

**AMERICAN BAR ASSOCIATION**

**ABA Commission on Ethics 20/20**

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**To: ABA Entities, Courts, Bar Associations (state, local, specialty and international), Law Schools, Individuals, and Entities**

**From: ABA Commission on Ethics 20/20 Working Group on Alternative Litigation Financing<sup>1</sup>**

**Re: For Comment: Issues Paper Concerning Lawyer's Involvement in Alternative Litigation Financing**

**Date: November 23, 2010**

**I. Introduction**

The American Bar Association Commission on Ethics 20/20 is examining a number of legal ethics issues arising from lawyers' involvement in alternative litigation financing ("ALF" - also commonly known as "third-party litigation financing") by individuals and entities other than parties to the action, their respective lawyers or insurers. An individual or entity that provides ALF is described as an "ALF supplier."<sup>2</sup>

The Commission has formed a Working Group to study the impact on legal ethics of ALF. This paper describes several issues that the Working Group has identified and seeks comments on possible approaches for dealing with the issues the Commission is currently considering. Comments received may be posted to the Commission's website and should be sent to the Commission as requested below by **February 15, 2011.**

<sup>1</sup> The members of the Working Group are Philip H. Schaeffer (Co-chair), Jeffrey B. Golden (Co-chair), Professor Stephen Gillers, Herman J. Russomanno, Hon. Kathryn A. Oberly, John C. Martin, Section of Litigation, Olav A. Haazen, Boies Schiller & Flexner LLP, Charles D. Schmerler, Section of International Law. Ruth Woodruff serves as Counsel.

<sup>2</sup> The term "alternative litigation financing" (ALF) is used throughout this document. See, e.g., Steven Garber, entitled "Alternative Litigation Financing in the United States: Issues, Knowns and Unknowns" (2010) [http://www.rand.org/pubs/occasional\\_papers/OP306/](http://www.rand.org/pubs/occasional_papers/OP306/). As noted in that report, the term "third-party financing" is not always an accurate characterization of the provision of capital by nontraditional sources because, in the United States, there are often already three or four parties involved in financing litigation, including plaintiffs, defendants, their lawyers, and defendants' insurers.

The Commission has taken no positions about the matters addressed in this paper. Rather, the Commission expects to use received comments to supplement the research the Commission has completed and facilitate development of reports and policy proposals. Types of proposals the Working Group may recommend to the Commission for its consideration include, but are not limited to, draft amendments to the Model Rules of Professional Conduct and/or its commentary, draft stand-alone court rules, practice considerations, or some combination thereof.

## I. A Brief Overview of ALF

The impact on the legal profession from globalization and technology are accompanied by changing economic forces that are presently manifesting themselves in three main ways: investment where allowed in law firm equity; outsourcing, domestically and internationally by lawyers and law firms; and third--the subject of this memo--alternative financing of litigation (ALF).

There is a spectrum of ALF providers that ranges, for example, from sophisticated investments in major cases such as critical patent litigation, with the investors seeking returns akin to venture capital returns, to support of personal injury litigation. ALF is presently characterized by spreading the risk of litigation to investors via various methods, including, predominately, nonrecourse or limited recourse financing.

ALF is relatively new in the United States but appears to be evolving as a method of providing financial support to litigants. It characteristically takes the form of non-recourse financing, secured solely by the claim.

Investors, both traditional and non-traditional financiers, advance funding either as a lump sum or periodic payments to a claimant in exchange for a share of the proceeds of the judgment on or settlement of the financed claim. The business model requires that the ALF supplier assume the risk that if the claim is unsuccessful, in whole or in part, the ALF supplier may not recover any or a part of the sums so advanced. A variation of ALF may be an investor's acquisition of a full or partial interest in a claim. Information obtained by the Working Group shows that at present investors in ALF are primarily financing the claimant, though defense side financing is also possible.

