PITFALLS

There are two basic types of third-party litigation-funding loans available: (1) direct loans to clients to help pay for personal expenses while litigation is ongoing, and (2) commercial litigation loans, which provide monies to the attorney prosecuting the case for litigation expenses.

A major advantage of the direct loans to clients over the client seeking credit in the marketplace is that these loans are most often non-recourse, meaning that if the litigation is unsuccessful, the plaintiff need not repay the loan. In both types of third-party loans, the main issues are ensuring that the attorney maintains confidentiality, and that the attorney exercises independent professional judgment in representing the client.

Third-party litigation funding has become prevalent in the United States in the last decade, but the practice has been widely accepted for many years in other parts of the world. (See Larry E. Ribstein, *The Death of Big Law*, 2010 Wis. L. Rev. 749, 754-59, 788-97 [exploring how litigation funding is emerging as a new law firm model]; see also, Susan Lorde Martin, *Litigation Financing: Another Subprime Industry that Has a Place in the United States Market*, 53 Vill. L. Rev. 83, 84 n.4 (2008) ["[M]any large lawsuits, such as the vitamins anti-trust suit, the asbestos cases and the Vioxx cases, have been supported by litigation financing companies which are funded by banks, private equity and hedge funds."].)

These loans carry extremely high interest rates, but ordinarily do not run afoul of usury laws, since they are considered the purchase of a contingent asset, rather than a loan with guaranteed repayment. (*Fast Trak Investment Co., LLC v. Sax* (9th Cir. 2020) 962 F.3d 455, 465-67.)

Litigation funding provides an opportunity to bring a lawsuit the plaintiff cannot otherwise afford and allows counsel to work on either a contingency or hybrid hourly/contingency basis, thereby advancing access to justice for underserved communities. When the monies from litigation-funding loans are for personal expenses, they can provide critical support when the plaintiff is out of work due to the injuries which are the subject of the litigation. For small businesses, a loan which pays for litigation expenses (and sometimes part of the attorneys' fees) can even the playing field against larger businesses.

Champerty laws and litigation funding

In jurisdictions where there are laws against champerty, courts have wrestled with the enforceability of litigation-funding loans. (*Charge Injection Technologies, Inc. v. E.I. DuPont De Nemours & Company*, 2016 WL 937400 (Del. Super. Ct. Mar. 9, 2016) [finding litigation-funding loan did not violate law against champerty since the client and attorney controlled the litigation].) Champerty is the act of maintaining a litigation to receive a stake in the litigation recovery. Champerty was first recognized in medieval times to prevent frivolous lawsuits, but it has been abolished in most jurisdictions which recognized it. California has no law against champerty which would invalidate a third-party litigation loan. (*Mathewson v. Fitch* (1863) 22 Cal. 86, 94-95; *Estate of Cohen* (1944) 66 Cal.App.2d 450, 458.)

In a recent opinion of the Standing Committee on Professional Responsibility and Competence (Formal Opinion No. 2020-204), the State Bar advised that litigation-funding loans are permitted, so long as the attorney maintains client confidentiality, the attorney exercises independent professional judgment and competence, and the attorney remains loyal to the client.

Nevertheless, both types of litigation-funding loans present special ethical challenges under the State Bar Act and the Rules of Professional Conduct. When considering or recommending such a loan in a particular case, an attorney must consider the applicable rules at the time the loan is arranged to avoid problems which might arise if the client balks at repayment at the conclusion of the case.

Maintaining confidentiality of client information

Before extending either a consumer or commercial litigation-funding loan, a lender will inquire into the quality of the case since the lender will only be paid if the litigation is successful. The trouble is maintaining the confidentiality of communications about the case with the litigation-funding company – especially the attorney's impressions as to the likelihood of success and merits. Tension exists between an attorney's duty of confidentiality to the client and a lender's need to know.

Rule of Professional Conduct 1.6(a) provides: "A lawyer shall not reveal information protected from disclosure by Business and Professions Code section 6068, subdivision (e)(1) unless the client gives informed consent, or the disclosure is permitted by paragraph (b) of this rule." Business and Professions Code section 6068(e)(1) states: "It is the duty of an attorney to . . . maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."

Client consent to the loan

Even when the client would benefit from a litigation-funding loan, the attorney must first obtain the client's informed written consent to discuss any confidential information about the case with the litigation-funding company. To obtain the client's informed written consent, the attorney will need to disclose all the material risks, including the opposing party's likely attempt to seek the confidential communications in discovery, and the potential adverse consequences of having the opposition know the attorney's impressions about the strengths and weaknesses of the client's case.

