MEMORANDUM

TO: Ethics Advisory Committee

FROM: Philip Casey Grove

DATE: March 28, 2020

RE: EO-20-0003

EO-20-0003: Lender-Law Firm Alternative Fee Financing in a Bankruptcy Action

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I. Background

An organization has presented the Ethics Advisory Committee (the "Committee") with several questions concerning the fee financing structure utilized by an Arizona bankruptcy practice (the "Firm"). According to the organization, the Firm was primarily funded through a line of credit from a lender, and this lender was in turn reimbursed via monthly payments made by the Firm's clients. Pursuant to an agreement between the lender and the Firm, the lender would advance funds directly to the Firm on a per-case basis in the following manner.

After a client seeking bankruptcy-related services hired the Firm and the parties entered into a fee agreement, the Firm would seek approval to receive an advance from the lender on the account by drawing on the line of credit. If the lender approved the account, it would eventually advance 75% of the total amount of legal fees associated with the account, retaining the remaining 25% of legal fees to cover financing and collection management services. The Firm secured this advance by assigning the lender the accounts receivable associated with the account. Due to this assignment, the lender, and not the Firm, would engage in collection activities with respect to the accounts receivable but the Firm remained ultimately liable for the line of credit from which the advance was drawn. The lender and Firm also agreed in writing that the Firm would remain responsible for any fee disputes. As part of this financing arrangement, the Firm provided the lender with copies of the fee agreement, payment authorization, pay stubs, bank account statements, and personal information related to collection activities. Finally, the Firm and the lender also agreed that the lender could not direct the legal representation of the client.

The fee agreement which formed the basis for the advances disclosed to potential clients that the firm had a financing arrangement with a lender and that it utilized a line credit from that lender. It also informed clients that: (1) the lender would collect payments directly from the clients; (2) could report payments made by clients to credit reporting agencies; and (3) the Firm had no financial interest in the lender. However, the fee agreement did not disclose the amount of fees retained by the lender or whether the client was being charged a higher fee for agreeing to this financing arrangement. The Firm also did not disclose this financing arrangement on disclosure statements filed with the bankruptcy court.

According to the organization, the purpose of this fee agreement and financing structure was to provide clients with options for paying attorney's fees over varying lengths post-petition, thus allowing clients to acquire representation during the preparation of their bankruptcy petition and post-petition proceedings even when they did not have the resources to pay the Firm's legal fees upfront. The organization requests the Committee issue an ethics opinion addressing whether this fee-financing structure complies with the Arizona Rules of Profession Conduct, and, if not, whether it can be modified to make it ethically permissible.

Questions Presented:

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 is liable for any default 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, what, if any, disclosures are required to be made to the clients? To the court?

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)?

Ethical Rules Implicated:

ER 1.5. Fees

(a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include the following:

> (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly
>
> (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer
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> (3) the fee customarily charged in the locality for similar legal services
>
> (4) the amount involved and the results obtained
>
> (5) the time limitations imposed by the client or by the circumstances
>
> (6) the nature and length of the professional relationship with the client
>
> (7) the experience, reputation, and ability of the lawyer or lawyers performing the services and
>
> (8) the degree of risk assumed by the lawyer.

(b) The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client in writing, before or within a reasonable time after commencing the representation, except when the lawyer will charge a regularly represented client on the same basis or rate.

* * *

ER 1.6. Confidentiality of Information

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted or required by paragraphs (b), (c) or (d), or ER 3.3(a)(3).

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ER 1.7. Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

*   *   *

(2) there is a significant risk that the representation of one or more clients will be materially limited . . . by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if each affected client gives informed consent, confirmed in writing, and:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client:

(2) the representation is not prohibited by law; and

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.

ER 1.8 Conflict of Interest: Current Clients: Specific Rules

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(e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

(1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter . . . .

*   *   *

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) the client gives informed consent;

(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

(3) information relating to representation of a client is protected as required by ER 1.6.

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ER 2.1 Advisor

In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.

ER 3.3. Candor Toward the Tribunal

(a) A lawyer shall not knowingly:

(1) make a false statement of fact or law to a tribunal . . . .

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ER 5.4. Professional Independence of a Lawyer

(a) A lawyer or law firm shall not share legal fees with a nonlawyer . . . .

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(c) A lawyer shall not permit a person who . . . pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.

II. Survey of Relevant Authority

Summary of Relevant Arizona Ethics Opinions

EOs 70-20 and 71-34: Payment of Attorney's Fees with Credit Card

Issued: 08/1970 and 11/1971

Relevant Rules Addressed: Canon 34 and DR 3-102, the former ethics rules prohibiting division of fees with a non-lawyer and predecessors to Arizona Rule of Professional Conduct ("ER") 5.4(a)

Location: Unavailable online, retrieved from Arizona State Law Library via records request, copies of opinions attached in appendix to memo.

Summary:

Op. 70-20 addressed a request from the State Bar of Arizona to examine the ethical "propriety of attorneys participating in bank Credit Card plans and programs for the payment of attorney's fees." The proposal presented by the Bar was as follows: pursuant to an agreement between participating attorneys and banks, an attorney would transfer ownership or "sell" charge slips evidencing payment of their fees by a client on credit to a bank. Assuming the charge slip complied with the terms of the agreement between the bank and the attorney, the bank would pay the attorney a cash sum for the face amount of the charge slip less a "discount rate" established by the agreement The transfer/sale of the charge slip would be without recourse to the attorney, and after the transfer the bank would (1) be the absolute owner of the charge slip and (2) be responsible for all collection activities related to the debt underlying the charge slip. However, under the terms of the agreement, the bank was obligated to notify the attorney if a client defaulted on payment and provide the attorney the option to repurchase the charge slip.

After reviewing the terms of the Bar's proposed plan, the opinion concluded the plan was not ethically improper, provided some additional conditions were complied with, including compliance with the model agreement's provision that the charge slips be without recourse to the attorney but retain the option for the attorney to repurchase them.

The opinion found that the bank's retention of a portion of the attorney's fee did not violate Canon 34's prohibition on dividing fees with non-lawyers. Quoting from ABA Formal Opinion 320 (1968), the opinion reasoned that participating attorneys were not dividing fees with the bank but were instead merely making payments of "financing charges to the bank for financial services rendered." The fact that these charges were subtracted from lawyer's fees was of no consequence because prohibiting a lawyer from paying bankers out of their fees would leave with no means to pay for any services whatsoever. Op. 71-34 approved a slightly modified and updated version of this same credit card plan.

EO 89-10: Confidentiality of Information; Conflict of Interest; Professional Independence of Lawyer

Issued: 12/1989

Relevant Rules Addressed: ER 1.6(a), ER 1.7(b)(1)–(2), ER 1.8(f)(1)–(3), ER 5.4(a), (c), ER 7.1(a)

Location: https://www2.azbar.org/Ethics/EthicsOpinions/ViewEthicsOpinion?id=595

Summary:

This opinion concerned the ethical propriety of credit card financing of legal fees and retainers under the Rules of Professional Conduct, which were adopted by Arizona in 1985. The opinion concluded: (1) that that the general disclosures an attorney would likely be required to make to facilitate the collection activities of the lender in a credit card transaction likely fell within the impliedly authorized disclosures contemplated by ER 1.6(a); (2) that although a credit financing plan involved a third-party payment to the attorney by the lender, the conflict of interest provisions of the Rules of Professional Conduct, ERs 1.7(b), 1.8(f), and 5.4(c), were not violated; (3) that credit financing arrangements did not violate ER 5.4(a)'s prohibition on sharing fees with a non-lawyer because "the lender acts merely as a collection agency for the attorney's fee"; and (4) under ER 7.1(a), the fee agreement concerning a credit card transaction must explicitly state which party will bear the cost of the creditor's discount to avoid a false or misleading communication or omission concerning the amount of the fee and the promise of services embodied by that figure.