No doubt because of the rules in the United Kingdom (U.K.) limiting contingency fees, ALF has proved to be a substantial industry there. Rule 8 of the Solicitor's Code of Conduct (2007) and prior bar rules specifically permit fee sharing between solicitors and laypersons. This Rule encourages ALF; in fact, a number of ALFs in the U.K. are publicly traded entities. There is currently discussion among the U.K. solicitors' community and its Law Society as to the merits and lack thereof of ALF. A newly emerging market for ALF has developed in Australia.

In the United States, experience with litigation financing is more limited and has tended, thus far at least, to be concentrated in litigation involving relatively inexperienced clients – those who are not repeated litigants. There is some reason to believe that experienced litigants, particularly business enterprises, are participating in ALF to support their claims and defenses.

In its modern and variant forms, ALF implicates historic, but potentially relevant doctrines. The older doctrines include maintenance, champerty, barratry, usury, and unconscionability. They are described in Part III. It also implicates to a greater extent, professional responsibility issues, such as confidentiality and privilege, professional independence, conflict of interest, fees, client-lawyer relationship, and settlement. They are described in Part IV. Each part is informed by the common law, the model rules, and the law governing lawyering.

### III. Historic Doctrines

Discussion of ALF has sometimes involved an analysis of common law prohibitions such as maintenance, champerty, and barratry. These prohibitions originated in medieval England and became a part of the common law of the American colonies. They were designed to protect litigants from “officious intermeddling” and profiteering from the sale of legal claims to third parties. A few jurisdictions recently have abandoned these doctrines, usually because other local doctrines of law are adequate to address the underlying concerns. *See, e.g., Osprey, Inc. v. Cabana Ltd. Pushup*, 532 S.E.2d 269, 277-78 (S.C. 2000); *Saladini v. Righellis*, 687 N.E.2d 1224, 1227 (Mass. 1997); and *Landi v. Arkules*, 835 P.2d 458, 464 n.1 (Ariz. Ct. App. 1992). Several courts have reviewed ALF arrangements on champerty/maintenance/barratry standards. The Commission's task is not to assess the validity or reasonableness of cases holding that ALF constitutes maintenance, champerty, or barratry. The task, instead, is to identify and analyze potential pitfalls under applicable rules of professional conduct for lawyers involved in ALF.

Other grounds for challenges to ALF have involved prohibitions against usury, because some types of litigation financing have been characterized as lending notwithstanding ALF characteristically does not provide for recourse against the claimant, the customary requirement for financing to be considered a loan. Usury is of course the taking of interest at a rate that exceeds the maximum rate provided by law for the particular category of lender involved in the transaction. There is considerable variation from state to state in the interest rates that constitute usury and in the extent to which different rates may be specified for different types of lenders (e.g., banks, insurance companies, merchants, etc.).

ALF may also be vulnerable to a challenge based on unconscionability. *See, e.g., Fausone v. U.S. Claims, Inc.*, 915 So.2d 626, 630 (Fla. Dist. Ct. App. 2005), *aff'd*, 931 So.2d 899 (Fla. 2006). Such a result is considerably more likely where the client is an unsophisticated individual, and thus suffering from an unequal bargaining position, than when the client is a business. *See e.g., Anglo-Dutch Petroleum Int'l, Inc. v. Haskell*, 193 S.W.3d 87, 91, 94, 105 (Tex. App. 2006).

#### IV. Modern Issues of Professional Responsibility

ALF arrangements can create pitfalls for lawyers in a number of different ways in addition to those that are an outgrowth of purely legal issues. Particular practices, such as lawyers owning equity interest in ALF providers, may span some of the categories of issues discussed below. An attempt has been made herein to organize the issues into familiar categories: Confidentiality and Privilege, Professional Independence, Conflicts of Interest, Fees, and the Client-Lawyer Relationship.

##### *Confidentiality and Privilege*

ALF suppliers often, as part of their underwriting process, require the lawyer to release information or to provide a litigation assessment referencing such information. That information is manifestly relevant to the decision of the ALF supplier. Such disclosures also clearly involve potential waivers of confidentiality and privilege that require client's consent.

As to privilege, the common interest exception very likely does not allow the lawyer who knows most about the matter to make disclosure to the ALF supplier without losing the benefit of the privilege and work product doctrine.

