NEW YORK CITY BAR

COMMITTEE ON PROFESSIONAL RESPONSIBILITY

PROPOSED AMENDMENTS TO NEW YORK RULE OF PROFESSIONAL CONDUCT 5.4 AS CONCERNS NON-PARTY LITIGATION FUNDING

On February 28, 2020, The New York City Bar Association Working Group on Litigation Funding (the "City Bar Working Group") presented a Report to the President (the "Working Group Report").[1] The Working Group Report suggested two possible revisions to New York Rule of Professional Conduct 5.4 in light of its findings concerning non-party litigation funding. The Committee on Professional Responsibility (the "Committee") received the Working Group Report and was asked to consider whether to (1) support either of the Working Group proposals, (2) make a proposal of its own for amending Rule 5.4, or (3) recommend that the Rule should remain in its current form. As discussed below, the Committee proposes the amendments to Rule 5.4 set forth in the Appendix to this Report, which incorporates various aspects of the Working Group proposals but differs from both of them.

I. Background

Rule 5.4(a) provides, in relevant part: "A lawyer or law firm shall not share legal fees with a nonlawyer," with certain exceptions that are not relevant for present purposes.

In 2018, the City Bar Committee on Professional Ethics (the "Ethics Committee") issued Formal Opinion 2018-5 of The Association of the Bar of the City of New York Committee on Professional Ethics ("City Bar Opinion 2018-5").[2] City Bar Opinion 2018-5 addresses the following question: "May a lawyer enter into a financing agreement with a litigation funder, a non-

[1] *See* NYCBA Working Group on Litigation Funding, Report to the President by the New York City Bar Association Working Group on Litigation Funding, (Feb. 2020) http://documents.nycbar.org/files/Report_to_the_President_by_Litigation_Funding_Working_Group.pdf (All websites last accessed on March 26, 2024).

[2] *See* NYCBA Committee on Professional Ethics, *Formal Opinion 2018-5: Litigation Funders' Contingent Interest in Legal Fees*, (July 2018) https://s3.amazonaws.com/documents.nycbar.org/files/2018416-Litigation_Funding.pdf.

lawyer, under which the lawyer's future payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters?"

Opinion 2018-5 "conclude[s] that such an arrangement violates Rule 5.4's prohibition on fee sharing with non-lawyers." Specifically, the Ethics Committee concluded that Rule 5.4(a) "forbids two alternative arrangements:"

- "[W]here an entity's funding is not secured other than by the lawyer's fee in one or more lawsuits, so that it is implicit that the lawyer will pay the funder only if the lawyer receives legal fees in the matter or matters;" and

- "[W]here a lawyer and funder agree, whether in a recourse or non-recourse arrangement, that instead of a fixed amount or fixed rate of interest, the amount of the lawyer's payment will depend on the amount of the lawyer's fees – for example, where the agreement sets a payment rate on a sliding scale based on the total legal fees or total recovery in the case or portfolio of cases."

City Bar Opinion 2018-5 at 2. City Bar Opinion 2018-5 "generated a significant amount of attention and commentary."[3] Since then, at least one attorney has actually been disciplined for, in part, entering into a loan agreement payable from fees to be earned from cases, in violation of Rule 5.4.[4]

"In October 2018, the City Bar's President, Roger Juan Maldonado, formed the Litigation Funding Working Group . . . to study third-party litigation funding and to provide a report on observations and recommendations regarding the practices utilized in connection with litigation funding." Working Group Report at 1.

The Working Group's report spans 90 pages and covers a wide range of topics relating to litigation funding. Most pertinent to this Committee, Section II of the Working Group Report presents two alternative proposals for amending Rule 5.4. It is these proposals that the Committee evaluated as a starting point for its consideration of the question of whether an amendment to the Rule is advisable, and if so, what form such amendment should take.[5]

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[3] Working Group Report at 1 (citing Paul B. Haskel & James Q. Walker, *New York City Bar Opinion Stuns the Litigation Finance Markets,* LEXOLOGY (Aug. 31, 2018)). *See also, e.g.,* Anthony E. Davis & Anthony J. Sebok, *New Ethics Opinion on Litigation Funding Gets It Wrong,* NYLJ (Aug. 31, 2018).

[4] *Matter of Antzoulatos,* 210 A.D.3d 31 (2nd Dep't, 2022). One of several charges brought against the attorney was that he violated Rule 5.4 by borrowing money from a non-attorney lender and agreeing to repay the lender by remitting 10% of his legal fees on each of his cases, and the court referred to that charge in imposing a suspension. However, there were other aggravating circumstances, such that it is difficult to say what weight the Rule 5.4 violation bore in the court's decision.

