Third-Party Litigation Funding: Understanding the Risks

by Christopher B. Little

I suggested my client borrow money to finance the lawsuit. What could go wrong?

The cost of hiring experts, paying for accident reconstruction, and otherwise funding a lawsuit is becoming prohibitive for many litigants, including plaintiffs involved in personal injury lawsuits. As these lawsuits increase in complexity and duration, many plaintiffs, often on the advice of counsel, are opting to seek litigation funding from third-party sources to support their lawsuits while they await compensation for their injuries. This article is an introduction to the use of third-party vendors in a lawsuit and generally explores issues that may arise when funding a lawsuit using third-party vendors whose only interest is profit.

Overview

Vendors typically provide litigation funding in one of two ways: (1) by making payments to medical health providers who provide treatment for the litigant; or (2) by providing cash payments directly to the litigant to pay for expenses. In many cases, the funding is not considered a loan because it is contingent on the outcome of the case, and a repayment obligation may not exist if the litigant does not prevail. Nevertheless, litigation-funding companies usually assist only those plaintiffs they believe have a high likelihood of prevailing in their lawsuit. Because of the risk involved, the repayment obligations are often coupled with an extremely high interest rate.

There is very little case law in Colorado on the use of litigation funding,[1] and the Colorado Bar Association has yet to address it in an ethics opinion. A reported decision in New York held that a litigation-funding company may sue a law firm for allegedly helping its client divert settlement money that should have been paid to the company.[2] Other states have visited the issue and permit contact between the financing company and the attorney.[3] However, lawyers must be aware that attorney–client privilege is to be protected in these conversations unless the client gives informed consent otherwise. Several states have ethics opinions that advise lawyers to warn the client about the possibility of losing the attorney–client privilege when making disclosures to financing companies.[4]

The Attorney's Role

Many litigants are unfamiliar with the availability of litigation funding, so the attorney often plays a significant role in initiating the arrangement, either by contacting the vendor directly or referring the client to a vendor. Although most funding agreements ultimately are between the funding company and the plaintiff, vendors usually require that the attorney acknowledge the funding agreement and agree to compensate them directly from the client's recovery.[5] In addition, most vendors will loan money or provide medical services only if they receive periodic reports from the attorney about the status of the case and, in some occasions, will not agree to issue funds until they have received detailed analysis of the claim from the attorney. In some engagement letters, the funding company requires that the lawyer provide at least the following:

- police report or accident incident report
- witness statements
- medical expense worksheet
- defendant policy limits and/or claim number
- hospital reports
- demand letter or summary of all damages
- doctor and expert summary reports.

Informed Consent

If the lawyer agrees to the terms of the agreement, he or she must obtain the client's informed consent. Whether informed consent was attained can have a significant impact on an eventual

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claim against the lawyer arising out of a mishandling of the personal injury lawsuit. Informed consent should be obtained in the form of a letter that addresses the following issues:

1. The lawyer must not have any interest, financial or otherwise, in the lender or medical provider.
2. The interest charged to the client may not exceed charges actually incurred by the lawyer.
3. The client must be fully informed of facts of and legal consequences to the arrangement, including discussions about:
   a. implied waiver of confidentiality
   b. third-party interest in the matter
   c. consent for settlement (does the vendor have a say in the outcome?)
   d. advantages and risks of the arrangement
   e. alternatives that might be available
   f. what happens if there is not a successful outcome.

How the lawyer obtains client consent, or how the client grants consent, is a complicated matter that has been the subject of much debate. Numerous articles explore the topic in detail, including Robert Keatinge's 2003 article on changes to the American Bar Association (ABA) Model Rules of Professional Conduct.[6]

Conflicts of Interest

When using litigation funding, it is important for the attorney and the client to understand how the addition of a third party will affect the attorney–client relationship and privilege. The funding company is involved to make a profit,[7] and may or may not enjoy a common interest with the lawyer or the injured client.[8] The lawyer cannot waive his or her client's privileges without the client's informed consent, because the privilege belongs to the client, not the attorney.[9] The lawyer should discuss cautiously but candidly with the client the potential for a conflict of interest and whether the lawyer or the funding company is becoming a creditor of the client.[10] The lawyer must be satisfied that the client has been properly advised about any and all potential ramifications of the transaction, including the possibility that the disclosure might waive the client's confidences. Absent this discussion, the client may not have given informed consent.

