KENTUCKY BAR ASSOCIATION
Ethics Opinion KBA E-420
Issued: November 15, 2002

Since the adoption of the Rules of Professional Conduct in 1990, the Kentucky Supreme Court has adopted various amendments, and made substantial revisions in 2009. For example, this opinion refers to Rule 1.5, which was amended to require that contingent fee contracts be in writing, signed by the client. Lawyers should consult the current version of the rules and comments, SCR 3.130 (available at http://www.kybar.org), before relying on this opinion.

Subject: **Lawyer Borrowing Litigation Costs and Granting Lender a Security Interest in Lawyer's Contingent Fee**

Question 1: May a lawyer who represents a client under a contingent fee contract borrow funds from a lending institution to cover litigation expenses?

Answer: Yes, subject to the cautions set forth below.

Question 2: May the lawyer pass the interest on the loan (along with other related fees) on to the client by deducting them from the proceeds of a judgment or settlement before computing the net sum owed to the client?

Answer: Yes, subject to the cautions set forth below.

Question 3: May the lawyer give a lender a security interest in the contingent fee in a particular case?

Answer: No, for reasons set forth below.

Principal References:

Utah State Bar Ethics Advisory Opinion 02-01 (2002); Ohio Board of Commissioners on Grievances and Discipline Opinion 2001-3 (2001); Utah State Bar Ethics Advisory Opinion 97-11 (1997); KBA Ethics Opinions E-216 (1979); *Chittenden v. State Farm Mutual Automobile Insurance Co.*, 788 So.2d 1140 (La. 2001); S.C.R. 3.130 [Kentucky Rules of Professional Conduct], Rules 1.4, 1.5, 1.6, 1.7, 1.8, 5.4.

OPINION

The inquiry before the Committee raises the question of whether, in a contingent fee case, a lawyer may borrow funds from a lending institution to pay litigation costs. The inquiry raises a further issue as to whether the lawyer may pass the interest and related loan fees on to the client,

deducting them from the proceeds of the judgment or settlement in the same manner as other disbursements. The final question raised is whether the lawyer may grant the lender a security interest in the lawyer's contingent fee as collateral for the loan.

I. Borrowing Litigation Costs from a Lending Institution

We begin with the issues of financial assistance to clients and lawyer borrowing. Rule 1.8 reflects the common law rule against providing financial support to a client "in connection with pending or contemplated litigation." The concern is that if a lawyer acquires a stake in the outcome, his or her ability to exercise independent judgment on behalf of the client may be impaired. Yet, despite this potential conflict, the prohibition has never been absolute. Rule 1.8(e)(1) embodies a long-standing exception to this general principle by providing that "[a] lawyer may advance court costs and expenses of litigation…." This exception reflects the reality that, without financial assistance to cover litigation costs and expenses, some clients would be unable to pursue their claims.

The inquiry before the Committee adds an additional layer of complexity to the transaction by interjecting a third party – the lending institution – into the relationship. The inquiry contemplates that rather than the lawyer lending his or her own funds to cover litigation costs and expenses, the lawyer will borrow the money from a lending institution. Upon conclusion of the case, the client will be obligated to reimburse the lawyer for the advanced litigation costs, along with interest charges and any related lender fees.

Although nothing in Rule 1.8(e) specifically prohibits a lawyer from borrowing money to cover litigation costs and expenses on behalf of a client, other relevant ethical rules, particularly those relating to personal conflicts of interest, client confidentiality and the lawyer's independent judgment, must be considered.

By borrowing money from a lending institution to cover advancements for costs and expenses, the lawyer assumes both a financial obligation and a debt management responsibility in the litigation. If these burdens become too great, particularly if a case becomes protracted, the lawyer's fidelity to the client could be compromised by the lawyer's perceived need to conclude the representation on a basis that will allow the loan to be paid and the attendant burdens to be lifted. These same observations might be made of any situation in which the lawyer has advanced costs and expenses to a client from personal funds or where a contingent fee is involved. Although we recognize the potential personal conflicts inherent with advancement of litigation costs and contingent fees, we permit these arrangements – subject to Rule 1.7 -- because they benefit the client and may provide the only means by which a client can pursue his or her claim.