However, concerning the conflict of interest rules, the opinion noted that credit card payment agreements between law firms and banks should be without recourse against the attorney, lest a conflict of interest arise between the attorney and the client over "any obligation to reimburse the lender upon the client's failure to pay the lender."

EO 92-04: Confidentiality; Accounts Receivable

Issued: 3/1992

Relevant Rules Addressed: ER 1.6(a) and ER 1.8(b)

Location: https://www2.azbar.org/Ethics/EthicsOpinions/ViewEthicsOpinion?id=643

Summary:

Op. 92-04 addressed whether a law firm could ethically disclose to a bank a list of its accounts receivable, including the name of the person or company owning the account, the account balance, and the age of the account, as part of a line of credit and financing agreement between the law firm and the bank.

The opinion found that this information was "information relating to the representation of a client" under ER 1.6(a) and that disclosure of the information was not impliedly authorized under the rule because providing it to the bank did not further the representation or provide a benefit to the client. Thus, the opinion concluded that such information could only be ethically disclosed to the bank if the client consented after consultation.

EO 94-11: Client Confidences; Collection Agencies

Issued: 9/1994

Relevant Rules Addressed: ER 1.6(a), (d), and ER 1.8(b)

Location:
https://www2.azbar.org/Ethics/EthicsOpinions/ViewEthicsOpinion?id=674#fn1

Summary:

This opinion addressed whether a lawyer could ethically disclose information about clients' indebtedness to a credit reporting agency or engage the services of a collection agency that also reports debtors to credit reporting agencies. Citing Ops. 89-10 and 92-04, the opinion found that a lawyer would violate ERs 1.6(a) and 1.8(b) if the lawyer disclosed the account balance of a client's accounts receivable to a credit reporting agency because: (1) the information related to the representation; (2) disclosure was not impliedly authorized because it was not necessary to further the representation and only benefited the lawyer, not the client; and (3) disclosure would adversely affect the client's interest. Prior consent of the client after consultation was therefore required for the attorney to avoid the unethical disclosure of information related to the representation.

As for engaging a collection agency that utilized a credit reporting agency, the opinion concluded that lawyer could not avoid his own ethical responsibilities concerning disclosure of client information by passing fee collection off to a third party. The opinion instead found that "a lawyer is legally and ethically responsible for the conduct of the agents of a collection agency and may not 'assist or induce' another to act unethically, if a lawyer does turn over delinquent accounts to a collection agency." Thus, because a lawyer is ethically responsible for the collection agency's activities, he or she "must insure that the collection agency maintains the confidentiality surrounding the information" absent prior consent of the client after consultation.

EO 98-05 Confidentially; Billing; Collection of Legal Fees; Client Fees

Issued: 3/1998

Relevant Rules Addressed: ER 1.6(a), (d), ER 1.7(b), ER 1.8(f), ER 5.4(a), (c)

Location: https://www2.azbar.org/Ethics/EthicsOpinions/ViewEthicsOpinion?id=490

Summary:

Op. 98-05 addressed the ethical obligations of a lawyer when he or she wishes to sell client accounts receivable to a "factor"[1] with the consent of the client after consultation. Under the terms of the proposed agreement between the lawyer and the factor, the factor was authorized, among other things, to resell the accounts receivable to other persons or entities at its sole discretion and to directly contact clients to engage in

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[1] As defined by Op. 98-05, "factors" are "financiers, often finance companies or similar institutions, that provide their clients with needed working capital and other assistance in the operation of the clients' businesses." The opinion noted that such arrangements typically involve "funds and credit . . . advanced against client accounts receivable, which are usually assigned to the factor." As later sources discussed in this memorandum demonstrate, the term "factor" and the nature of factoring arrangements are fluid and defy a single definition or characterization.

collection activities. At the outset, the opinion noted that, unlike a typical factoring or litigation financing agreement, the agreement proposed by the lawyer was for the outright sale of accounts receivable and was not made in connection with a financing agreement between the lawyer and the factor. The opinion also noted that the purchase price for the sale of the accounts received would be at a discount.

In assessing the ethical propriety of this proposed agreement, the opinion first found that the broad disclosures required to facilitate the sale of an accounts receivable, including the time records associated the representation and "probably the entire lawyer file of the client," violated ER 1.6(a) in a manner that could not be waived even by the client's consent after consultation. The opinion explained that the disclosure of time records and the client's file implicated not only ER 1.6(a), but also the attorney-client privilege, and that, as a result, "[t]he lawyer could not conceivably anticipate and communicate to the client all of the factual permutations and legal implications of such a sale to a factor." The opinion also found these disclosures to be far broader than the disclosures it had found could be authorized by the client after consultation in Ops. 89-10, 92-04, and 94-11. Finally, the opinion concluded that the additional provision of the proposed agreement permitting the factor to resell the accounts receivable at its discretion also violated ER 1.6(a) because the lawyer could not possible provide the client with sufficient information concerning the dissemination of information related to the representation (as well as privileged information) throughout the marketplace.

Second, the opinion concluded that the proposed agreement constituted the sharing of fees with a non-lawyer, a violation of ER 5.4(a), because the agreement contemplated that the factor would "recoup the discounted fee portion of the client's account receivable." The opinion distinguished this scenario from one where a lawyer obtains a line of credit to pay for the expenses of litigation, explaining that in such a situation, "the bank charges interest only to the lawyer in consideration of the money advanced."[2]

Finally, in a cursory final note, the opinion concluded the proposed agreement was unethical because it permitted the factor to directly contact and demand payment from clients and "the factor could rely on otherwise confidential and privileged information in enforcing payment of the client accounts receivable."

EO 01-07: Advancing Funds to Clients; Loans; Costs and Expenses of Litigation; Financial Institutions; Interest; Confidentiality

<u>Issued:</u> 9/2001

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[2] The opinion also cited the Arizona Supreme Court's discussion ER 5.4(a)'s prohibition on fee sharing within *In re Struthers*, 179 Ariz. 216 (1994), which discussed below.

Relevant Rules Addressed: ER 1.7(b), ER 1.8(c)

Location: https://www2.azbar.org/Ethics/EthicsOpinions/ViewEthicsOpinion?id=275

Summary:

Op. 01-07 concerned whether a law firm could ethically: (1) set up a line of credit with a third-party lender to advance the court costs and litigation expenses; and (2) pass on the interest charges associated with the line of credit to the client as a client cost. The opinion concluded both actions were ethically permissible so long as:

(1) the lawyer had no interest in the lender;

(2) the lawyer complied with ER 1.7(b) if the lawyer's past or ongoing business relationship with the lender raised concerns of a conflict of interest;

(3) the lawyer did not charge a premium for interest charges incurred on the line of credit;

(4) the passing of any interest charges occurred after the arrangement was "explained clearly to the client in writing and . . . agreed upon by the client in writing"; and

(5) the lawyer disclosed information regarding the representation as required by the lender only after receiving client consent following consultation.