The Working Group is considering whether such disclosures to an ALF supplier could feasibly be limited to otherwise discoverable materials relevant to furthering the financing of the litigation, and, if so, whether informed consent of the client would still be required. If such a limitation is not practicable, the Working Group will then consider what to recommend to the Commission to preserve confidentiality and privilege in this situation. Issues include what disclosures must be made by the lawyer to the client concerning the risk that confidentiality and/or privilege may be waived. Further, the Working Group will consider what disclosures must be made to the client concerning the possibility that information shared with the ALF supplier may be used to the client's disadvantage in setting the terms of the financing.

*Professional Independence of the Lawyer*

An ALF supplier may, as part of the financing documentation, require the lawyer to acknowledge a duty to pay over the proceeds recovered by judgment or settlement or a part thereof to the ALF supplier. Executing such an acknowledgment may compromise the lawyer's position later on, undermining the duty of loyalty to the client, having entered into an agreement with a third person whose interests might become adverse to the client's: in other words, a Hobson's choice between the duty of loyalty to the client and a contracted duty owed to an ALF supplier. (*See* Model Rule 1.7(a) and (b)).

Care must be taken that the arrangement does not run afoul of Model Rule 5.4(c)'s prohibition against compromising the lawyer's independent professional judgment. Situations can be foreseen (and perhaps some cannot) in which the interests of the ALF supplier conflicts with what the lawyer perceives to be in the best interest of the client. The existence of the financing arrangement may sow confusion about who actually owns the claim, who controls the lawsuit, the role (if any) of the ALF supplier participating in significant decision-making during the litigation, and how to resolve conflicts between the client's directive, the ALF supplier's financial expectations, and the lawyer's assessment of the client's best interests.

Similarly, a variety of issues (relating not just to professional independence but to other categories as well) arise where lawyers themselves own interests in ALF suppliers. Some of these issues are presented more specifically in the questions for comment appended to this paper. The Working Group is also interested in receiving comment on whether these issues are different

in kind from those arising in somewhat analogous contexts (*e.g.*, where the costs of litigation are being borne by an insurer or an indemnitor).

In these and other situations, the lawyer must review the applicable rules of professional conduct and ethics opinions of the jurisdictions involved and provide adequate disclosure and advice to the client, so that informed consent, where necessary, can be given. The lawyer will also have to assess the consequences if the client chooses to execute the ALF agreement in contravention of the lawyer's advice. In particular cases, several factors – such as the need for informed consent, the possibility of waivers of confidentiality and privilege and their impact on discovery, the need for waivers of conflicts of interest, and insertion into the mix of a third person with an economic interest in prolonging litigation to increase its profit – may place a significant (and possibly intolerable) strain on the client-lawyer relationship, all of which would also have to be discussed with the client.

#### *Conflicts of Interest*

Many clients contemplating ALF will look to their lawyers for advice as to the wisdom of their proposed course of action. Typically the lawyer furnishing that advice will be the same lawyer representing the client in the litigation. A variety of circumstances can arise in which the lawyer in such a situation could have a conflict of interest. How ALF might affect lawyers' duties as advocates, the potential for conflicts, the parameters of disclosure to the client with a view toward obtaining informed consent, and the ability of clients to provide informed consent are all matters for discussion.

Issues include the obligation, if any, a lawyer may have to advise an ALF supplier of material adverse developments in the litigation being financed and whether the existence of such an obligation creates a conflict covered by Model Rule 1.7. Additionally, there are questions as to conflicts created where the ALF lawyer is asked to provide litigation assessments (before the financing or afterward or both). Another, issue to be confronted is whether an ALF supplier that acquires an interest in the litigation is a joint, concurrent client of the lawyer for purposes of the conflict of interest rules.

In assessing consentability and waiver issues, an issue is whether the client must have independent advice from a lawyer other than the one representing the client in the litigation.

Further, should any distinction be drawn between experienced or “sophisticated” clients and other clients?