But borrowing money from a lending institution to finance litigation expenses raises additional risks not present when the lawyer merely advances personal funds or takes a case on a contingent fee. Where a lending institution is involved, it might attempt to influence the lawyer's handling of a case in order to ensure timely repayment of the loan. Similarly, it might seek information about a case or its status and the client's right to confidentiality under Rule 1.6 might be jeopardized. These risks are substantially reduced if the loan is not tied to a particular case, but rather is a line of credit upon which the lawyer may draw upon for any case. In any event, the Committee recognizes that there are some risks, but also recognizes the client's

interest in having adequate funds available to cover litigation costs and expenses. As a recent Ohio opinion observed:

> Since clients are not always financially able to obtain a loan to finance the expenses of litigation, the clients look to lawyers to advance the expenses of litigation. Depending upon the lawyer's financial position, a lawyer may need to obtain a loan in order to advance the litigation expenses. As a fiduciary for the client, the lawyer must negotiate appropriate and reasonable loan terms. Ohio Board of Commissioners on Grievances and Discipline Opinion 2001-3 (2001)

A number of other jurisdictions have addressed litigation-financing arrangements similar to those described above. Although many have acknowledged the potential problems discussed here, the overwhelming majority has concluded that such arrangements are permissible. *See, e.g.,Chittenden v. State Farm Mutual Automobile Insurance Co.,* 788 So.2d 1140 (La. 2001); Utah State Bar Ethics Advisory Opinion 02-01 (2002); Ohio Board of Commissioners on Grievances and Discipline Opinion 2001-3 (2001); Association of the Bar of the City of New York Committee on Professional and Judicial Ethics Opinion 1997-1 (1997); Georgia Advisory Opinion 92-1 (1992). State Bar of Texas Opinion 465 (1990); New Jersey Supreme Court Advisory Committee on Professional Ethics Opinion 603 (1987).

The committee is in agreement with those jurisdictions that have authorized the lawyer to borrow funds to finance litigation costs and expenses. In our view, the rules do not prohibit such a loan transaction, as long as the lawyer guards against improper influences and improper disclosure of client confidences.

II. Charging the Client Interest on the Loan and Deducting It from Proceeds

The next question is whether a lawyer who borrows money from a lending institution can pass the interest charges and other related expenses on to the client. In KBA E-216, this Committee decided that with "full consent and disclosure" the lawyer could charge interest on advancements made from the lawyer's own funds. In the Committee's view, "an interest charge on advancements would seem to be only a further expense of the litigation and as such could be charged against the client." From the client's financial perspective, there is no difference between charging the client interest on the lawyer's money and charging the client interest on the financial institution's money – both are expenses occasioned by the litigation. *See also,* Ohio Board of Commissioners on Grievances and Discipline Opinion 2001-3 (2001).

But the inquiry does not end here. Recent decisions from other jurisdictions, as well as the current Rules of Professional Conduct, suggest that much more is required that mere consent and disclosure. Of particular importance are the rules dealing with client communications, business transactions and fees.

We begin with Rule 1.4, which addresses the importance of keeping the client informed and of explaining matters to the extent reasonably necessary to permit a client to make informed decisions. Thus, in the context of this inquiry, it would appear that the loan and other fees, along with the interest rate and its method of calculation, must be explained fully to the client and the client must consent. *See, e.g.,* New Jersey Supreme Court Advisory Committee on Professional Ethics Opinion 603 (1987).

Moreover, once the advancement authorized by 1.8(e) take the form of a loan with interest, it takes on the characteristics of a business transaction and is subject to the mandates of Rule 1.8(a). *See,* American Law Institute, *Restatement (Third) of the Law Governing Lawyers* § 36, *comment c* (lawyer may advance costs and expenses of litigation, with client to repay the advance from proceeds of case, but any greater obligation on the part of the client, such as payment of interest, subjects the arrangement to rules governing business transactions between a lawyer and client).

Business transactions covered by Rule 1.8(a) must be "fair and reasonable." This assumes, among other things, that the charges to the client are reasonable in amount, that they do not exceed those paid by the lawyer, and that the lawyer does not have an interest in the financial institution that would violate Rule 1.7(b). *See, e.g.,* Association of the Bar of the City of New York Op. 1997-1 (1997). Moreover, Rule 1.8(a) requires that the arrangement be "fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client." In addition, the client must have a "reasonable opportunity to seek the advice of independent counsel" and must "consent in writing." *See, e.g.* Ohio Board of Commissioners on Grievances and Discipline Opinion 2001-3 (2001).