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At a minimum, an attorney who recommends a litigation-funding loan should have a nondisclosure agreement with the lender, and prominently mark as "Confidential" all communications with the lender. This is necessary to meet basic standard of competency required by Rule of Professional Conduct 1.1, that "[a] lawyer shall not intentionally, recklessly, with gross negligence, or repeatedly fail to perform legal services with competence."

Evidence Code section 952 renders confidential any communication necessary to advance the client's interests, even when third parties are part of the communication. (*De Los Santos v. Superior Ct.* (1980) 27 Cal.3d 677, 683.) Section 952 defines "'confidential communication between client and lawyer' [as meaning] information transmitted between a client and his or her lawyer in the course of that relationship and in confidence by a means which, so far as the client is aware, *discloses the information to no third persons other than those who are present to further the interest of the client in the consultation or those to whom disclosure is reasonably necessary for the transmission of the information or the accomplishment of the purpose for which the lawyer is consulted*, and includes a legal opinion formed and the advice given by the lawyer in the course of that relationship" (emphasis added).

The loan agreement should provide that status reports as to the progress in the litigation are necessary to obtain and maintain the funding, to support an argument that communications with the lender should be treated as confidential as reasonably necessary for the purpose for which the lawyer was consulted.

It is an open question whether sharing information which would otherwise be confidential with a litigation-funding company defeats the privilege. Cases across the country have analyzed the issue in terms of the attorney-client privilege and the work product doctrine, or both. (See, e.g., *Leader Techs., Inc. v. Facebook, Inc.* (D. Del. 2010) 719 F. Supp. 2d 373, 376-77 [attorney-client privilege not applicable to communications with litigation-funding company prior to loan issuance since no common interest between plaintiff and lender existed at that time]; *Mondis Tech., Ltd. v. LG Elecs., Inc.*, 2011 WL 1714304, at *1-3 (E.D. Tex. May 4, 2011) [work product protection not waived by communicating details about case to litigation-funding company].)

If communications with any potential litigation-funding company are sought in discovery, the attorney must be prepared to assert any privilege, and, if required, to identify the communications on a privilege log so that the propriety of the assertion of privilege can be tested. (See *Hernandez v. Superior Ct.* (2003) 112 Cal.App.4th 285, 294, as modified (Oct. 23, 2003).)

Competence in advising client about the litigation-funding loan

When advising a client whether to consider a litigation-funding loan, the lawyer must have the learning and ability necessary to advise the client on the pros and cons of entering into the loan as required by Rule of Professional Conduct 1.1(b).

Rule of Professional Conduct 1.4(a) provides, "[a] lawyer shall: . . . (2) reasonably consult with the client about the means by which to accomplish the client's objectives in the representation." Rule 1.4(b) provides, "[a] lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." Taken together, these provisions mean the lawyer must competently explain both the advantages and disadvantages (such as the relatively high interest and the principal which will be repaid from the settlement proceeds), of the litigation-funding loan, in terms the client can understand.

The more unsophisticated the client, the more time the attorney will need to explain the benefits and disadvantages of the proposed loan. The attorney should manage the client's expectations at the outset, since litigation-funding loans usually become an issue when the client is incensed by how much of the recovery goes to satisfying the loan lien.

Before recommending a litigation-funding loan or any particular lender, attorneys must educate themselves as to the law on litigation finance, including the funding's potential impact on the client's litigation and decisions in the litigation.

Attorney's duty to exercise independent professional judgment

Rule of Professional Conduct 2.1 states, "[i]n representing a client, a lawyer shall exercise independent professional judgment and render candid advice." The attorney owes an undivided duty of loyalty to the client. (*Flatt v. Superior Ct.* (1994) 9 Cal.4th 275, 282.) Thus, an attorney cannot enter into a business transaction with a client without meeting certain conditions and obtaining informed written consent. (Rule of Professional Conduct 1.8.1.) Similarly, an attorney cannot represent adverse parties without informed written consent. (Rules of Professional Conduct 1.7 and 1.9.)

Rule of Professional Conduct 1.7(b) prohibits an attorney from representing a client where there is a significant risk that the continued representation will be materially limited by the attorney's duties to or relationship with a third party or the attorney's own interests. Even with informed written consent, the attorney cannot continue the representation unless the attorney reasonably believes she can provide competent representation.

Lender tries to dictate course of litigation

If, as a requirement to obtain and maintain a litigation-funding loan, the lender dictates the course of the litigation, there is a serious risk that the attorney's professional judgment might be impaired. Moreover, if the loan agreement provides that part of the attorney's fees are paid from the proceeds of the loan, there is a substantial likelihood that the lender will exercise influence on the direction of the

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litigation, undermining both the attorney's loyalty to the client and the attorney's own professional judgment.

