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Advocate's VIEW

An update on non-recourse litigation loans

It has been three-and-a-half years since the publication of our last article on non-recourse litigation loans, which summarized the then-relevant legal and ethical implications of such loans when made to personal injury plaintiffs.

At the time of the article's publication in early 2012, proposed bills concerning regulation of non-recourse litigation loans had not managed to pass in the legislature, and there was very little case law on the topic. We queried to what extent the court system would be called upon to address the issues raised by non-recourse litigation loans to personal injury plaintiffs.

We are now moving toward the end of 2015, and not only is there no relevant legislation pending in New York, but there has been very little case law developed, and the litigation loan market is continuing to grow at a rapid speed. This article revisits and further discusses the legal and ethical implications of such loans, focusing specifically on how they can impact the attorney-client relationship.

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Non-recourse litigation loans – What are they and how they work

A little over a decade ago banks, hedge funds and private investors, while looking for the next investment opportunity, began to take notice of the market for and potential returns on litigation funding. Since then, the litigation funding industry has continued to grow.

The industry is generally split into two areas: commercial litigation funding and consumer litigation funding. In both areas, funders advance monies to litigants in exchange for a (usually hefty) stake in the recovery – that is, if there is a recovery. These transactions are non-recourse, meaning that the lender may only collect on the collateral pledged, which, in this case, is a certain portion of the proceeds of the litigation. The borrower is not personally liable for the debt. It is this contingent nature of the transaction and the inherent risk to the funders that allows funders to charge exorbitant fees and interest on their advances while avoiding usury laws.

New York's usury laws only apply to loans, and some courts have held that these "litigation loans" are not loans at all, see N.Y. CLS Gen. Oblig. § 5-501 (usury statute); *In re Lynx Strategies LLC v. Ferreira*, 28 Misc. 3d 1205(A) (Sup. Ct. NY County 2010) ("[U]sury applies to loans . . . [t]he instant transaction . . . is an ownership interest in proceeds for a claim, contingent on the actual existence of any proceeds."); accord *Lawsuit Funding LLC v. Lessoff*, 2013 NY Misc. LEXIS 5685 (Sup. Ct. NY County Dec. 4, 2013); but see *Echeverria v. Estate of Lindner,* 7 Misc. 3d 1019(A) (Sup. Ct. Nassau County 2005) (holding litigation loan was indeed a loan because the underlying action was premised on strict liability, and thus, recovery was a "sure thing").

(Our 2012 article discussed the then-pending case of Joseph Gill, who sued LawBuck$ for usury after he was told he owed an astonishing $116,000 for two litigation loans he received totaling $4,000. The day the motion to set aside the contracts as usurious was to be heard in Kings County Supreme Court, the motion was withdrawn. There have been no further developments in the case.)

These funding companies, however, do not take uncalculated risks when funding litigation. Funding companies conduct due diligence to determine the merits of each case and, thus, to size up their risk. The greater the risk to the funder, the higher the cost to the borrower.

When looking at the transaction from the perspective of commercial litigation funding, a sophisticated corporation's calculated decision to pay a high fee to a funding company to avoid taking the full risk in litigating a claim does not seem unreason-

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able. It is when you look at the transaction from the perspective of an individual plaintiff that the high fees become subject to higher scrutiny.

While the supporters of litigation finance, namely, the finance industry, argue that the high fees and interest are justified for the greater good – i.e. access to justice – critics lament that unknowing consumer litigants are hit with unexpectedly high fees that often swallow much of their recovery from litigation or prevent reasonable settlements.

The legal and ethical implications of litigation funding: attorney-client relationship

You are in your office when you get a call from one of your clients. He wants you to recommend a litigation funding company – he intends to use the funds to pay counsel fees. You care about your client's interests and know that litigation funding fees are obscenely high. But you know that this funding will raise a potential conflict for your firm, as it will receive the proceeds from the loan. As it is your duty as an attorney to provide your client with honest, unbiased advice, it may be wise to refer your client to another attorney to avoid this conflict of interest, see N.Y. Rules of Prof'l Conduct R. 1.7.

If, however, you are in a position where you can provide unbiased advice, it is wise to first have a conversation with your client concerning the client's true need for the funding. Are there any other alternatives? Perhaps the client, swayed by the funding company, does not have a real appreciation for the true cost of the funding? After all, litigation funding is almost wholly unregulated, and there is no standard consumer disclosure requirement. It is also prudent to advise the client concerning the potential funder, the provisions within the financing agreement, and the legal and ethical impact it will have on your relationship and in the litigation.

The funder

If your client is looking to you to recommend a lender, you should conduct a "reasonable investigation to determine whether particular providers are able and willing to offer financing on reasonable terms," see Ass'n of the Bar of the City of N.Y. Comm. on Prof'l Ethics, Formal Op. 2011-2; see also N.Y. State Bar Assoc. Ethics Op. 666 (1994) (attorney may refer client to a lending institution).

However, you "may wish to make clear that such assistance itself is not an endorsement of the financing company," see Ass'n of the Bar of the City of N.Y. Comm. on Prof'l Ethics, Formal Op. 2011-2.

The litigation finance agreement

If you are a litigator in a particular area of law, you may be outside your skillset reviewing, analyzing and advising your client concerning the financing agreement. New York Rules of Professional Conduct, Rule 1.1, Competence, requires you to become competent in that area of law before advising your client, to obtain the assistance of a competent attorney, or to refer your client to a competent attorney.