In many states, a lawyer's referral of a client to litigation-funding companies will be considered appropriate as long as the funding arrangement does not intrude on the lawyer's professional judgment and the lawyer does not disclose any client confidences without the client's consent.[11] Lawyers who have an interest in, or who receive referral fees or other benefits from the finance companies to which they refer their clients, must be cautious because these agreements may violate their state's rules of professional conduct.[12]

Some states do allow a lawyer to own an interest in the companies that provide funding to clients. Other states limit this to cases when the funds are provided to people who are not the attorney's clients.[13] For example, an Ohio appeals court held that a law firm's assignment of its interest in attorney fees to a litigation finance company was enforceable and did not violate Ohio Rule of Professional Conduct 5.4.[14]

A few states also allow an attorney to bill his or her client for services in representing the client while making an agreement with the financing company. Some opinions also state that attorneys may borrow money from the lending institution for case expenses and charge or pass on to the client the interest or finance charges of the institution.[15] This may acceptable, so long as the lawyer obtains the client's informed consent and the interest rate is reasonable.

When a lawyer obtains nonrecourse loans to finance the litigation in a contingent-fee scenario, the arrangement may violate ABA Model Rule of Professional Conduct 5.4.[16] Utah and Ohio are two states where the lawyer's obligation to repay the loan from the generated fee has been found to constitute the sharing of legal fees with nonlawyers.[17]

When Things Go Wrong

Many issues can arise when the case is lost, or the funding company is otherwise left out of the reward (for example, if the client settles for less than he or she owes, or abandons the claim altogether). Absent fraud or other intentional misconduct on the part of the attorney and the client, the funding company may have a breach of contract claim against the client, or against the client and the attorney.[18] The language of the retention letter with the funding company will control. The general review of a number of these letters suggests that the injured client is obligated in some cases, but in a majority of them, the client has no obligation to pay if there is no recovery from the original tortfeasor.

Things become more complicated when the client files a malpractice claim against the attorney.[19] Can the funding company "chase the funds" through the client's right to sue the attorney? As far as equitable subrogation is concerned, the answer may be no. In *State Farm Fire & Casualty Company v. Weiss*,[20] the Colorado Court of Appeals considered the issue of first impression of "whether an equitable subrogation action premised on a professional negligence claim against an attorney will lie." The court held that this type of action "will not lie."[21] In reaching this conclusion, the court started its analysis with the proposition that Colorado law prohibits the assignment of legal malpractice claims.[22] In Colorado, unless it involves fraud or malice, a legal malpractice claim must be based generally on the existence of an attorney–client relationship between the plaintiff and the defendant.[23] At the time this article was published, the lawyer could be responsible to the funding company on a claim of negligent misrepresentation, negligence, breach of contract, or even fraud. If the lawyer is sued by the client for causing the loss of the "case within the case," the funding company may want a piece of that pie.

Conclusion

Lawyers must be aware of potential ethical issues that accompany their clients' agreements with litigation-funding companies. Because Colorado has yet to make a statement on these issues, it is especially important for lawyers to fully inform their clients of the potential risks that may arise when entering into a litigation-funding agreement.

Notes

1. The Colorado Court of Appeals recently issued an opinion in *Mintz v. Accident and Injury Medical Specialists, PC*, No. 08CA1867 (Nov. 10, 2010), discussing an attorney who represented thirty-seven clients in automobile accident cases and the problems the attorney faced when required to account to the numerous medical providers who were hired to

treat the clients and who were supposed to be paid from the clients' settlement proceeds with the various tortfeasors. Although disposing of the claims in the attorney's favor, the attorney's efforts likely were time-consuming and expensive.