This particular inquiry relates to a contingent fee case. Consequently, Rule 1.5(c) must be considered, because it sets out certain requirements about both the agreement's form and its content. Specifically, it provides as follows:

> A contingent fee agreement shall be in writing and should state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal, litigation and other expenses to be deducted from the recovery, and whether such expenses are to be deducted before or after the contingent fee is calculated.

Thus, in the context of this inquiry, the contingent fee agreement must be in writing and must explain how the interest will be calculated, and that the interest and other loan related expenses will be deducted from the settlement or judgment as an expense of litigation. The contingent fee agreement also must clearly state whether contingent fee percentages are computed before or after the deduction of these expenses. Finally, the agreement must advise the client of whether the duty to repay litigation expenses (including interest) is contingent upon the outcome of the case. *See, e.g.,* Ohio Board of Commissioners on Grievances and Discipline Opinion 2001-3 (2001); Chittenden v. State Farm Mutual Automobile Insurance Company, 788 So.2d 1140 (La. 2001); Association of the Bar of the City of New York Formal Opinion 1997-1 (1997).

The duty to inform the client about fees and other charges extends beyond the initial agreement. Once there has been a recovery, Rule 1.5 obligates the lawyer to provide the client with a written statement "showing remittance to the client and the method of determination," which would include deductions for the advances, interest and other reimbursable charges. This written statement should be sufficiently detailed so that the client can understand what costs, including loan-related expenses, the client has been charged. *See,* ABA Formal Opinion 93-379 (1993).

Therefore, upon review of the applicable rules and the opinions from other jurisdictions, the Committee finds no specific prohibition against a lawyer obtaining a third-party loan to cover litigation expenses and later deducting expenses – including interest and lender fees – from the proceeds recovered on behalf of the client. However, the lawyer is cautioned that several Rules of Professional Conduct are implicated in such a transaction, and the lawyer must consider each one of them carefully before entering into a loan transaction to finance the litigation expenses of a client.

Granting the Lender a Security Interest in the Lawyer's Contingent Fee

The final question -- whether the lawyer may grant a security interest in his or her contingent fee as collateral for the loan – is more problematic. One of the primary purposes of the conflict of interest rules (Rule 1.7 – 1.12) is to protect the lawyer's independent judgment. Under these rules, the lawyer must avoid representations where the lawyer's own interest or those of another person may impair the lawyer's judgment on behalf of a client. If a loan is tied, either formally or informally, to a specific case the lender may try to protect its investment by attempting to influence the lawyer's management of the case. This is always a risk, but it becomes even more so when the lawyer's prospective fee in a specific case serves as collateral for the loan. The fact that the agreement with the lender might recite a disavowal that the lender would interfere with the lawyer's independent judgment, or that the client has consented to the loan arrangement, does not alter the economic reality that the lawyer could feel pressured to bring the case to conclusion -- thereby turning the unearned fee expectancy into an earned fee -- in order to satisfy the claim of a creditor with a security interest in that specific fee. In addition, a secured creditor might deem itself insecure if the lawyer missed one or more monthly interest payments, and might seek to accelerate the loan, bringing even greater pressure on the lawyer to conclude the matter quickly or, perhaps, to relinquish control to another lawyer.

The Committee recognizes that lawyers and law firms borrow money from lending institutions every day and, in some cases, they secure those loans with various firm assets. But this is far different than the arrangement under consideration here. The circumstances in which a lawyer would borrow money and grant a security interest in the fee are those in which neither the lawyer nor the client has other access to funds (or other security) – thus setting the stage for the economic pressure that may compromise the lawyer's judgment.

For the above reasons, the Committee is of the view that it would be unethical for a lawyer to borrow funds to pay litigation expenses in a particular case and grant a security interest in the lawyer's contingent fee as collateral for the loan.

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Note to Reader

This ethics opinion has been formally adopted by the Board of Governors of the Kentucky Bar Association under the provisions of Kentucky Supreme Court Rule 3.530 (or its predecessor rule). The Rule provides that formal opinions are advisory only.