[5] We also considered the amendment to Model Rule 5.4 proposed by the American Bar Association's Kutak Commission in 1981. The Kutak Commission proposal would reformulate Rule 5.4 to, among other things, permit

II. The Working Group Proposals

The Working Group denominated its proposals "Proposal A" and "Proposal B."[6] For ease of reference, we adhere to this naming convention.

Working Group Proposal A would amend Rule 5.4 as follows:

A lawyer or law firm shall not share legal fees with a nonlawyer, except that:

* * *

(4) a lawyer or law firm may share legal fees with an entity in exchange for the entity's providing financial assistance to the lawyer specifically for use with respect to a legal representation of one or more clients, provided that:

(i) the entity and its representatives do not participate, directly or indirectly, in the decision-making regarding the representation;

(ii) the lawyer or law firm maintains professional independence;

(iii) the client provides written informed consent to the financial arrangement; and

(iv) the lawyer or law firm complies with all other applicable rules, including Rule 1.6 and Rule 1.7.

Working Group Proposal A is directly responsive to City Bar Opinion 2018-5's focus on situations where a funder's recovery depends on the outcome of a particular case or cases being handled by a lawyer, as it expressly addresses the situation where funding is provided "for use with respect to a legal representation of one or more clients." The Proposal permits such funding, but includes provisions intended to protect lawyer independence (proposed Rules 5.4(a)(4)(i)-(ii)), and also requires that "the client provides written informed consent to the financial arrangement."

Working Group Proposal B would amend Rule 5.4 as follows:

A lawyer or law firm shall not share legal fees with a nonlawyer, except that:

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non-lawyer ownership of law firms under specified conditions. We did not deliberate on the merits of such a proposal because we determined that it is outside of our mandate.

[6] Working Group Report at 24-33.

* * *

(4) a lawyer or law firm may share legal fees with an entity in exchange for the entity's providing financing for the lawyer's or law firm's practice provided that:

(i) the lawyer and law firm do not permit the entity to participate directly or indirectly in a matter except for the benefit of the client;

(ii) the lawyer and law firm do not disclose confidential client information except as Rule 1.6 may permit;

(iii) the lawyer and law firm comply with Rule 1.7; and

(iv) the lawyer or law firm informs the client in writing that they are sharing or may share fees with an entity in exchange for the entity's providing financing for the lawyer's or law firm's practice.

Working Group Proposal B is broader than Proposal A in the sense that it permits funding for a particular case or cases, but also permits funding of a "law firm's practice" more generally. *See* Working Group Report at 29 ("The proponents of Proposal B considered requiring that the funds be provided 'specifically for use in a legal representation of one or more clients,' but decided not to include such a requirement."); *id.*at 30 ("Proposal B expressly allows a nonlawyer to share in the prospect of a success or failure of a lawyer in a matter, thus reducing ambiguity in Rule 5.4 and providing clarity to the bar."). Like Proposal A, Proposal B includes certain protections for lawyer independence. (Proposed Rule 5.4(a)(4)(i)). Unlike Proposal A, Proposal B does not require informed written client consent, although it does require that "the lawyer or law firm informs the client in writing that they are sharing or may share fees with an entity in exchange for the entity's providing financing for the lawyer's or law firm's practice."

The Committee recommends against supporting either of these proposals in its entirety for several reasons.

First, we believe that both of the Working Group Proposals are too complicated, and do not fit comfortably within the structure of the Rules. We recommend amendments that are more narrowly tailored and adhere more closely to the current text of Rule 5.4, as set forth below.

Second, we believe that the limitation on "participation, directly or indirectly" by litigation funders, which appears in both Working Group proposals, is too broad. Funders – like consulting experts, insurers and other participants in the litigation process – may have valuable insights that may benefit the client. We do not believe that there is any reason to preclude funders from sharing these insights. Working Group Proposal B is less problematic than Proposal A

in this respect because it requires only that such "participation, directly or indirectly" be "for the benefit of the client." We nonetheless believe that this language is unnecessary, and that lawyers should be free to consider the input of funders in the exercise of their independent, professional judgment without a priori judgment as to whether such input is or is not beneficial.

Third, as to Working Group Proposal A, we believe that an informed consent requirement would be unduly onerous. A lawyer is already required to obtain informed consent of his or her client under various circumstances specified in the Rules. While the members of the Subcommittee are not unanimous on this point, the majority view is that there is nothing unique about a funding relationship that requires imposing an additional consent requirement. For the avoidance of doubt, nothing in our proposed amendment to Rule 5.4 set forth below relieves a lawyer of any obligation to obtain informed client consent that he or she might already have under the Rules.