2. *See PS Finance LLC v. Parker Waichman Alonso,* N.Y.Sup.Ct. Reichmont Cnty., No. 100292/10 (June 28, 2010).

3. *See* Comm. on Rules of Prof'l Conduct of the State Bar of Az. Op. 2001-07 (2001) ("If a lawyer obtains client consent and certain other conditions are met, a lawyer may set up a line of credit with a third-party lender to advance costs and pass on the line of credit's interest charges to the client as a client cost.").

4. *See, e.g.*, Comm. on Prof'l Ethics of the Conn. Bar Ass'n Op. 99-2 (1999); Comm. on Ethics of the Md. State Bar Ass'n Op. 92-25 (1992); Mo. Office of Chief Disciplinary Counsel Informal Op. 2000-0229 (Nov. 2000); N.J. Advisory Comm. on Prof'l Ethics Op. 691 (2001); Comm. on Legal Ethics and Prof'l Responsibility of the Penn. State Bar Op. 99-8; Mich. State Bar Op. RI 321 (2000) (finding an agreement between a venture capital company and the plaintiff adverse and onerous, creating irreconcilable conflicts of interest between the lawyer and his client).

5. This acknowledgement can impose on the privilege between attorney and client and also raises a question of whether principles of champerty or usury have been violated. "Champerty" is defined as an agreement between a stranger to a lawsuit and a litigant "by which the stranger pursues the litigant's claim as consideration for receiving part of any judgment proceeds." *Black's Law Dictionary* (7th ed., 1999). In simpler terms, it may be an agreement to pay for litigation in return for a part of the proceeds. Colo. RPC 1.8(i) states that a lawyer is not to acquire a proprietary interest in the litigation that the lawyer is conducting for a client. This rule derives from champerty concepts and is designed to avoid giving the lawyer too great a stake in the representation. For information about usury, *see Lawsuit Financial, L.L.C. v. Curry*, 683 N.W.2d 233, 236-39 (Mich.App. 2004) (advances to the plaintiff were usurious because the lending company "had an absolute right to repayment").

6. Keatinge, "House of Delegates Approves the Ethics 2000 Report: The New Model Rules Compared with the Colorado Rules," 31 *The Colorado Lawyer* 37 (May 2002).

> Informed consent is defined in the Model Rules as "agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." Three levels of consent in the rules are: (1) "informed consent," which need not be in writing or signed by the client; (2) "informed consent, confirmed in writing," which must be communicated in written form by the lawyer, but does not have to be signed by the client; and (3) "informed consent confirmed in writing signed by the client," which requires the affirmative written consent of the client.

7. *See* Appelbaum, "Investors Bankroll Lawsuits to Profit From Payouts," *The New York Times* (Nov. 10, 2010), available at www.nytimes.com/2010/11/15/business/15lawsuit.html (discussing the lucrative opportunities for large banks, hedge funds, and private investors to invest in other people's lawsuits in the hope of sharing in the potential outcome).

8. Although not completely germane here, the question of damages that can be recovered for the injured client raises a serious question about candor with opposing parties and with the tribunal. In customary cases where the injured plaintiff has private insurance, the "billed versus paid" debate may persist. *See Tucker v. Volunteers of America*, 242 P.3d 1080 (Colo. 2010). It is likely that *Tucker* will not dispose of the "elephant in the room" question when an injured plaintiff retains a litigation-funding company to pay bills or to provide medical services. The litigation-funding company is not a collateral source. It has a stake in the outcome of the case. If the attorney is to present medical bills or out-of-pocket losses, the attorney risks a considerable challenge on the "billed versus paid" issue, including unexpected tax ramifications to the successful plaintiff. It would be intellectually dishonest to claim these expenses as damages when the contract states that the funding company will be repaid only on success of the claim. Clearly, the retained attorney will need to discuss this with the injured client.

9. CRS § 13-90-107(1)(b) ("An attorney shall not be examined without the consent of his client as to any communication made by the client to him or his advice given thereon in the course of professional employment. . . .").