If you decide to review the finance agreement, you can expect the litigation finance agreement to outline the maximum investment by the funder, the expected return based upon the passage of time, the due diligence to be conducted by the funder, confidentiality, funder involvement in the case, termination of the relationship, and the priority and method of payment to the funder.

When advising your client on the provisions contained within the finance agreement, it is especially important to note the provisions governing the true cost of the funding, based upon the projected length of the litigation (which is of course subject to many variables out of counsel's control, including the court's calendar), and the projected recovery (of course taking into account any attorney contingency fee). It is also equally as important to advise your client concerning the potential impact of the funder's due diligence on privilege in the case at hand, and the impact of the funder's involvement in case strategy.

You may even be required to certify that you have reviewed the litigation finance agreement with your client. Several financing companies entered into a Stipulation with the New York state attorney general that requires the companies to obtain an attorney certification before entering into litigation loan agreements, among other requirements, see American Legal Finance Association, ALFA Agreement (Feb. 17, 2005), available at http://bit.ly/1ZDBR0Z. However, you may charge for your review of the agreement and attendant advice, see N.Y. State Bar Ass'n Ethics Op. 769 (2003).

The funder's due diligence

As part of due diligence prior to agreeing to advance funds for litigation, funding companies request client documents to assess the merits of the case. This is problematic because disclosure of material protected by the attorney-client privilege to a third party who has no legal interest in the case generally constitutes a waiver of the privilege, see, e.g., *Ambac Assur. Corp. v. Countrywide Home Loans, Inc.,* 124 AD3d 129 (1st Dept. 2014) (there is a waiver unless the communication is made to further a legal interest or common strategy of the parties); see also *Leader*

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Techns., Inc. v. Facebook, Inc., 719 F. Supp. 2d 373 (D. Del. 2010) (compelling disclosure of documents shared with financing companies during discussions about potential financing where no common interest established).

However, it has also been held that where attorney work product has been disclosed to a third-party under the protection of confidentiality provisions contained within the litigation finance agreement, such information is not subject to discovery, see *Miller UK Ltd. v. Caterpillar, Inc.*, 17 F. Supp. 3d 711 (N.D. Ill. 2014) (attorney work product shared with a litigation funder under a confidentiality agreement was protected from discovery).

Nevertheless, it is your duty under New York Rules of Professional Conduct, Rule 1.6, to obtain your client's informed consent prior to disclosure of any confidential or protected information to the funding company by explaining to the client the potential for waiver of the privilege and the consequences it may have in discovery and at trial, see N.Y. State Bar Ass'n Ethics Op. 769, supra. Further, it is important to only disclose that which is absolutely required – and nothing more.

Funder involvement in the case

Some funders require close involvement in cases. Your client should be made aware that the funder will not always have the client's interest in mind, but rather will consider its own financial interests when making suggestions or proposing a strategy. Your client must first consent to allowing the funder to direct strategy decisions, see Ass'n of the Bar of the City of N.Y. Comm. on Prof'l Ethics, Formal Op. 2011-2.

Where funders are closely involved in a case, the relationship between the funder, the attorney and the client resembles the tripartite relationship formed when an insurer selects counsel to represent and defend its policyholder. In both cases, in your role as an attorney, you must at all times make strategy decisions using your independent professional judgment, see N.Y. Rules of Prof'l Conduct R. 2.1. However, third-party insurers, unlike litigation funders, are subject to bad faith causes of action where they engage in bad faith settlement negotiations, see Maya Steinitz, "Whose Claim Is This Anyway? Third-Party Litigation Funding," 95 Minn. L. Rev. 1268, 1333 (2011) (for further discussion of insurer regulations versus funder freedoms).

Insurers are also subject to a stringent set of state regulations, whereas litigations funders are not. "[T]o protect its own interest in maximizing the fee it may earn, a financing company may object to steps calculated to advance the client's interests, such as pursuing a promising line of additional discovery at a cost the company would prefer to avoid, or accepting a settlement offer that does not meet the company's expectations regarding the return on its investment," see Ass'n of the Bar of the City of N.Y. Comm. on Prof'l Ethics, Formal Op. 2011-2.

Post-resolution roadblock

Even after you have settled the case, or taken it to a successful verdict, a roadblock may arise where your client instructs you not to pay the funding company its fee, even though you signed the financing agreement, see, e.g., L*egal Capital Corp. v. Rolnik*, 2013 NY Misc. LEXIS 4821 (Sup. Ct. NY County Oct. 9, 2013) (attorney breached obligation to pay litigation funder its share of the settlement proceeds).

In such a case, it may be best to notify your client and the funding company of the conflicting claims to the funds and hold the funds in the client trust account until the parties have resolved the dispute, see James M. Fischer, "Litigation Financing: A Real or Phantom Menace to Lawyer Professional Responsibility?" 27 Geo. J. Legal Ethics 191 (2014).

Conclusion

Litigation loans cause risks to all parties involved – the attorney, the client and the funder. However, attorneys arguably bear the greatest burden, both ethically and legally, in navigating through the rough waters to protect their clients and themselves. As litigation funding becomes more prevalent and widespread, attorneys will be faced with many legal and ethical questions heretofore unanswered.

At some point New York courts will be forced to attack these issues head on, and perhaps some court action will finally provide the impetus for our legislature to protect consumer litigants (and thereby provide further guidance to attorneys).

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