Summary of Relevant Arizona Case Law

***In re Struthers*, 179 Ariz. 216, 223–24 (1994)**

Relevant Rules Addressed: ER 5.4(a)

Summary:

In re Struthers concerned the disbarment of an attorney for violations of numerous provisions of the Rules of Professional Conduct. *See generally* 179 Ariz. at 226. One allegation concerned an alleged violation of ER 5.4(a) resulting from the attorney's relationship with a management company run by non-lawyers. *Id.* at 218, 223. Under an agreement between the management company and the attorney, the attorney was required to turn over all legal fees he received in litigating cases to the management company, who would pay its expenses with the funds and distribute the remaining profits "by agreement of the parties." *Id.* at 223. The Arizona Supreme Court concluded this arrangement constituted impermissible fee-sharing under ER 5.4(a) because the attorney conveyed the entirety of his fee to the management company, who then split the fee with the attorney. *Id.* at 223–24. The court provided the following example illustrating the difference between payment for services rendered out of collected fees, which is ethically permissible, and impermissible fee-sharing:

> For example, if the creditor had been a plumber instead of MIROVI, it would have been proper upon transferring fees from the trust account to an operating account to then pay the plumber's bill for specific services rendered. However, it would be improper for a lawyer to agree to simply transfer all of the lawyer's fees to the plumber and then split what remained after paying costs.

Id. at 224.

Summary of Relevant Out-of-State Ethics Opinions

ABA Comm. On Ethics & Prof'l Responsibility Formal Opinion 484: A Lawyer's Obligations When Clients Use Companies or Brokers to Finance the Lawyer's Fee.

Issued: 11/2018

Relevant Rules Addressed: Model Rules of Professional Conduct ("MR") 1.5(a)–(b), 1.6(a), 1.7(a)(2), 1.8(a), which are substantively identical to current Arizona Ers 1.5(a)–(b), 1.6(a), 1.7(a)(2), and 1.8(a) for the purpose of this memorandum

Location:
https://www.americanbar.org/content/dam/aba/images/news/2018/11/formal_opinion_484.pdf

Summary:

ABA Formal Opinion 484 ("ABA 484") has been partially summarized by the Ethics Opinion request, and its summary is accurate and helpful. *See* EO-20-0003 request at PDF 5. Of particular importance to this memorandum is ABA 484's conclusion that a litigation funding agreement where the lawyer is charged a financing or subscription fee from the lawyer's fee does not constitute impermissible fee-sharing in violation of MR 5.4(a).

ABA 484 explained that such fees are akin to credit card merchant fees, which have long been held to be ethically permissible. ABA 484 also found that a legal fee financier receiving a discounted portion of a lawyer's fee did not violate MR 5.4(a) because the core purpose of Model Rule 5.4(a), to protect a lawyer's "professional independence of judgment," was not implicated because the financier had "no direct financial interest in the outcome of the matter."

Maine Board of the Overseers of the Bar Professional Ethics Commission Opinion 193: Loans: Non-recourse litigation expense loans to an attorney

Issued: 12/2007

Relevant Rules Addressed: Maine Bar Rule 3.12(a), which is substantively identical in relevant to current Arizona ER 5.4(a) for the purpose of this memorandum

Note: the Maine Bar Rules were abrogated in 2009 and replaced by the Maine Rules of Professional Conduct, but the relevant provision addressed in Maine Op. 193 (the prohibition on fee-sharing) remained the same.

Location: https://www.mebaroverseers.org/attorney_services/opinion.html?id=86896

Summary:

Maine Op. 193 concerned whether non-recourse loan advances to attorneys representing clients under contingency fee arrangements violated Maine Bar Rule 3.12(a)'s prohibition on fee-sharing with non-lawyers. Under the terms of the loan advance, the company supplying the loan would either: (1) recover nothing if the case was unsuccessful; or (2) be entitled to recover the proceeds of the loan along with substantial interest. The opinion found this loan violated the ethical prohibition on fee-sharing with a non-lawyer because "[r]epayment to the finance company [was] tied directly to the recovery of legal fees by the attorney in the particular case" under the contingency fee arrangement between the lawyer and the client. The opinion concluded that a non-recourse loan to finance litigation in a contingency fee case "creates an unacceptable risk that the professional independence of the lawyer will be influenced by the non-lawyer who has an interest in the attorney's fee."

New York State Bar Association, Committee on Professional Ethics Formal Opinion 2018-5: Litigation Funders' Contingent Interest in Legal Fees

Issued: 1/2018

Relevant Rules Addressed: New York Rule of Professional Conduct 5.4(a), which is substantively identical to current Arizona ER 5.4(a) for the purpose of this memorandum

Location: 2018 WL 4608937

Summary:

New York Op. 2018-5 has been partially summarized by the Ethics Opinion Request, and its summary is accurate and helpful. *See* EO-20-0003 at PDF 4. However, three aspects of the opinion are particularly relevant to the situation contemplated by this memorandum, and thus merit further attention. First, in explaining its conclusion that New York Rule 5.4(a) forbids "business arrangements in which lawyers agree to make payments based on the receipt of legal fees or the amount of legal fees in particular matters," the opinion cited prior New York State Bar opinions forbidding lawyers from compensating non-lawyer companies based on an amount or percentage of fees from particular matters.

Second, the opinion was careful to note that its interpretation of New York Rule 5.4(a) did not prohibit traditional recourse loans in which an attorney: (1) agrees to repay a loan with interest over time; and (2) secures the loan with accounts receivable in one or more matters. The opinion explained that such loans did not violate the prohibition on fee-sharing because "there is no implicit or explicit understanding that the debt will be repaid only if legal fees are obtained in particular matters, and the creditor may seek repayment out of all of the law firm's assets."

Finally, the opinion called into question several New York court decisions upholding litigation funding agreements against public-policy challenges, explaining:

> insofar as the lawyers' payments to funders in these cases depended on the receipt of legal fees in particular matters, the judicial decisions enforcing the lawyers' contracts do not necessarily establish that Rule 5.4 applies differently to litigation funding arrangements than to other business arrangements.

State Bar of Nevada Standing Committee on Ethics and Professional Responsibility Formal Opinion No. 36

Issued: 1/2007

Relevant Rules Addressed: Nevada Rules of Professional Conduct 1.8 and 5.4, which are substantively identical to current Arizona ERs 1.8 and 5.4 for the purpose of this memorandum

Location: https://www.nvbar.org/wp-content/uploads/opinion_36.pdf

Summary:

Nevada Op. 36 addressed two questions: (1) whether an attorney could ethically finance litigation costs through a loan obtained from a third-party lending institution in which the loan is with recourse to the attorney and the client is still obligated to pay for litigation costs; and (2) whether an attorney could pass through the interest and other costs associated with obtaining financing to the client. The type of loan contemplated by the opinion was a recourse loan which counsel would be responsible to pay regardless of the outcome of a particular case, but could be secured with potential fees from the representation, other accounts receivable, or other types of security altogether. The opinion found such a loan was permissible under Nevada Rule 5.4 because "[l]oans directly to counsel on a recourse basis do not pose the problems associated with direct, contingent, nonrecourse loans to clients."

The opinion concluded that such an arrangement was ethically permissible, subject to several conditions/ethical considerations. Those conditions included that:

(1) the client be advised of the attorney's intention to seek financing, the nature of the loan and its terms, and a warning that the attorney's acquisition of debt could affect his or her judgment in rendering advice;

(2) the client give prior written consent to the financing arrangement;

(3) the loan must be a recourse loan that counsel is obligated to pay;

(4) the borrowed funds must be a reasonable amount based on the same considerations that control determination of a reasonable fee; and

(5) the attorney must take steps to ensure the lender understands and respects the attorney's obligation to provide independent and candid advice and to not allow third-parties to direct litigation.