### *Fees*

Some variety of fee-related issues that can arise in connection with ALF involve whether a lawyer who refers a client to an ALF provider may receive a finder’s fee. This may depend on whether the fee is ultimately paid by the client or the ALF supplier. If the fee will be paid by the ALF supplier, must the lawyer obtain the client’s informed consent?

The Working Group sees an open question as to the likely impact of finder’s fees on “big picture” policy issues such as access to justice and proliferation of litigation, whether Rule 7.2(b)(4) adequately addresses such finder’s fees or whether there should be further regulation of finder’s fees intended to prevent “steering” practices and excessive fees.

Other issues include whether a lawyer may enter into an arrangement pursuant to which a ALF supplier pays non-contingent legal fees and whether the provider’s right of repayment may be subject to prior payment of all of the lawyer’s fees.

### *Client-Lawyer Relationship*

Professional issues may arise in the context of termination of the client-lawyer relationship. The existence of ALF and the provisions of the ALF agreement may have consequences upon the client’s ability to terminate the lawyer’s engagement or the lawyer’s ability to terminate or withdraw from the engagement.

If the ALF agreement between the ALF supplier and the client required the former’s prior written consent to terminating or changing counsel, without which consent such termination or change would constitute an event of default, the client’s rights or the lawyer’s rights and professional obligations may be impermissibly compromised.

If the client wishes to terminate, or the lawyer wishes to terminate or withdraw from the engagement, there may be limitations by reason of an ALF agreement provision requiring that the ALF supplier (or, at its option, the existing lawyer) play a role or have veto power in the selection of substitute or successor counsel.

V. Questions on which the Commission Seeks Your Comments

The American Bar Association Commission on Ethics 20/20 is assessing the professional implications of a growing trend (ALF) in which a variety of individuals and corporate entities are providing financing for litigation. The Commission and the Working Group expect to do further research, take testimony at public hearings, and use the comments received in response to the invitation in this paper to develop any proposals or reports on ALF. This includes considering whether any amendments to existing ethics rules as a result of this emerging ALF industry are necessary or appropriate. To that end, the Commission invites comments on any issues posed above and the following specific questions:

1. May a lawyer share confidential information with an ALF supplier consistent with the lawyer's duty of confidentiality under Model Rule 1.6 and the law of agency? This question encompasses both confidential information that is privileged and the broader category of information that includes privileged information plus information that is confidential but is not privileged.
  - a. With regard to privileged confidential information, can a lawyer be confident that sharing this information with an ALF supplier will not destroy the privilege? How certain should the lawyer be that sharing will not lose the privilege? What is the lawyer's duty to counsel the client on the risk of loss of privilege?
  - b. May a lawyer confidently assume that privileged information shared with an ALF supplier will remain privileged or does the level of confidence the lawyer needs to have before sharing require a change in the common interest doctrine?
  - c. With regard to non-privileged confidential information, are there any precautions the lawyer must or should take before sharing this information with an ALF supplier beyond informed client consent?
  - d. Will sharing information protected by Rule 1.6 require a change in the language of Rule 1.6?

- e. Is there any reason why ALF suppliers cannot intelligently assess whether to invest in a matter if it has no access to any confidential information in the lawyer's possession? If it has no access to privileged confidential information?
  - f. What does the lawyer's duty require him or her to do to insure that any such sharing protects such information against further dissemination to others?
  - g. If after an ALF supplier has made an investment in a matter, can the client withdraw the lawyer's authority to share further confidential information with the ALF supplier? What should the lawyer tell the client about that?
2. May a lawyer who is representing a client on a matter also have an equity interest in the ALF supplier that is funding the client?
- a. Does this situation present conflicts of interest for the lawyer that cannot be waived?
  - b. If not, does the client require independent legal advice whether to enter such a transaction and the terms? Does current Rule 1.8(a) now adequately protect the client or would an additional rule be needed?
  - c. Will the lawyer's investment unacceptably undermine the lawyer's ability to give disinterested advice on whether or not to settle (and for how much) and other management of the matter?
  - d. What is the effect of this situation on the answers to question 1?  
  
