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Formal Advisory Opinion Request
Arizona Supreme Court Advisory Ethics Committee
1501 W. Washington Street
Suite 229
Phoenix, AZ 85007

Dear Members of the Attorney Ethics Advisory Committee:

The seeks the Committee's guidance on whether it is ethically permissible for an attorney to be a party to his or her client's loan to fund legal fees in a bankruptcy action, and, if it is permissible, what disclosures must be made to clients and the courts. Because this Committee and the bankruptcy courts have not addressed this issue, the requests an ethics opinion.

I. Background

An Arizona bankruptcy practice was primarily funded through a line of credit from a lender who was reimbursed in monthly installments by the firm's clients. The lender advanced funds directly to the firm on a per-case basis, eventually advancing 75% of the total amount of legal fees payable in connection with each approved account; the lender retained the remaining 25% of the legal fees to cover the financing and collection management services.

The firm assigned the lender the accounts receivable associated with approved accounts as collateral for the agreement, but the firm was liable for the line of credit and therefore responsible for any amounts unpaid by clients. The firm and lender agreed in writing that the firm would remain responsible for fee disputes, and that the lender could not direct the legal representation.

The firm's fee agreement disclosed to all potential clients that the firm had a financing arrangement and utilized a line of credit from the lender. Clients were also informed that the lender would collect payments directly from the clients and could report client payments to credit reporting agencies. The fee agreement informed the client that the firm did not have a financial interest in the lender. The fee agreement did not specify the amount of fees retained by the lender and/or whether the client was charged a higher fee for utilizing the line of credit.

The firm provided the lender with copies of the fee agreement, payment authorization, pay stubs, bank account statements, and personal information related to collection of payments but did not provide other client confidences to the lender.

The firm's fee agreement provided clients with options for paying attorney fees over varying lengths of time post-petition. This allowed clients to get their bankruptcy cases filed quickly when they did not have the resources to pay all their attorney fees.

The firm did not disclose the use of this third-party payment system on disclosure statements filed with the bankruptcy court.

The firm described above ceased transactions with the lender and no longer uses financing agreements of any kind. However, the believes that the lender has similar agreements with other Arizona law firms with the same or substantially similar terms as those described above.

II. The Committee should issue an opinion because this question has not been directly addressed by an ethics opinion or Arizona case law and is of statewide importance.

While litigation financing is not new, the type of arrangement described in the instant request has not been evaluated by this Committee or the Arizona Bankruptcy Court.

AZ Ethics Opinions

Ethics Opinion No. 89-10 allows for lawyers to receive payments under a credit card financing plan so long as client consents, there is no interference with professional judgment, and confidential information is protected.

Ethics Opinion No. 92-04 opined that it was ethical for a lawyer to furnish their bank, as part of their line of credit and other financial arrangements, with a list of their accounts receivable, identifying the name of the affected client and the account balance, so long as the client consents in advance.

Ethics Opinion No. 98-05 concluded that it was unethical[1] for an attorney "to enter into a factoring agreement that permits the factor to directly contact each client to request and demand payment because the factor could rely on otherwise confidential and privileged information in enforcing payment of the client accounts receivable."

NY Opinion: Litigation Funding

New York City Bar Association Ethics Committee Formal Opinion 2018-5 found that a lawyer's arrangement with "a litigation funder, a non-lawyer, under which the lawyer's future payments to the litigation 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" was a violation of Rule 5.4 because it constituted fee sharing with non-lawyers. The committee distinguished the lawyer-funder agreement from that of a client-funder agreement, noting that the latter would not implicate Rule 5.4 "because the lawyer is not a party to the arrangement and payments are made by the client … and do not affect the amount of the lawyer's fee."

The committee also noted that Rule 5.4 did not extend to traditional recourse loans, even those secured by collateral such as accounts receivable because "repayment was not contingent on the receipt or amount of fees" obtained in particular matters. "Rightly or wrongly, [Rule 5.4] presupposes that when nonlawyers have a stake in legal fees from particular matters, they have an incentive or ability to improperly influence the lawyer."[2]

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[1] The opinion found the conduct violated ERs 1.6, 1.7, 1.8, 5.4.

[2] There is a pending rule change petition that could affect ER 5.4, but the submits that ER 5.4 is just one of several concerns addressed herein for this Committee to consider; further, any potential change to ER 5.4 would not resolve the other outstanding issues.

ABA Opinion: Fee Financing

American Bar Association Standing Committee on Ethics and Professional Responsibility Formal Opinion 484 addressed several fee financing scenarios, noting that fee financing arrangements can be "ethically permissible" so long as attorneys explain the arrangement in a way that allows clients to make informed decisions about representation. The opinion detailed topics to cover with clients to include the lawyer's relationship with the financing company, including fees paid by or to the lawyer, the costs and benefits of the transaction to the client, including whether the lawyer charges a higher fee because of the financing arrangement and what alternative payment options are available to the client, and if financing the legal fee affects the rights and remedies of the client to obtain repayment, return, forgiveness, or reduction of client's debt if there is a dispute about the lawyer's performance. Of note in the opinion is that all the example scenarios specified that the loan to the client "is non-recourse as to the lawyer."