Oregon State Bar Association Board of Governors Formal Opinion 2005-133: Attorney Fees: Financing Arrangement

Issued: 8/2005

Relevant Rules Addressed: Oregon Rules of Professional Conduct ("RPC") 1.6, 1.7, 5.4(a), which are substantively identical to Ers 1.6, 1.7, and 5.4(a) for the purpose of this memorandum

Location: 2005 WL 5679599; or https://www.osbar.org/_docs/ethics/2005-133.pdf

Summary:

Oregon Op. 2005-133 addressed a financing plan offered by a non-lawyer company to enable clients to finance their lawyer's legal fees. Under the terms of the financing plan, the company would establish a "credit facility" for the client to pay the lawyer's legal fees up to a credit limit established by the company. As the lawyer rendered services and earned fees, the lawyer and the client would approve vouchers representing the fees to the company, who would then pay the lawyer for the amount of the voucher less a 10% service charge. The client was responsible for paying the amount of each voucher plus interest, and the company was responsible for collecting any amounts owed by the client. Subject to certain limited exceptions, the company had no recourse against the lawyer.

The opinion concluded that a lawyer could participate in such a plan subject to certain conditions. First, the opinion found that Oregon RPC 5.4(a)'s prohibition on fee-sharing with nonlawyers, reasoning that the lawyer's "professional independence of judgment" was not implicated by the use of a nonlawyer to collect legal fees, "even when the nonlawyer is paid from the collected fees." Second, the opinion found that because the lawyer may have an incentive to recommend the financing plan to further his or her own financial interests (namely, the upfront payment of fees and avoiding the expense of collecting fees), the lawyer should be prepared to comply with the informed consent and waiver provisions of Oregon RPC 1.7. Finally, to the extent the submitted vouchers contained billing records and other information related to the lawyer's representation of the client, the lawyer was required to obtain informed consent to disclose that information under Oregon RPC 1.6.

Utah State Bar Ethics Advisory Opinion Committee Ethics Opinion No. 17-06

Issued: 9/2017

Relevant Rules Addressed: Utah Rules of Professional Conduct ("RPC") 1.5(a), 1.7, 5.4(a), which are substantively identical to current Arizona Ers 1.5(a), 1.7, and 5.4(a) for the purpose of this memorandum.

Location: https://www.utahbar.org/wp-content/uploads/2017/11/2017-06.pdf

Summary:

Utah Op. 17-06 addressed several ethical issues surrounding law firms' and attorneys' practices in consumer Chapter 7 bankruptcies, including:

(1) the ethical constraints that bind attorneys when they request clients sign a separate fee agreement after the petition for bankruptcy has been filed, meaning it cannot be discharged in the bankruptcy proceeding;

(2) whether and what kind of disclosures must be made if an attorney intends to sell the rights to collect on the post-petition fee agreement to a litigation financing company;

(3) whether a relationship between the attorney and the litigation financing company creates a conflict of interest; and

(4) whether an attorney's fee can be considered reasonable if he sells that fee for a deep discount to a litigation financing company.

The opinion noted that the typical practice in Chapter 7 bankruptcies was for attorneys to charge a low initial fee to prepare a client's petition for bankruptcy, and then provide the client the option to engage the lawyer in a separate agreement for post-petition work. The pre-petition fees were dischargeable in bankruptcy. The post-petition fees were not.

After reviewing several ethical considerations not relevant to this memorandum, the opinion found the sale or encumbrance of the accounts receivable associated with the post-petition fee agreement was not unethical or unlawful, citing favorably a Texas court decision which held that there was a significant difference ethically between sharing legal fees and paying debts with legal fees. Although the litigation funding arrangement at issue was therefore not unethical *per se*, the opinion noted several considerations that any attorney entering into such an arrangement should follow, including that:

(1) the attorney must fully inform the client about the use of the litigation financing company, that the company will collect the fee, that the attorney would not represent the client in a dispute with company, and that the post-petition fees are not dischargeable.

(2) the attorney must be mindful of disclosing information related to the representation to the funding company, and must acquire the client's informed consent, confirmed in writing, when disclosure is required, Utah RPC 1.6;

(3) the attorney must take care to protect their independence from influence by his or her relationship with the litigation financing company; and

(4) the attorney is subject to the reasonable fee provisions of Utah RPC 1.5 and must not unreasonably increase the price of their services to cover the discount associated with the litigation financing agreement.

Virginia State Bar Standing Commission on Legal Ethics, Advisory Opinion 1764: Attorney Fee Sharing with Finance Company

Issued: 5/2002

Relevant Rules Addressed: Virginia Rule of Professional Conduct 5.4(a), which is substantively identical to current ER 5.4(a)

Location: https://www.vsb.org/docs/2009-10-pg-rpc.pdf

Summary:

Virginia Op. 1764 concerned the following hypothetical: An attorney enters a fixed fee agreement with a client. The attorney plans to obtain financing from a financing company for the amount of the fixed fee less a discount to be kept by the financing company. The client would be obligated by contract to pay the finance company in monthly installments until the fee was paid plus interest.

After reviewing the agreement, the opinion concluded that the fee arrangement presented "a basic ethical problem" because the agreement called for the finance company to receive a portion of the attorney's fee in violation of Virginia Rule 5.4(a), which prohibits fee-sharing with non-lawyers. The opinion explained that "while the attorney may arrange for the client to pay interest to the finance company, the attorney may not agree to provide the finance company with a portion of his fee."

Summary of Relevant Bankruptcy Cases/Authority

11 U.S.C. § 329: Debtor's transactions with attorneys

Section 329 of the Bankruptcy Code provides that:

> [a]ny attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.

11 U.S.C. § 329(a). The statute also authorizes the bankruptcy court to void any agreement and disgorge any compensation paid that "exceeds the reasonable value of any such services" and return the excessive portion. 11 U.S.C. § 329(b).

Federal Rule of Bankruptcy Procedure 2016: Compensation for Services Rendered and Reimbursement of Expenses

Federal Rule of Bankruptcy Procedure ("Rule") 2016 contains two provisions relevant to the scenario contemplated in this memorandum. First, Rule 2016(a) requires that "an entity seeking interim or final compensation for services . . . from the estate shall file an application setting forth a detailed statement of (1) the services rendered, time expended, and expenses incurred, and (2) the amounts requested." As part of this application, the entity is also required to disclose any:

> payments [that] have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case, the source of the compensation so paid or promised, whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation received or to be received for services rendered in or in connection with the case, and the particulars of any sharing of compensation or agreement or understanding therefor . . . .

Fed. R. Bankr. P. 2016(a).

Second, Rule 2016(b) specifically mandates that every attorney for a debtor, whether applying for compensation as part of the bankruptcy proceedings or not, must file "the statement required by § 329 of the [Bankruptcy] Code including whether the attorney has shared or agreed to share the compensation with any other entity. The statement shall include the particulars of any such sharing or agreement to share by the attorney . . . ."

***In re Wright*, 519 B.R. 68 (Bankr. N.D. Okla. 2018)**

<u>Relevant Rules Addressed:</u> Oklahoma Rule of Professional Conduct 3.3, which is substantively identical to Arizona ER 3.3 for purposes of this memorandum.

