

## Utah Ethics Opinions

2006.

### 06-03. UTAH STATE BAR ETHICS ADVISORY OPINION COMMITTEE

Opinion No. 06-03

Issued December 8, 2006

**1. Issue:** Under what circumstances may a Utah lawyer be personally involved in a lending transaction to finance a client's cause of action or obtain funds for the payment of the lawyer's legal fees and expenses?

**2. Conclusion:** (a) A lawyer may not directly or indirectly represent a lender to the lawyer's client in connection with a loan that is made for the purpose of enabling the client to pay the lawyer's fees or costs. (b) A lawyer may not participate in a contingent, non-recourse loan with a third-party lender to finance the costs and expenses of litigation where the terms of the lending arrangement create the potential that the financial risk to the lawyer of the lending arrangement are lessened if the lawyer obtains no recovery for the client.

3. The Committee has received two separate requests regarding the propriety of financial transactions between Utah lawyers and third-party lending sources. Although the factual backgrounds are substantially different, they both raise similar questions concerning lawsuit funding for clients who may not be in a position to pay a lawyer's ongoing fees or costs up front.

**4. Background for EAO File No. R0206:** In the first situation, a Utah lawyer ("Lawyer") has clients who cannot pay Lawyer's retainer or flat fee because they do not have sufficient available cash on hand, although they are employed and could repay a loan over time. Lawyer proposes to organize and manage a consumer money-lending company ("Affiliated Lending") as a limited liability company that would be capitalized and owned by Lawyer's relatives. Affiliated Lending would be a manager-managed limited liability company ("LLC"), and Lawyer would be the sole manager of the LLC. Lawyer would review loan applications, initiate and service loans for Affiliated Lending. Lawyer also would receive compensation from Affiliated Lending for these services. Affiliated Lending would consider and make loans to the public, as well as to Lawyer's clients. If the client were subsequently to default on a loan, any judicial collection action would be referred by Affiliated Lending (presumably acting through its manager-lawyer) to a third-party

collection agency. Lawyer would never represent Affiliated Lending in pursuing a collection action against one of Lawyer's clients.<sup>1</sup>

5. In referring clients to Affiliated Lending, Lawyer would explain potential conflicts of interest to the client in a written disclosure. This disclosure would explain that Affiliated Lending is owned by Lawyer's relatives, that Lawyer manages Affiliated Lending, that the client has the right to have the arrangement reviewed by independent counsel, that there would be severe repercussions to the client if there is a default on a loan, and that a potential conflict could arise between Lawyer and the client if the client did default. The client would be required to sign this written disclosure before applying for a loan from Affiliated Lending. The loans would be made at or below market rates for comparable high risk, short-term loans.<sup>2</sup>

**6. Analysis:** The proposed lending-fee arrangement here places Lawyer in a dual relationship with conflicting loyalties. On the one hand, Lawyer owes a duty of loyalty to the client, while, at the same time, Lawyer owes a duty of loyalty to Affiliated Lending as its sole, managing employee. The relationship between Affiliated Lending and the client is adverse: Affiliated Lending is a creditor of the client. As such, Lawyer's duties to both the client and Affiliated Lending are in conflict. More importantly, Lawyer's dual loyalties make it difficult, if not impossible, for Lawyer to provide objective, unbiased advice and representation to the client where, by doing so, the interests of Affiliated Lending might be impaired, or the personal interests of Lawyer in Affiliated Lending might be adversely affected.

7. For example, Lawyer has an interest in causing Affiliated Lending to make a loan to the client that is sufficient to pay Lawyer's fees, whereas it may not be prudent for Affiliated Lending to make such a loan, or for the client to obtain such funds on the terms offered. Lawyer's personal interest in the loan proceeds also may taint the lawyer's judgment in negotiating and documenting the loan. Further, Lawyer's loan documents and credit negotiations with the client might be called into question if the client subsequently were to default on the loan.

8. Rule 1.6(a) 3 provides:

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 by paragraph (b).<sup>4</sup>

9. Comment [2] of this rule describes client confidentiality

as a "fundamental principle in the client-lawyer relationship" and notes that the principle "contributes to the trust that is the hallmark of the client-lawyer relationship." Comment [4] of Rule 1.6 further notes that "[t]his prohibition also applies to disclosures by a lawyer that do not in themselves reveal protected information but could reasonably lead to the discovery of such information by a third person."

10. Here, information that Lawyer learns about the client may prejudice the client in either the negotiations to obtain the loan or in the lender's efforts to collect the loan. If Lawyer were to withhold this information from the lender, Lawyer's duty of loyalty to the lender likewise would be compromised. On the other hand, if Lawyer were to reveal sensitive information to the lender, then Lawyer's duty of confidentiality to the client is compromised.