The opinion distinguished fee financing from litigation funding, concluding that a legal fee lender has no direct financial interest in the outcome of the matter, and therefore has no incentive to attempt to influence the lawyer's advice. The opinion also states that the charges to the client must still be reasonable, and "the lawyer must inform the client that the lawyer will be charging the client a higher fee to account for the finance or subscription fee that the lawyer must pay to the finance company or broker. Further, the opinion warns of the "possibility of a material limitation conflict of interest under Model Rule 1.7(a)(2)" because of the risk "the lawyer will recommend the finance company or broker to the client even though fee financing is not in the client's interest because the client's arrangement of financing best assures payment or timely payment of the lawyer's fee."

The opinion referenced the North Carolina State Bar 2018 Formal Ethics Opinion 4, which remarks that providing payment options to a client does not necessarily mean that a lawyer has put their own financial interests ahead of his client, but "given the lawyer's self-interest in being paid in full for his services, the lawyer may not recommend one payment option over another." Unlike the New York opinion, the ABA did not find that deducting a certain percentage from individual cases constituted fee sharing because it is "basically an administrative fee that is deducted from the payment to the lawyer," comparing financing fees to merchant fees charged by credit card companies.

In re Wright: Recently Sanctioned Bankruptcy Attorney

A bankruptcy attorney in Oklahoma was recently sanctioned and ordered to return client payments in 17 Chapter 7 cases for failing to disclose the amount and source of his compensation, for charging unreasonable fees by charging clients more for use of fee financing, and for allowing legal fees to be paid before case filing fees were paid in full. *In re Wright*, 591 B.R. 68 (2018). The attorney, J. Ken Gallon, contracted with a fee financing company, BK Billing, that provided factoring services to Chapter 7 attorneys. The bankruptcy court that issued the *Wright* decision found that Mr. Gallon essentially sold his accounts receivable for post-petition services by uploading his client contracts into the finance company's billing system. The contract with the financing company initially called for Mr. Gallon to receive 70% of the total contractual value of the client account within 2-3 days. The contract was amended to increase Mr. Gallon's percentage to 75% of the value of the contract, but Mr. Gallon was only immediately given 60% so that BK Billing could hold 15% as security for the company until the account fully performed.

Mr. Gallon's clients signed pre-petition fee agreements and post-petition fee agreements, agreeing that their account could be sold to the financing company and they could be contacted directly by the financing company for collection of funds. By billing the bulk of his services post-petition, Mr. Gallon was able to immediately file for bankruptcy protection with little to no money down but then collect his legal fees as debt not subject to discharge. Mr. Gallon failed to disclose the source of the compensation paid or agreed to be paid on the bankruptcy paperwork, and the Court found that this failure was a violation of his obligation of candor to the tribunal. The Court declined to rule on the issue of bifurcation of pre- and post-petition fees and instead focused on Mr. Gallon's poor record keeping and reporting.

Statewide Importance

As stated in the background section above, the believes that the lender has extended lines of credit to several Arizona bankruptcy firms. Therefore, this is an ethical issue that lawyers throughout Arizona may encounter.

III. Can an attorney be a party to legal fee financing such that they are paid directly by the lender and liable for any amount not paid by the client? If so, what disclosures must be made to the client and the court?

Unlike other litigation financing scenarios, in the lending arrangement described in the instant matter, the firm and the clients were parties to the financial transaction with the lender.[3] This has resulted in the asking the following questions:

1. Is it ethically permissible for an attorney to engage the services of a financing company whereby the attorney is directly advanced funds from the lender and are liable for any defaulted payments not made by the clients?
2. Does the lender's retention of 25% of the total amount of legal fees paid by the client constitute impermissible fee sharing?
3. Is it a violation of ER 1.6 for an attorney to provide the lender with the client's fee agreement, bank account information, and personal information related to the collection of the legal fee?
4. Does the firm's involvement in the financing arrangement create a conflict of interest with their client, especially in the event of the firm being liable for legal fees advanced by the lender and unpaid by the client?
5. Does the firm's use of the lender as the primary source of funding create a conflict of interest because of the risk "the lawyer will recommend the finance company or broker to the client, even though fee financing is not in the client's interest because the client's arrangement of financing best assures payment or timely payment of the lawyer's fee"? (ABA Formal Opinion 484).
6. If such a financing arrangement is ethical, if any, disclosures are required to be made to the clients? To the court?

[3] Because the above-described firm voluntarily ceased the financing transactions, and due to the unsettled state of the law in Arizona on the issues set forth in this request, the and the firm agreed it would be unfair to the firm to seek resolution of these issues through a lawyer discipline case, and that the s instant request for an ethics opinion was a fair and equitable approach. This conclusion is bolstered by the facts that ethics opinions now are provided to members for comment, the Supreme Court ultimately reviews and issues opinions, and once issued, opinions now have the force of law.

7. If any of the questions posed above are answered in the negative (meaning the described conduct would violate the Arizona Rules of Professional Conduct), can the conduct be made ethically permissible through (a) modification of the business terms described herein; (b) disclosures to the client; (c) consent (informed or otherwise) of the client; (d) court approval; or (e) any combination of (a)-(d)?

IV. Conclusion

The , respectfully requests that the Committee issue an ethics opinion to provide guidance to Arizona attorneys on this important issue.