<u>Location:</u> Westlaw

<u>Summary:</u>

This case addressed the conduct of a consumer bankruptcy attorney, J. Ken Gallon, who was involved in a fee financing scheme remarkably similar to the scenario presented by EO-20-0003, in 17 consolidated cases. In 2017, Gallon entered an "Accounts Receivable Assignment Agreement" with a litigation financing company, BK Billing LLC ("BK Billing"), which, according to the bankruptcy court, "provides factoring services to bankruptcy counsel in Chapter 7 cases." Under the terms of the agreement, Gallon would "factor," or sell, his accounts receivable for post-petition fee agreements with his clients to BK Billing in exchange for 70–75% of the value of the fee agreement. BK Billing would then engage in collection activities on the accounts receivable.

As part of its services to Gallon, BK Billing also assisted him in creating a "bifurcated" fee agreement model, which contemplated Gallon entering two separate retention agreements with clients who elected to participate in what the court described as the "BK Billing Model". The first agreement would cover services "up to and including filing the petition," while the second, executed post-petition, would cover all remaining services. The post-petition fee agreement disclosed that the post-petition accounts receivable could be assigned to BK Billing, that BK Billing would collect payments for the fee and report payments to credit reporting agencies, and requested the client's consent to share client file information with BK Billing.

Utilizing the BK Billing Model, Gallon executed at least 17 post-petition fee agreements, and all but three were sold to BK Billing for a discount. However, in disclosure statements filed with the bankruptcy court pursuant to the requirements of 11 U.S.C. § 329 and Bankruptcy Rule 2016, Gallon did not disclose that he had agreed to accept a discounted payment from BK Billing instead of the amount of fees contemplated by the post-petition fee agreements, and asserted that he had not agreed to share compensation for services with any other person or entity.

After engaging in an intensive review of Gallon's billing practices in each of the cases before it, the bankruptcy court concluded that Gallon had violated his duty of disclosure under the Bankruptcy Code and Rules and his duty of candor to the tribunal under Oklahoma Rule of Professional Conduct 3.3. The court found that his failure to disclose the fee arrangement with BK Billing rendered the information he provided concerning his compensation to be "grossly misleading, if not out right false," and that Gallon should have known that he was required to notify the court that BK Billing was paying Gallon's fees. The court also found that he worked a fraud on the court by incorporating pre-petition work into the fees he charged in post-petition fee agreements, thereby rendering an ordinarily dischargeable debt into a non-dischargeable one.[3] Citing these instances of misconduct and its authority under 11 U.S.C. 329(b), the court ordered disgorgement of all fees collected by BK Billing post-petition from Gallon.

<u>Note:</u> In response to Gallon's defense that he relied on BK Billing to "train and advise him on the use of their model," the court observed that "[s]uch reliance on BK Billing in the discharge of his professional duties and judgment" violated Gallon's duty to maintain his independent professional judgment and not allow third-parties to direct or otherwise control litigation under Oklahoma Rules of Professional Conduct 1.8(f), 2.1, and 5.4(c).

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[3] Gallon asserted that BK Billing actively encouraged this practice in its instructional material.

***In re Hazlett*, Bankr. No. 16-30360, 2019 WL 1567751 (Bankr. D. Utah Apr. 10, 2019).**

Relevant Rules Addressed: Utah Rules of Professional Conduct ("RPC") 1.5, 1.6, which are substantively identical to Arizona Ers 1.5 and 1.6

Location: Westlaw

Summary:

In re Hazlett concerned a motion for sanctions filed by the United States Trustee against a law firm who utilized a similar bifurcated fee agreement model to the model at issue in *In re Wright* (it was even the same litigation finance company, BK Billing LLC) for clients who could not afford to pay a fixed, up front attorney's fee for representation in Chapter 7 bankruptcy proceedings. The United States Trustee sought guidance from the court as to the legal and ethical propriety of using bifurcated fee agreements with factoring/litigation financing companies.

In the decision, the court found that bifurcated fee agreements were not *per se* impermissible or unethical under bankruptcy law and the Utah Rules of Professional Conduct, and opined that such agreements, when properly handled, help to aid debtors who otherwise would be forced to navigate the bankruptcy system *pro se* achieve the efficient and effective resolution of their cases. The court found that this fact furthered the underlying purpose of the bankruptcy system, which is to protect debtors and provide them a means for a fresh start. The court explained that "high-minded requirements and restrictions" surrounding the payment of attorney's fees in bankruptcy cases "often result in greater prejudice to debtors who do not receive a discharge . . . simply because they are too poor to pay a retainer up front to procure the needed legal representation."

Concerning how to properly handle such fee arrangements, the court, relying heavily on Utah Op. 17-06, described a set of essential practices attorneys should follow to avoid legal and ethical issues.

First, any attorney wishing to advise a client about the use of bifurcated fee agreements and other related payment options must ensure that they do so based on the client's best interests and not their own financial interests, and must provide appropriate disclosures, options, and explanations to the client.

Second, all fees associated with legal services must be reasonable. The court noted that while an attorney could potentially charge a client more for a fee financing/bifurcated post-petition fee agreement than an up-front retainer, the overall price must still be reasonable and could not include the cost of pre-petition services.

Third, an attorney must fully reveal all fee arrangements in statements to the bankruptcy court, including "the details of the pre-petition and post-petition fee agreements, any payment plan, and any interest charge on installment payments." This includes full disclosure of any factoring or financing arrangement with a litigation financing company.

After outlining these practices, the court concluded the attorney's conduct at-issue in the case, although not perfect, did not merit sanctions. Citing Utah Op. 17-06 and *In re Wright*, however, the court cautioned against use of the fee factoring/financing arrangement utilized by "the BK Billing arrangement, or a similar factoring mechanism, unless it strictly complies with the guidance in the Utah Ethics Opinion."

Other Relevant Materials (With Brief Descriptions)

1. Daniel E. Garrison, *There's No Such Thing As Too Much Information: Disclosure of Bifurcation and Financing in Chapter 7 Cases*, 38-JUL Am. Bankr. Inst. J. 20 (2019):

This source discusses bifurcation fee agreements, factoring, and financing arrangements in Chapter 7 bankruptcy proceedings and their interactions with the disclosure requirements of the bankruptcy code.

2. Adam D. Herring, *Problematic Consumer Debtor Attorneys' Fee Arrangements and the Illusion of "Access to Justice"*, 37-OCT Am. Bankr. Inst. J. 32 (2018):

This source highlights the concerns surrounding "factored" bifurcation fee agreements in bankruptcy proceedings, whereby an attorney "assigns the right to collect from the debtor under the post-petition agreement to [a] third-party finance company in exchange for a lump-sum discounted payment."

3. Joseph R. Prochaska, *Alternative Fee Payment Arrangements in Consumer Cases: The Good the Bad and the Ugly*, *in* Avoiding Potential Ethical Traps in Unbundling, Factoring, and Other Fee Arrangements in Consumer Cases, 93rd Ann. Nat. Conf. of Bankr. Judges at 36 (2019), https://ncbjmeeting.org/2019/materials/Avoiding%20Potential%20Ethical%20Traps.pdf

This source provides a useful summary of the complications surrounding the payment of attorney's fees in bankruptcy proceedings, the incentives created by this system for attorneys to craft alternative fee arrangements, and the disclosure requirements concerning fees in the Bankruptcy Code. The source discusses factoring as one such method of alternative fee financing.