In all cases where the litigation-funding loan provides for payment of attorney fees directly from the lender, the attorney must obtain the client's informed written consent for accepting compensation from a third party. Rule 1.8.6 of the Rules of Professional Conduct provides:

> A lawyer shall not enter into an agreement for, charge, or accept compensation for representing a client from one other than the client unless:
> (a) there is no interference with the lawyer's independent professional judgment or with the lawyer-client relationship;
> (b) information is protected as required by Business and Professions Code section 6068, subdivision (e)(1) and rule 1.6; and
> (c) the lawyer obtains the client's informed written consent at or before the time the lawyer has entered into the agreement for, charged, or accepted the compensation, or as soon thereafter as reasonably practicable . . .

In all cases the litigation-funding agreement may be a factor which impacts the attorney's advice to the client, but the litigation-funding agreement cannot abrogate the attorney's duty to pursue the best interests of the client. (See *Saunders v. Weissburg & Aronson* (1999) 74 Cal.App.4th 869, 873, as modified (Aug. 24, 1999), as modified on denial of reh'g (Sept. 8, 1999).)

Where a client approaches the attorney about whether to secure a litigation-funding loan either to pay the mounting litigation costs the client can no longer afford, or to pay the client's living expenses, the attorney must determine whether the attorney has enough experience and knowledge about litigation finance to provide competent advice. If the attorney lacks that expertise, the attorney can refer the client to another attorney to properly advise the client about litigation funding.

When the loan will pay part of the attorney fees

If the litigation-funding loan will be used to pay part of the attorney fees, it is important for the attorney to disclose that the litigation-funding loan may cause a significant risk that the attorney's representation of the client will be materially limited, either in the recommendation of the litigation-funding company or the terms of the litigation-funding contract. In those circumstances, under Rule 1.7(b), the attorney will be required to obtain informed written consent, after the client is provided an opportunity to seek advice of a disinterested attorney.

If the attorney has a relationship with the litigation-funding company, including any ownership interest, the litigation- funding loan would also have to comply with Rule 1.8.1 of the Rules of Professional Conduct since it would constitute a business transaction with the client.

Option for attorney to loan funds to the client

An alternative to a third-party direct loan to the client is for the attorney to loan funds directly to the client. California is one of the jurisdictions which allows such humanitarian loans. Rule 1.8.5(a)
of the Rules of Professional Conduct provides: "A lawyer shall not directly or indirectly pay or agree to pay, guarantee, or represent that the lawyer or lawyer's law firm will pay the personal or business expenses of a prospective or existing client."

However, Rule 1.8.5(b)(2) states, "[n]otwithstanding paragraph (a), a lawyer may . . . after the lawyer is retained by the client, agree to lend money to the client based on the client's written promise to repay the loan, provided the lawyer complies with rules 1.7(b), 1.7(c), and 1.8.1 before making the loan or agreeing to do so." Essentially, so long as the loan to the client is fair and reasonable (as required by Rule 1.8.1) and the attorney obtains the client's informed written consent after the client has the opportunity to obtain the advice of independent counsel, the attorney can provide an advance on the recovery to the client, so long as the client agrees in writing to the terms and that the loan will be repaid.

Conclusion

Litigation-funding loans are permitted in California both to cover litigation costs (and attorneys' fees) and for client living expenses. When recommending a litigation-funding loan or advising a client about the advantages and drawbacks for litigation funding, the attorney must possess the requisite skill and knowledge about litigation finance. If the attorney does not have the expertise, the attorney can consult with another knowledgeable attorney or can refer the client to another attorney for a consultation. Where the litigation-funding loan may materially limit an attorney's representation, the attorney must obtain the client's informed written consent.

If the attorney has any interest in the litigation-funding company, the attorney must disclose the relationship and obtain the client's informed written consent before entering any loan arrangement with the client. In that case, the attorney must fully comply with the requirements for a business transaction with the client under Rule 1.8.5, which requires that the loan be fair and reasonable to the client and that the client provides informed written consent after the client has had an opportunity to seek independent counsel. As an alternative to consumer litigation funding, the attorney can provide a loan for living expenses to an existing client, provided the attorney complies with Rule 1.8.5.

Attorney Erin Joyce has extensive experience in State Bar investigations and disciplinary proceedings, as a former State Bar prosecutor for over 18 years. Erin's practice areas include State Bar discipline, moral character determination proceedings, reinstatements before the State Bar Court, professional licensing and ethics consultations.