11. Rule 1.7 provides, in part:

(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 the lawyer's responsibilities to another client, a former client *or a third person or 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:

(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;

(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 another proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

(Emphasis added.)

12. As is made clear by Comment [1] of Rule 1.7: "Loyalty and independent judgment are essential elements in the lawyer's relationship to a client. Concurrent conflicts of interest can arise from the lawyer's responsibilities to another client, a former client *or a third person or from the lawyer's own interests.*" (Emphasis added.)

13. Further, Comment [8] of Rule 1.7 provides:

Even where there is no direct adverseness, a conflict of interest exists if there is a *significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests.* . . . The mere possibility of subsequent harm does not itself require disclosure and consent. The critical questions are the likelihood that a difference in interests will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.

(Emphasis added.) And, as stated in Comment [9] of Rule 1.7, "a lawyer's duties of loyalty and independence may be materially limited . . . by the lawyer's responsibilities to other persons, such as fiduciary duties arising from a lawyer's service as a trustee, executor or corporate director."

14. Comment [13] of Rule 1.7 addresses the subject of third persons who pay for a lawyer's service:

A lawyer may be paid from a source other than the client, including a co-client, if the client is informed of that fact and consents *and the arrangement does not compromise the lawyer's duty of loyalty or independent judgment to the client.* See Rule 1.8(f). If acceptance of the payment from any other source presents a *significant risk* that the lawyer's representation of the client will be *materially limited by the lawyer's own interest in accommodating the person paying the lawyer's fee* or by the lawyer's responsibilities to a payer who is also a co-client, then the lawyer must comply with the requirements of paragraph (b) before accepting the representation, *including determining whether the conflict is consentable* and, if so, that the client has adequate information about the material risks of the representation.

(Emphasis added.)

15. Here, if the client defaults on the loan, Lawyer will be required to take certain steps on behalf of Affiliated Lending to collect the obligation. Those efforts will place Lawyer in an adverse position to the client, even if Lawyer is not directly involved in any judicial collection proceedings. For instance, prior to initiating a collection action, Affiliated Lending must give the client notice of default, make a demand for payment and, where appropriate, negotiate modified repayment terms with the client. Presumably, all of these activities will be conducted by Lawyer as the manager of Affiliated Lending. During these negotiations, Lawyer might still be representing the client. In addition, as the principal spokesperson for Affiliated Lending, it will be difficult, if not impossible, for Lawyer to represent Affiliated Lending adequately in its

collection activities if Lawyer is not involved in reviewing and approving recommendations made by the third-party collection agency. Finally, if Lawyer is representing the client in a bankruptcy, Affiliated Lending's loan will be directly affected by Lawyer's services for the client.

16. Other services provided by Lawyer for the client also could affect Affiliated Lending. For example, if Lawyer is retained by the client to defend a criminal proceeding, the outcome of the criminal proceeding could affect the client's ability to repay the loan, particularly if the client is incarcerated, required to pay a fine, or required to pay restitution to a victim. All of these situations place Lawyer in the untenable position of having divided loyalties between Lawyer's client and Lawyer's employer.

17. In the case before us, Affiliated Lending is not a client of Lawyer, but, as Lawyer's employer, it is a "third person" to which Lawyer has duties and responsibilities and in which Lawyer has a familial, personal and financial interest. With such duties and responsibilities, the proposed arrangement compromises the loyalty and independent judgment of Lawyer to the client.

18. The appropriate inquiry is whether the arrangement would materially interfere with Lawyer's independent professional judgment in considering alternatives, or foreclose courses of action that reasonably should be pursued on the client's behalf.<sup>5</sup> Violations commonly occur when Lawyer has a financial or proprietary interest that may be affected by the advice given to the client.<sup>6</sup> Here, Lawyer has a direct financial interest in the client's loan from the Lending Company, a familial interest in the owners of the Lending Company, and a personal interest in the future success of the Lending Company.

19. In addition, the prohibitions in Rule 1.8(a) and (b) may be implicated by the proposed arrangement. Lawyer has a close familial relationship with the owners of Affiliated Lending and is a key employee of the company. Under certain circumstances, the relationship between Lawyer and the lender may be so close as to blur the distinctions between Lawyer and the entity, especially in the mind of the client. In such circumstances, a lending arrangement like the one proposed may run afoul of Rule 1.8(a).<sup>7</sup> Comment [1] of Rule 1.8 is instructive:

A lawyer's legal skill and training, together with the relationship of trust and confidence between lawyer and client, create the possibility of overreaching when the lawyer participates in a business, property or financial transaction with a client, for example, a loan or sales transaction or a lawyer investment on behalf of a client. The requirements of paragraph (a) must be met even when the transaction is not closely related to the subject matter of the representation, as when a lawyer drafting a Will for a client

learns that the client needs money for unrelated expenses and offers to make a loan to the client.