4. American Bar Association Commission on Ethics 20/20, *Informational Report to the House of Delegates* (2012), https://www.americanbar.org/content/dam/aba/administrative/ethics_2020/

20111212_ethics_20_20_alf_white_paper_final_hod_informational_report.authcheckdam.pdf

This source provides an extensive analysis of the ethical considerations surrounding Alternative Litigation Funding, the ABA's adopted term for "the funding of litigation activities by entities other than the parties themselves, their counsel, or other entities with a preexisting contractual relationship with one of the parties, such as an indemnitor or a liability insurer." The source gathers substantial commentary on the subject, and concludes that many alternative litigation funding models can be ethically navigated provided attorneys take care to avoid and/or remedy the potentially numerous disclosure (ER 1.6), conflict of interest (ER 1.7 and ER 1.8), and professional independence (ER 1.8(f), ER 2.1, and ER 5.4(c)) issues raised by such arrangements.

5. Steven Garber, Rand Institute for Civil Justice, Law, Finance and Capital Markets Program, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns* (2010) (Occasional Paper series), https://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf

This source offers an in-depth discussion of the origins and developments of alternative litigation funding and the legal, ethical, and moral questions raised by the practice.

III. Analysis and Recommendations

Fee Sharing (ER 5.4(a))

Analysis:

On its face, the fee financing arrangement at issue in EO-20-0003 raises concerns of unethical fee-sharing with a non-lawyer in violation of ER 5.4(a). Under the terms of the arrangement, the lender, a non-lawyer entity, advanced only 75% of the agreed upon fee in the fee agreement between the Firm and the client in exchange for assignment of the associated accounts receivable, retaining 25% of the fee to "cover financing and collection management services." An Arizona ethics opinion, Op. 98-05, concluded that the mere fact that a financing company would "recoup [a] discounted portion of the client's account receivable" was sufficient to find fee-sharing in violation of ER 5.4(a). And at least one other jurisdiction, Virginia, applied the same rationale to a hypothetical with close parallels to the situation presented in EO-20-0003. *See* Virginia Op. 1764, at PDF 1–2 (2002) ("The committee opines that, in line with those opinions, while the attorney may arrange for the client to pay interest to the finance company, the attorney may not agree to provide the finance company with a portion of his fee.").

However, an easy resolution of this question cannot be found here, for two reasons. First, Arizona Ethics Opinion 98-05 addressed fee-sharing in the context of an *outright sale* of a lawyer's accounts receivable for a discounted price and did not involve a loan or advance of funds. The fee financing arrangement at-issue here, however, concerns a discount for financial and collection-related services charged in relation to an *advance* drawn from a line of credit and *secured* by the assignment of a lawyer's accounts receivable. These facts render the fee financing arrangement more akin to a credit card financing plan, which have consistently been found not to constitute unethical fee-sharing. In Arizona Ethics Opinions 70-20 and 71-34, for example, the opinions concluded that a credit card payment plan did not violate the ethical prohibition on fee-sharing, despite the fact that the lender would keep a percentage of the lawyer's fee, because the "financing charges to the bank [were] for financial services rendered" that could be segregated from the receipt of the lawyer's fee.

Arizona Ethics Opinion 89-10 likewise concluded that a credit card financing plan did not violate ER 5.4(a) because the "the lender act[ed] merely as a collection agency for the attorney's fee." There appears to be no principled distinction between the fee financing arrangement at-issue here and the credit card financing plans approved in Arizona Ethics Opinions 70-20, 71-34, and 89-10 for the purposes of ER 5.4(a). Like those plans, the portion of the fee retained by the lender is payment for financial services rendered in connection with the advance of fees and the collection of fees. And viewing a discount charged in a fee financing arrangement as distinct from the types of agreements that constitute fee-sharing aligns with the opinion of the American Bar Association in Formal Opinion 484. *See* ABA Formal Opinion 484, at 10 (2018) (when finance company charges financing or subscription fee, it "is basically an administrative fee that is deducted from the payment to the lawyer"); *see also* Oregon Opinion 2005-133 (2005) (prohibition on sharing fees "does not prohibit [a] [l]awyer from using a nonlawyer to collect legal fees, even when the nonlawyer is paid from collected fees").

Second, focusing the analysis under ER 5.4(a) solely on whether a discount or financing fee is paid out of the lawyer's legal fees in one or more cases, as Arizona Ethics Opinion 98-05 did, ignores the underlying purpose of ER 5.4(a), which is "to protect the lawyer's professional independence of judgment." ER 5.4 cmt. 1. Several jurisdictions have held that any fee financing arrangement that conditions repayment of an advance or loan on either the recovery of fees or the recovery of a specific amount of fees violates the purpose of ER 5.4(a) because the lender is given a stake in the outcome of the litigation that will incentivize it to try and influence the lawyer's independent judgment. New York Opinion 2018-5, at 5–6 (2018); Maine Opinion 193 (2007). But here, no such stake exists; the lender is entitled to collect on the assigned accounts receivable regardless of the outcome of any litigation financed by the funds borrowed. And even more, because the agreement between the lender and the Firm to advance funds is with recourse to the Firm, "there is no implicit or explicit understanding that the debt will be repaid only if legal fees are obtained in particular matters, and the creditor may seek repayment out of all of the law firm's assets." New York Opinion 2018-5, at 5, n.9 (2018). Thus, applying Arizona

Ethics Opinion 98-05's unnuanced rationale to the fee financing arrangement at issue in EO-20-0003 does not serve to effectuate the underlying purpose of ER 5.4(a).

Recommendation:

If the Committee decides to grant the ethics opinion request, it should find that the fee financing arrangement outlined in EO-20-0003 does not constitute ethically impermissible fee-sharing because: (1) the agreement is akin to an ethically permissible form of financing agreement; and (2) finding that the fee financing agreement violated ER 5.4(a) would not serve the underlying purpose of the rule. To the extent necessary, the opinion should distinguish or outright reject the reasoning of Arizona Ethics Opinion 98-05.[4]

Reasonableness and Disclosure of Fee (ER 1.4(b) and ER 1.5(a), (b))

Analysis:

In the background provided by EO-20-0003, the organization submitting the request indicated that the fee agreements between the Firm and clients "did not specify the amount of fees retained by the lender and/or whether the client was charged a higher fee for utilizing" the fee financing option. This fact raises serious ethical concerns about: (1) whether the fee being charged by the Firm to clients who utilize the fee financing arrangement are being charged a reasonable fee under ER 1.5(a); and (2) whether the terms and basis for the fee are being adequately explained to the client, ER 1.4(b); ER 1.5(b).

ER 1.5(a) provides that a "lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount of expenses." In entering into a fee agreement with a client, a lawyer must also communicate to the client in writing "the basis or rate of the fee and expenses for which the client will be responsible." ER 1.5(b). The lawyer must also "explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." ER 1.4(b). When a lawyer wishes to pass charges not associated with the fee for his or her services onto a client as part of a fee agreement, the lawyer must inform the client of the details to extent reasonably necessary to allow the client to make an informed decision concerning whether to agree to pay those expenses. *See* Arizona Ethics Opinion 01-07 (2001). With respect to fee financing arrangements that involve the subtraction of a discount or service

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[4] As the Committee is no doubt aware, a rule change petition is currently pending before the Arizona Supreme Court that would eliminate ER 5.4 altogether. Dave Byers, R-20-0034 Petition to Restyle and Amend Supreme Court Rule 31; Adopt New Rule 33.1; and Amend Rules 32, 41, 42 (Various ERs from 1.0 to 5.7), 46–51, 54–58, 60, and 75–76, https://www.azcourts.gov/Rules-Forum/aft/1118 (last visited 3/28/20). Depending on the Committee's assessment of that petition, it may limit the need to discuss ER 5.4(a).

charge from the lawyer's accounts receivable, the lawyer may only pass that charge onto the client if his or her fee remains reasonable, Utah Opinion 17-06 at PDF 11, and if the attorney informs the client of the nature and details of the charge. Arizona Ethics Opinion 01-07. If passing the service charge or discount onto the clients results in the attorney charging a higher fee for a fee financing arrangement than another payment option, the attorney must inform the client of that fact. ABA Formal Opinion 484 at 8 (2018).