Fourth, we believe that the references to Rules 1.6 and 1.7 in both proposals are surplusage. If anything, calling out specific Rules in this manner may suggest that there is less concern about compliance with other Rules that are not specified – which is not the case.

Finally, the Working Group's proposed commentary to Working Group Proposal A suggests that registration requirements may be imposed on funders. *See* Working Group Report at 27 ("There are currently no registration or filing requirements for entities providing litigation funding to lawyers in New York, but should such requirements be adopted, lawyers should only participate in funding transactions with entities that comply with these requirements."). We do not believe that a registration requirement should be imposed, and thus do not support inclusion of such a comment.

III. The Committee's Recommendation

The Committee recommends that Rule 5.4 be amended, with Comments, as set forth in the Appendix to this Report. The Committee agrees with the Working Group's conclusion that non-recourse litigation funding tied to the results of specific cases ought to be permitted. But we also understood that the Ethics Committee had concluded that Rule 5.4, in its current form, prohibits such financing arrangements.

In particular, the Committee notes that the Ethics Committee itself understood that the language of the Rule may be overly restrictive given the evolution of litigation finance over the years. "Rightly or wrongly," it wrote, "the rule presupposes that when nonlawyers have a stake in legal fees from particular matters, they have an incentive or ability to improperly influence the lawyer."[7] And yet, the Ethics Committee also recognized that "even under a recourse loan, a law firm . . . may be unable to make payments to a funder or to others to whom a law firm is in debt… [or otherwise]…unable to meet its financial obligations. One might therefore argue that any creditor has an incentive to encroach on lawyer independence and that there is no reason to single out those particular creditors who have a stake in lawyers' fees in particular matters." Id. at 6, note

[7] City Bar Opinion 2018-5 at 6.

11. Thus, the Ethics Committee candidly conceded being bound by "90 years of ethics rules and opinions interpreting them" in concluding that, although "[t]here is room to argue whether the prohibition on fee sharing is overbroad[,]…that is a matter to be decided by the state judiciary…or by the state legislature."[8]

The Committee agrees with the Working Group in concluding that, in the words of City Bar Opinion 2018-5, "the rule sweeps more broadly than is necessary to serve its purpose of protecting lawyers' independence…"[9] The Committee settled on its recommended text after its working subcommittee considered and discussed a number of variants over many weeks, including the Working Group's Proposals A and B. The Committee's ultimate textual choices were largely driven by these considerations:

1. The Committee concludes that there is no reason to treat funders secured by fees in individual cases any differently from other financers of law firms. In all cases, it is the responsibility of lawyers and their firms to maintain their own independent judgment when it comes to client services. To restrict how lawyers and law firms finance their practices by presupposing that one type of financing has the power to corrupt a lawyer's professional ethics more than any other financial arrangement with a nonlawyer is an exercise in paternalism that the Committee, based on the Working Group Report and its own subcommittee's research, cannot justify. To the contrary, there is now a long history of court decisions enforcing the very type of arrangements that Opinion 2018-5 takes issue with.[10]

2. The Committee attempted to craft the simplest text and commentary that would both permit case-dependent litigation funding and maintain the lawyer's independent and overarching obligations to preserve professional independence, protect client confidences and avoid conflicts of interest. The Committee does not believe it prudent to enshrine in a Rule what provisions any such financial arrangements must or must not contain. Rather, the Committee concludes that lawyers must be trusted not to enter into transactions that compromise their professional obligations, as they are trusted to self-regulate in all other matters of professional responsibility.

3. The Committee concludes that clients whose cases are subject to such financial arrangements should be notified and given an opportunity to inquire. Clients may have objections to the arrangement or conflicts with the nonlawyer funder of which the lawyer would not otherwise be aware. Notice and opportunity to obtain information upon which to base an objection protects the client and the lawyer from any unexpected conflicts that may arise from the funding activity.

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[8] *Id.*

[9] *Id.*

[10] *See, e.g., Heer v. North Moore Street Developers, L.L.C.,* 36 N.Y.S.3d 93 (1st Dep't 2016); *Hamilton Capital VII, LLC v. Khorrami, LLP,* 22 N.Y.S.3d 137 (Sup. Ct., N.Y. Cty., 2015); *Lawsuit Funding LLC v. Lessoff,* 2013 WL 6409971 (Sup. Ct., N.Y. Cty., Dec. 4, 2013); *Brandes v. North Shore University Hospital,* 856 N.Y.S.2d 496 (Sup. Ct., Queens Cty., 2008). *See also PNC Bank, Delaware v. Berg,* 1997 WL 527978 (Del. Super. 1997).

