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PERSPECTIVE

State Bar offers ethical guidance on third-party litigation funding

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In less than five years, the growth of third-party funding has grown five-fold. A growing market which continues to expand as the costs of litigation rise and firms and solo practitioners seek alternative ways to fund the ever increasing cost of plaintiffs' lawsuits. When a lawyer and law firm receive third-party funding, the well-known professional duties to a client can easily become blurred and the need for ethical guidance by the State Bar of California has never been timelier.

On Oct. 1, the State Bar issued Formal Opinion No. 2020-204 to address ethical considerations for lawyers using third-party litigation funding in exchange for potential proceeds recovered in a lawsuit. Opinion No. 2020-204 provides much needed guidance for lawyers in this relatively new and growing part of the plaintiffs' bar, which is categorized as two distinct types: First, consumer litigation funding, which normally provides advances for personal funding in plaintiff claims. And second, and the more complex of the two, is commercial litigation funding, which is a risk-reward scheme where investment brokers fund litigation in order to potentially profit on a successful case.

By taking a secured contingent interest in the litigation, these third-party funders have a staked interest in the outcome of the case that has the potential to frustrate the attorneys' professional duties to their client. Third-party funders may try to influence the handling of a case and even offer up requests or demands on when and for how much to settle the client's case. Opinion No. 2020-204, which is summarized below, correctly notes that these types of third-party litigation funding arrangements create potential hotbeds of

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ethical and legal challenges for a lawyer to maintain their compliance with their sacrosanct professional duties to their client, including duty of loyalty, competency and communication, as well as confidentiality.

Maintaining Independent Professional Judgment: Duty of Loyalty

At all times, an attorney must reasonably believe they can provide competent and diligent representation, notwithstanding the potential conflict or relationship with a third person. Rule of Professional Conduct 1.7(d). However, due to retaining a direct interest in the outcome of the case, third-party funders commonly use contract language that potentially requires attorneys to breach client confidentiality and loyalty. Before advising a client on these types of funding agreements, attorneys should consider if they (i) understand funding agreements, (ii) have experience working with and negotiating agreements with funders, and (iii) ensure they understand the risk-profile of the case and the

success fee structure. Negotiating the terms of this third-party funding agreement is arguably a scope of representation unto itself.

Third-party funding contracts may create a risk that third-party lenders will exercise influence and control over pending litigation and strategy, which directly conflicts with an attorney's duty of loyalty to their client. The contract may contain settlement clauses, giving the lender ultimate power over settlement agreement. The funder might also require due diligence, a period of exclusivity, and a priority return, which may call into question an attorney's ability to maintain independent professional judgment while also beholden to the funder. Therefore, attorneys must be aware of the potential ethical violations created by third-party funder relationships and strive to maintain independent professional judgment.

Duties of Competence and Communication

An attorney has a duty to provide com-

petent representation, which requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation. Rule 1.1. If an attorney does not possess such skills, they must obtain the necessary understanding of litigation financing in order to adequately advise the client, consult with another attorney who has the requisite expertise, or inform the client that third-party funding agreements are outside the attorney's expertise. *Id.*

The duty to communicate with the client includes communicating the means by which an attorney hopes to accomplish the client's objectives in the representation. Rule 1.4(a)(2). An attorney's representation of the client may involve advising the client as to whether litigation funding would assist in accomplishing the client's goals. Whether or not the attorney is advising and/or negotiating a funding contract on behalf of a client, the attorney must understand how the terms of the funding agreement impact decisions in the litigation and communicate the same to the client.

Lastly, accepting compensation from third-party funders creates specific ethical obligations. "Rule 1.8.6 prohibits a lawyer from entering into an agreement for or accepting compensation for representing a client from one other than the client unless the client gives informed written consent, the attorney complies with the attorney's duty of confidentiality, and the payment arrangement will not interfere with the attorney's independent professional judgment or with the attorney-client relationship." Opinion No. 2020-204.

An attorney must ensure their independent professional judgment is not impaired by any funding arrangement with a third party. An attorney's actions must be dictated by the attorney's ethical obligation to pursue the client's best interest — and that alone — and not the interests of the third-party funder.

Complying with Duties of Confidentiality

Some third-party funding contracts require case updates and disclosures in order to fund and monitor their investments. How-

ever, attorneys have an ethical obligation to maintain the confidentiality of information learned throughout the course of representation. Attorneys must be diligent in avoiding potential disclosures which may cause adverse consequences to the client. Rule 1.6 prohibits an attorney from sharing confidential information without the client's informed consent. In practice, informed consent means the client must be informed of the relevant circumstances and the material risks of disclosure, including any actual and reasonably foreseeable adverse consequences.

Potentially, disclosing privileged information extends to whether attorney-funder communications may be discoverable. To prevent inadvertent disclosures, an attorney should advise the client to any risk of discoverability, take necessary steps to minimize the risk, and receive consent to disclosure. It remains an open question whether funding agreements and communications with funders is privileged communication as this issue has not yet been addressed by the courts. However, since case law is still developing in this area, attorneys should inform the client of the potential risks of waiver of the attorney-client privilege on disclosure of communication and work product to a third party, including a third-party litigation funder and obtain written consent

from the client prior to disclosure.

Takeaway

Attorneys who represent clients that use third-party litigation funding must be aware of the potential conflicts inherent in those contractual engagements and should not lose sight of their ethical and professional obligations to their clients. Attorneys are duty-bound to provide independent professional judgment, irrespective of the participation of a third-party funder in their case, and cannot be influenced by a third-party's interest in the outcome of the litigation.

Any time an attorney allows for a third party to participate in a case, whether it's a payor of attorney fees or litigation funder, a written conflict waiver explaining the potential conflict of interest and notice to obtain independent counsel on the issue is required. Failure to abide by the Rules of Professional Conduct on these central pillars of an attorneys' ethical obligations to their client as captured in the most recent State Bar Opinion No. 2020-204 can potentially result in disciplinary conduct or has the potential to give rise to a legal malpractice and/or breach of fiduciary duty action. Bottom line for attorneys: be aware of the risks involved in accepting litigation funding from third parties and proceed with caution. ■

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