Here, the Firm's failure to disclose the amount of fees retained by the lender and whether the Firm charges a higher fee for clients who utilize the fee financing arrangement likely violates both ER 1.5(b) and ER 1.4(b). A potential client cannot make an informed choice with respect to entering the fee financing arrangement without information concerning: (1) where the fees will be allocated; and (2) whether selecting the fee financing arrangement will result in a greater expense than an alternative payment option. Even if the fee itself remains reasonable, the Firm cannot conceal expenses unrelated to the services it agrees to provide a client within the amount it charges for legal fees or fail to provide information concerning other payment options. And although the situation presented in EO-20-0003 does not contain enough information to conclude whether the fee is reasonable, Utah Opinion 17-06 made the following observation that is relevant to this question: "If the lawyer is willing to do the work with a thirty percent discount, we question, but do not resolve, whether the total fee is reasonable." Utah Opinion 17-06, ¶ 19 (2017); *see also In re Wright*, 519 B.R. 68 (Bnkr. N.D. Okla. 2018) (questioning the reasonableness of a fee when attorney "was willing to accept roughly . . . 75%" of the amount the attorney actually charged for the value of his services).

<u>Recommendation:</u>

If the Committee grants the ethics opinion request, it should find that the Firm's failure to disclose the amount of the agreed upon fee retained by the lender and whether it charges clients a higher fee to utilize the fee financing arrangement violated ERs 1.5(b) and 1.4(b). The Committee should also consider incorporating Utah Opinion 17-06 and ABA Formal Opinion 484's discussion of the considerations surrounding the reasonableness of fees in this context into the opinion.

<u>Disclosure of Information Related to Representation (ER 1.6(a))</u>

<u>Analysis:</u>

In the scenario described by EO-20-0003, the organization submitting the request indicated that 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 disclosure of such information falls within the scope of ER 1.6(a), which provides that "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent."

Several Arizona ethics opinions, Arizona Ethics Opinions 89-10, 92-04, and 94-11, have concluded that a lawyer may disclose information such as a list of his or her accounts receivable, including the name of the person or company owning the account, the account balance, and the age of the account, to a bank to facilitate acquiring a line of credit or to assist a collection agency in collecting delinquent fees. Arizona Ethics Opinion 98-05, on the other hand, concluded that the sale of accounts receivable to a factor created a ER 1.6(a) issue that could not be waived even after client consultation. Although Opinion 98-05 indicated that the disclosures likely involved in the sale of an accounts receivable would extend further than in situations considered in previous opinions, its chief concern was the fact that, under the terms of the proposed agreement at issue in that opinion, the factor was permitted, in its sole discretion, to resell the accounts receivable it purchased from the lawyer in the marketplace. The opinion found:

> The lawyer could not conceivably anticipate and communicate to the client all of the factual permutations and legal implications of such a sale to a factor. It is unlikely any lawyer could assess the uncertainty of client accounts receivable being sold into the secondary market replete with the time cards, file, correspondence, legal memoranda, and all other confidential matters relating to the client, sufficiently, for the client to appreciate the significance of what he is being asked to do.

However, the disclosures contemplated in EO-20-0003 are not nearly so broad or far-reaching. Under the terms of fee financing arrangement between the Firm and the lender, the lender merely acts as the financer of the line of credit and the collection service for the accounts receivable. There is no indication that the lender has any right to engage in the activities that would lead to disclosures the lawyer could not possible "anticipate and communicate to the client." Instead, the disclosures involved here fall within the types of disclosures Arizona has long found ethically permissible, so long as the Firm obtains informed consent from the client to disclose the information. This view of the issues involving disclosures in fee financing arrangements aligns with the opinions of several jurisdictions, including Utah and Oregon, and the American Bar Association. Utah Opinion 17-06, ¶ 17 (2017); Oregon Opinion 2005-133 (2005); ABA Formal Opinion 484 at 8(2018).

In obtaining that informed consent, however, the Firm must take care to inform the client of the full range of consequences that may result from the disclosure of financial information related to the representation, including the potential waiver of attorney-client privilege. The Firm must also be aware that assigning the accounts receivable to the lender does not obviate its responsibility to limit the disclosure of information falling within the ambit of ER 1.6. *See* Arizona Ethics Opinion 94-11 (1994) ("[A] lawyer is legally and ethically responsible for the conduct of the agents of a collection agency and may not 'assist or induce' another to act unethically, if a lawyer does turn over delinquent accounts to a collection agency."). Accordingly, the Firm must supervise the lender's collection activities to ensure compliance with ER 1.6, and, if necessary, intervene to prevent the unauthorized disclosure of information related to the representation.

Recommendation:

If the Committee decides to grant the ethics opinion request, the Committee should find that the disclosure of information related to the representation at issue in EO-20-0003 is ethically permissible so long as the Firm acquires informed consent for the disclosure. ER 1.6(a). To the extent necessary to avoid a conflict with Arizona Op. 98-05, the opinion should distinguish it on the ground that it concerned the outright sale of accounts receivable with the possibility of resale, while the fee financing agreement considered here involves accounts receivable used as collateral for an advance on a line of credit. The opinion should, however, emphasize that lawyers must warn clients of all the possible consequences associated with the disclosure of information related to representation to a collection agency/finance company, including the possible waiver of attorney-client privilege. The opinion should also warn lawyers that their ethical duties with respect to the disclosure of information do not end when they assign accounts receivable to a collection agency or finance company.

Conflicts of Interest (ER 1.7 and ER 1.8)

Analysis:

The scenario presented in EO-20-0003 implicates several actual and potential conflicts of interest contemplated by ER 1.7(a), ER 1.8(a), and ER 1.8(f) that would merit discussion if the Committee granted the ethics opinion request.

The first and perhaps most significant conflict of interest at issue in EO-20-0003 originates from the fact that the advances issued by the lender to the Firm are recourse loans as to the Firm, meaning the Firm can be held liable for any fees a client subject to the fee financing agreement fails to pay. This arrangement places the Firm in a position directly adverse to the client's should the client be unable to pay the lender or dispute some aspect of the lender's collection activities. This in turn raises the possibility that the Firm will place its financial and pecuniary interests in avoiding liability for the client's unpaid fees ahead of the client's interests. *See* ER 1.7(a) (conflict of interest arises if attorney's representation "will be materially limited . . . by a personal interest of the lawyer"); ER 1.8(a) ("[A] lawyer shall not . . . knowingly acquire a[] . . . pecuniary interest adverse to a client . . . ."). Prior Arizona ethics opinions considering third-party financing arrangements have consistently stated that the arrangements must be without recourse to the attorney to avoid such conflicts of interests. *See* Arizona Ethics Opinion 70-20 (1970); Arizona Ethics Opinion 89-10 (1989); Arizona Ethics Opinion 98-05 (1998). However, these opinions did not address whether a conflict arising out of a recourse loan could be consented to pursuant to ER 1.7(b) and ER 1.8(a).