4. The Committee does not favor uniformly requiring "informed consent" from clients prior to lawyers entering into such financing arrangements. Certainly, if any client, being given notice and having obtained information, objects to the financing, the lawyer must refrain from proceeding. And if any funding relationship requires client consent, as in, for example, to disclose confidential information or to waive a conflict of interest, the lawyer must obtain informed consent by operation of other Rules (such as 1.6, 1.7, and 1.8, as noted in the Comments).

5. The Committee also proposes amendments to Rule 5.4(c) to include financers among those persons listed, who a lawyer may not permit to interfere with his or her professional independence or to cause him or her to disclose a client's confidential information or to incur a conflict of interest. This seems to the Committee the simplest way to ensure that funding arrangements of any kind did not in any way diminish lawyers' professional obligations. Other proposed amendments to Rule 5.4(c) are technical in nature, to make that subsection more consistent with the rest of the Rule (like adding "law firm") and to ensure that all professional rules must be followed (not only Rule 1.6 to maintain confidential information, as the current text may suggest).

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April 2024

APPENDIX

PROPOSAL OF
THE COMMITTEE ON PROFESSIONAL RESPONSIBILITY
TO AMEND
RULE OF PROFESSIONAL CONDUCT 5.4

Rule 5.4 Professional Independence of a Lawyer

(a) A lawyer or law firm shall not share legal fees with a nonlawyer, except that:

(1) **[NO CHANGES]**

(2) **[DELETE** "and" at the end]

(3) [**DELETE** terminal period and **ADD** at the end "; and"]

[**ADD**] (4) A lawyer or law firm may pay, assign, pledge or grant security interests in earned or unearned legal fees on account of legal services rendered to one or more specific clients to satisfy obligations legally incurred by the lawyer or law firm to a nonlawyer in connection with the practice of law, so long as the lawyer or law firm notifies any such client in writing of any material terms[11] thereof that may reasonably affect the representation and provides

[11] In the original version of this document posted on April 5, 2024, the word "items" appeared here, rather than the correct word "terms". On April 12, 2024 we corrected the typographical error in the online version of the report.

any such client reasonable time and opportunity to inquire prior to any such assignment, pledge or grant of security interest.

(b) [**NO CHANGES**]

[AMEND] (c) Unless authorized by law, a lawyer or law firm shall not permit a person who recommends, employs or pays the lawyer or law firm to render legal services for another or who lends or otherwise provides financial accommodations to the lawyer or law firm to direct or regulate the lawyer's or law firm's professional judgement in rendering such legal services or to cause the lawyer or law firm to compromise the lawyer's or law firm's ~~duty~~ duties under the Rules of Professional Conduct, including the duties to maintain ~~the~~ confidential information ~~of the client under Rule 1.6~~ and to avoid conflicts of interest.

(d) [**NO CHANGES**]

COMMENT

[ADD COMMENT 1C AND COMMENT 3]:

[1C] Paragraph (a)(4) clarifies that a lawyer or law firm may use earned, unearned, and contingent legal fees relating to particular clients or matters to secure financing to maintain the practice of law. It has always been permissible for lawyers and law firms to create a security interest in general receivables to secure loans and other financial accommodations. This Rule extends that general permission to fees recoverable from particular clients and matters, which might otherwise be construed as the sharing of legal fees with nonlawyers. In that regard, the Rule's use of the phrase "obligations legally incurred" is intended to include all lawful arrangements between lawyers and nonlawyers, whether termed debts, financial accommodations, assignments or contractual promises. However, whether creating a security interest in general receivables or legal fees attributable to particular matters, lawyers and law firms must always act in accordance with the Rules of Professional Conduct including maintenance of their professional independence, protection of confidential information and avoidance of conflicts of interest. Creating a security interest in contingent fees, especially to secure non-recourse financing, may be relevant to some clients' decision to commence or continue the representation. Accordingly, the

Rule requires that clients be notified of such material terms of the lawyer's financial arrangement that the lawyer reasonably believes could have an impact on the representation of the client, and be given the opportunity to ask questions before that client's matter becomes the subject of such a security interest. In responding to questions from clients, lawyers and law firms must be mindful of their obligations under Rule 1.4(a)(4) and (b). See also Comments 2 and 3.

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[3] When a lawyer creates a security interest in legal fees to a nonlawyer financial provider to secure loans or other financial accommodations as permitted by this Rule, the lawyer must ensure that his or her professional judgement and independence are not impaired as a result of the relationship with that financial provider. In these financial relationships, there is a danger that a financial provider may exert undue pressure on the lawyer. Also, there may be requests to disclose confidential information to the financial provider, or conflicts of interest may arise between the client and the financial provider. A lawyer in a relationship with a financial provider must always comply with the Rules of Professional Conduct, including, among others, Rules 1.6, 1.7 and 1.8. Those and other Rules may require informed consents from certain clients in appropriate circumstances.