Is it possible to protect privileged or non-privileged confidential information, where advisable or where the client chooses, if the lawyer is also an investor in the ALF supplier?
  - e. Does this raise the prospect of a lawyer recovering so large a part of the client's recovery – for example 75 percent of the recovery or more, whether the lawyer is working for a contingency fee or other fee – as to be unreasonable under Rule 1.5?

- f. To the extent ALF is meant to allow the client to meet personal living expenses while the action is pending, does this violate Rule 1.8(e)?
  - g. Does this situation violate Rule 1.8(i) by giving the lawyer a “proprietary interest” in the client’s claim or the subject matter of the litigation?
  - h. Do any of these answers change when the lawyer in a firm that is representing a client does not have an interest in the ALF supplier but other firm lawyers do have individual investments in the ALF supplier that is making the investment? If so, can law firms avoid stricter controls by having different groups of lawyers invest in different ALF suppliers such that any matter can be handled by an individual lawyer who is not an investor in the ALF supplier funding his or her client’s matter?
- 3. Should a law firm be permitted to represent a client on a matter in which an ALF supplier has invested and concurrently represent the ALF supplier on an unrelated matter? Should a law firm be permitted to represent a client and also represent the ALF supplier on its investment in the same client’s matter? If the answer to either question is yes, under what conditions and what if any client consents are required?
- 4. What duties does a lawyer have to counsel the client when the client identifies an ALF supplier? What duties does a lawyer have to counsel a client when the lawyer suggests an ALF supplier, and in particular when the lawyer recommends a particular ALF supplier? Specifically, how if at all should a lawyer’s duties vary depending on whether the client is legally and financially sophisticated (a Fortune 500 company) or an individual with a personal injury claim who is inexperienced in dealing with lawyers and the legal system?
- 5. Will payment of a portion of a client’s recovery to an ALF supplier be consistent with Rule 5.4’s prohibition against sharing legal fees with a nonlawyer? Does the answer depend on how the arrangement is constructed?
- 6. What disclosures should a lawyer be required to make about his or her relationship to an ALF supplier in which the lawyer (and the lawyer’s associates) have no financial interest? For example, the ALF supplier may be the source of other work for the law

- firm. The ALF supplier may provide a benefit to the law firm for recommending it such as a finder's fee. Should a lawyer be allowed to accept any such benefit?
7. What if any role should a lawyer allow an ALF supplier to have to participate in decisions during the conduct of the matter, including but not only in settlement decisions?
  8. Traditionally, many law firms have advanced the cost of litigation and may do so with recoupment contingent on recovery. Rule 1.8(e)(1). Law firms may also be permitted to charge interest on these advances. An ALF supplier can substitute for this funding and thus free law firms from the risk of non-recovery. However, in the event of recovery, the client will be responsible not only for repayment of the advance (possibly plus interest), as now, but for the much larger profit to the ALF supplier. As such, in some circumstances, the rise of ALF suppliers may be disadvantageous to clients. Further, a client who shops around may find law firms that are willing to advance the costs of litigation and others that expect the client to go to an ALF supplier. What duty should a law firm that is unwilling to advance the cost of litigation have to inform the client that competing law firms may be willing to do so and to explain how that will benefit the client in the particular circumstances?
  9. What if any protections should legislation that authorizes ALF suppliers require to avoid excessive fees to the ALF supplier and predatory practices?
  10. Is ALF proper in financing class action law fees for plaintiffs? If so, what protections for the class should be established?
  11. To what extent are the ethical issues presented by ALF similar to those arising in more traditional instances in which an entity other than the named party for both finances and bears some portion of the risk of the litigation (for example, those arising out of the "tripartite relationship" between defendant, defense counsel, and liability insurer)?
  12. What lessons, if any, can be drawn from foreign experience (including without limitation that of the U.K. and Australia) with ALF?
  13. With regard to enforcement:
    - a. Should a party in litigation be able to challenge the opposing party's alternative litigation financing via a disqualification motion or other procedure?

- b. Should a client be able to challenge its lawyer's acceptance of alternative litigation financing via a challenge to the fees or otherwise?

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