Thus, at a minimum, a lawyer or firm wishing to enter into a fee financing arrangement with a client and a lender that will involve an advance or loan with recourse to the lawyer or firm must comply with the process for waiving the conflicts of interest presented by such an arrangement under both ER 1.7(b) and ER 1.8(a). To properly acquire the client's informed consent, the lawyer must inform the client of the nature and details of the recourse loan and of the possibility that the lawyer's judgment could be affected by the threat of liability. *See* Nevada Opinion 36, at 7 (2007) ("Counsel should explain that incurring debt in connection with a case could affect counsel's assessment of what constitutes reasonable resolution of the case and thus affect counsel's advice to the client regarding settlement."). To the extent the Firm failed to do so before entering the fee financing arrangement with its clients, it is difficult to say that the clients truly gave the informed consent necessary to waive the conflict of interests raised by the recourse loan.

Second, and as identified in the ethics opinion request, a material limitation conflict of interest under ER 1.7(a)(2) may arise from the financial incentives a fee financing arrangement such as the one outlined in EO-20-0003 may provide a lawyer or firm. As stated in ABA Formal Opinion 484: "the . . . risk is that the lawyer will recommend the finance company or broker to the client even though fee financing is not in the client's interests because the client's arrangement of financing best assures payment or timely payment of the lawyer's fee." ABA Formal Opinion 484, at 8–9 (2018); *see also* Oregon Opinion 2005-133 at PDF 6 (2005). However, a conflict of interest could potentially be avoided altogether if a lawyer refrained from recommending a fee financing arrangement but instead presented it as one of several payment options for the client to consider. ABA Formal Opinion 484, at 9. And a client may nonetheless give informed consent to the representation even in the face of such a conflict so long as the requirements of ER 1.7(b) are properly satisfied. *See* ABA Formal Opinion 484, at 9.

Third, assuming the Firm and the lender described in EO-20-0003 have an ongoing business relationship, a potential material limitation conflict of interest could arise out of the Firm's personal interest in maintaining that relationship. *See* Arizona Ethics Opinion 01-07 (2001). Thus, to the extent the Firm or a similarly situated lawyer or law firm believes that their relationship with a lender rises to the level of a material limitation conflict of interest, they must comply with the requirements of ER 1.7(b).

Finally, because the situation described in EO-20-0003 involves the Firm "accepting compensation for representing a client from one other than the client," the Firm must also comply with the requirements of ER 1.8(f). From the facts presented in the ethics opinion request, it is unclear whether the fee agreement between the Firm and the client adequately conveys information surrounding the fee financing arrangement to provide a client with an adequate basis to give informed consent.

Recommendation:

If the Committee grants the ethics opinion request, it should address the numerous actual and potential conflicts of interests raised by the situation described within it, with special attention paid to material limitation and pecuniary interest conflicts of interest created by the recourse nature of the loan at issue in EO-20-0003. The Committee should emphasize the need for lawyers to be mindful of the many pitfalls presented by fee financing arrangements and that they stringently follow the requirements of ER 1.7(b), 1.8(a), and 1.8(f) when entering into such an arrangement.

Candor to the Tribunal (ER 3.3(a)(1))

Analysis:

The factual situation outlined in EO-20-0003 indicates that the Firm "did not disclose the use" of the litigation financing agreement "on disclosure statements filed with the bankruptcy court." Given the affirmative obligation placed on attorneys representing debtors in bankruptcy proceedings to disclose both (1) any arrangement to share fees and (2) any source of compensation paid or agreed to be paid to the attorney in connection with the proceedings, the Firm's failure to disclose the use of a litigation financing agreement to advance its fees clearly violates its ethical duty of candor to the tribunal under ER 3.3(a)(1).

ER 3.3(a)(1) provides that an attorney shall not knowingly "make a false statement of fact or law to a tribunal . . . ." Comment 3 to the rule further explains that:

> an assertion purporting to be on the lawyer's own knowledge, as in an affidavit by the lawyer or in a statement in open court, may properly be made only when the lawyer knows the assertion is true or believes it to be true on the basis of a reasonably diligent inquiry. There are circumstances where failure to make a disclosure is the equivalent of an affirmative misrepresentation.

In every bankruptcy case, the attorney or firm representing the debtor must submit a statement to the bankruptcy court disclosing any arrangement to share legal fees with another entity and the source of any compensation paid or agreed to be paid to the attorney. 11 U.S.C. § 329(a); Fed. Bankr. R.P. 2016; *In re Wright*, 519 B.R. 68, 89–90 (Bankr. N.D. Okla. 2018).

Here, as in *In re Wright*, the Firm's failure to disclose the terms of the fee financing arrangement, including the fact that a portion of the Firm's fee would be kept by the lender and that the lender would essentially pay the lawyer's fee on behalf of the client, "is the equivalent of an affirmative misrepresentation" by the Firm. By submitting statements to the bankruptcy court without these disclosures, the Firm has, in effect, misrepresented to the court that: (1) it, and no other entity, is entitled to the full amount of the fees contemplated in the fee agreement; and (2) it either has been paid by the client instead of a third-party or has not been paid at all, depending the content of the statement. This is misleading and could easily be characterized by the bankruptcy court as a fraudulent attempt to conceal unsavory aspects of the fee financing arrangement from the court's scrutiny, including whether the fee charged itself is unreasonable. *See In re Wright*, 519 B.R. at 93–95.

To avoid violating its ethical duty of candor to the tribunal in the future, the Firm and other similarly situated lawyers and firms should follow the guidance provided by *In re Hazlett* and disclose "the details of the pre-petition and post-petition fee agreements, any payment plan, and any interest charge on installment payments," as well as the relevant details of any factoring or financing arrangement with a litigation financing company. 2018 WL 1567751, at *10 (Bankr. D. Utah Apr. 10, 2019).

Recommendation:

If the Committee decides to issue an opinion addressing EO-20-0003, the Committee should find that an lawyer's failure to disclose a litigation financing arrangement such as the one contemplated here would likely constitute a false statement or material omission in violation of ER 3.3(a)(1). Although issues of bankruptcy law lie outside the scope of the Committee's purpose, the Committee should make note of the applicable Bankruptcy Code and Rules provisions governing disclosure of fee agreements and attorney compensation, and, drawing from rationale outlined in *In re Wright*, should explain that failing to disclose such a fee agreement in the face of an lawyer's clear statutory and rule-based obligations misleads the court, undermines its statutory authority to review fees, and impugns the integrity of the bankruptcy proceedings. In providing guidance on how lawyers can avoid violating ER 3.3(a)(1), the Committee should consider incorporating the essential practices described by the Bankruptcy Court for the District of Utah in *In re Hazlett*.

IV. Conclusion/Recommendation

The Committee should issue an opinion addressing the ethical propriety of the scenario described in EO-20-0003, which raises several ethical issues of first impression in Arizona that have gained increasing national attention in recent years, and provide guidance as to the concerns raised in this memorandum. In doing so, the Committee should consider incorporating and/or adopting the reasoning and analysis set forth in recent ethics opinions issued by the American Bar Association, New York, Nevada, and Utah, and the decisions issued by Bankruptcy Court for the District of Utah and the Northern District of Oklahoma. The Committee may also wish to seek additional information concerning the fee financing agreement and the practices of the Firm, including whether the fee financing arrangement is utilized in specific bankruptcy proceedings (Chapter 7 or Chapter 13, for example) and whether the Firm utilized a bifurcated fee model, and to expand or narrow the scope of the opinion depending on the answers received.