10. *See* Colo. RPC 1.4 (duty to inform client whenever informed consent is required); 1.4, cmt. 5 (informed consent placed on spectrum of "explaining matters"); 1.5(d)(2), cmt. 2 (fee agreement confirmed in writing—discussion on fee division.); 1.6, cmt. 3 (confidentiality rule covers all information related to the representation and confidential information cannot be disclosed "except as authorized by these rules").

11. *See* Fl. State Bar Ass'n Op. 00-3 (2000) ("A lawyer may provide client with information about litigation finance companies if the lawyer believes this to be in the client's best interest. The lawyer also may give factual information about the case with the client's consent and the lawyer may honor the client's written assignment of a portion of the recovery to the company."). *See also* N.J. Advisory Comm. on Prof'l Ethics Op. 691 (2001).

12. Comm. on Prof'l Ethics of the N.Y. State Bar Op. 666 (1994); Penn. Op. 91-9; Board of Comms. on Grievances and Discipline of the Ohio Supreme Court Op. 2000-01 (2000).

13. N.Y. State Bar Op. 769 (2003); Ethics Advisory Comm. of the S.C. Bar Op. 92-06 (1992); Tex. Ops. 465 and 483 (1990, 1994) (a lawyer may own an interest in a lending institution that loans money to the lawyer's personal injury clients so long as the lawyer complies with the rules on conflicts of interest, advertising, and misconduct).

14. *Core Funding Group, LLC v. McDonald*, 2006 WL 832833 (Ohio App. 2006).

15. Comm. on Rules of Prof'l Conduct of the State Bar of Az. Op. 2001-07 (2001); Me. Board of Bar Overseers Op. 177 (2001); Mo. Bar Ass'n Informal Op. No. 970066 (2001); N.Y. State Bar Op. 754 (2002); Ethics Comm. of the Utah State Bar Op. 02-01 (2001).

16. American Bar Association Model Rule 5.4 states that "[a] lawyer or law firm shall not share legal fees with a nonlawyer," with a few numbered exceptions.

17. Ohio Supreme Court Op. 2004-2; Utah Bar Ass'n Op. 97-11 (1997).

18. Most lawyers' professional liability policies specifically exclude a claim against the attorney for breach of contract. If there is no insurance coverage for the breach of contract action, the attorney may have to satisfy any judgment out of his or her own pocket.

19. *See Holmes v. Young*, 885 P.2d 305, 311 (Colo.App. 1994); *McGee v. Hyatt Legal Services, Inc.*, 813 P.2d 754, 757 (Colo.App. 1990). To prevail on his or her professional negligence claim against an attorney, the client must establish the following elements: (1) the attorney owed a duty of care to plaintiff; (2) the attorney breached that duty; and (3) the attorney proximately caused damage to the injured client. *Bebo Constr. Co. v. Mattox & O'Brien, P.C.*, 990 P.2d 78, 83 (Colo. 1999). Colorado recognizes the "case within the case" doctrine with respect to the causation element of a professional negligence claim. *Id., citing Miller v. Byrne*, 916 P.2d 566 (Colo.App. 1995). Under this approach, the injured client must demonstrate that the claim underlying the malpractice action should have been successful if the attorney had acted in accordance with his or her duties. *Id.*

20. *State Farm Fire & Cas. Co. v. Weiss*, 194 P.3d 1063 (Colo.App. 2008).

21. *Id.* at 1065.

22. *Id. See also Roberts v. Holland & Hart*, 857 P.2d 492, 495 (Colo.App. 1993) (prohibits claims based on speculation).

23. *Mehaffy, Rider, Windholz & Wilson v. Cent. Bank Denver*, 892 P.2d 230, 239 (Colo. 1995). *But see Steele v. Allen*, 226 P.3d 1120 (Colo.App. 2009), *cert. granted* ("Thus, whether statements are made during an initial consultation for legal services or in a casual manner in a social setting may ultimately be determinative of whether a lawyer is liable for negligent misrepresentation."). ■