20. Comment [3] of Rule 1.8 further provides:

The risk to a client is greatest when the client expects the lawyer to represent the client in the transaction itself or when the lawyer's financial interest otherwise poses a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's financial interest in the transaction.

21. Thus, there is a clear conflict of interest under both Rules 1.7(a)(2) and 1.8(a). We next examine whether the facts permit the lawyer to seek the client's "informed consent" to such a lending arrangement. Lawyer proposes to require that the client sign a written disclosure. This disclosure would explain the relationship between the lender and Lawyer, would advise the client of the right to have the arrangement reviewed by independent counsel, would explain the consequences to the client if there is a default on the loan, and would further explain that a potential conflict could arise between Lawyer and the client if the client defaulted on the loan.

22. Some conflicts cannot be waived because Lawyer's personal interest in obtaining the waiver casts doubt about the effectiveness of the client's consent and about the adequacy of the information provided by Lawyer to the client in seeking the consent.<sup>8</sup>

23. "Informed consent" is defined in Rule 1.0(f) as denoting "the agreement of a person to a proposed course of conduct after Lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of action." If the client is asked to consent to a possible future conflict, the effectiveness of a waiver is generally determined by the extent to which the client reasonably understands the material risks that the waiver entails.<sup>9</sup>

24. Here, Lawyer is employed by the debtor-client's lender, earns a fee for services performed for the lender in making a loan to the client and also has a personal interest in both the lender and in the loan proceeds. We conclude that this combination of conflicts is so problematic that a lawyer could not "reasonably believe[ ] that the lawyer [would] be able to provide competent and diligent representation to [the] client."<sup>10</sup>

25. For the reasons stated above, the proposed funding arrangement creates a nonconsentable conflict of interest under Rule 1.7.

**26. Background for EAOB File No. R0506:** In the second situation, a Utah lawyer proposes to borrow money in the form of a contingent, non-recourse loan from an

independent third-party lending company ("Third-Party Lender") for the purpose of financing the costs and expenses of litigation. The client is not a party to the agreement and the client gives written informed consent to the arrangement. Before the loan is approved, the lawyer is required to sign a litigation-funding agreement ("Agreement") that contains carefully structured provisions to avoid conflict with Rule 1.6 (Confidentiality of Information) and Rule 1.8 (Conflict of Interest). The essential terms of the agreement are:

*Funding fee options.* The lawyer can borrow up to 80% of the litigation costs from Third-Party Lender. If the lawyer is successful and receives a recovery for the client, the lawyer is obligated to repay to the Third-Party Lender the lesser of the funding or the recovery, plus an additional funding fee. The funding fee is calculated using one of three options available to the lawyer. Under Option 1, the funding fee is equal to the amount of the funding advanced (i.e., the equivalent of 100% return on the funding <sup>11</sup>). Under Option 2, the funding fee is equal to a percentage of the funding that depends on when the recovery is obtained (85% of the funding if the recovery is obtained within 24 months, ranging to 125% of the funding if the recovery is obtained after 36 months). Under Option 3, the funding fee is a negotiated percentage (e.g., 5%) of the net recovery (gross recovery minus litigation expenses), subject to a negotiated cap on the funding fee expressed as a multiple of the funding advanced (e.g., 5 times the funding). <sup>12</sup>

*The client is not a party to the Agreement.* The only parties to the Agreement are Third-Party Lender and the lawyer. However, the lawyer must provide the client with reasonable and adequate information about the material risks and reasonable alternatives to entering into the Agreement.

*The client must sign a disclosure and consent form.* Before the lawyer may enter into a contract with Third-Party Lender, the lawyer is required to disclose fully the lending arrangement to the client, and the client must give written consent to the Agreement.

*There is no expressed security interest in lawyer's fees or client recovery.* Third-Party Lender requires that lawyer establish a bank account at Third-Party Lender's bank to be utilized by Third-Party Lender for funding advances for the borrowing lawyer and by lawyer for making payments to Third-Party Lender. Third-Party Lender is granted a security interest in this account. Third-Party Lender's conditional right to payments under the Agreement is not secured by any lien, security interest or assigned interest upon or in any funds held by the borrowing lawyer in any other account, the lawyer's interest in the contingent fee agreement with the client, or any funds held by the client. The lawyer, however, agrees upon a recovery to

"subordinate" the lawyer's right to repayment by the client of costs advanced directly by the lawyer for the client, to Third-Party Lender's right to repayment of the funding and the funding fee.<sup>13</sup>

*Repayment is contingent only upon recovery.* If the borrowing lawyer does not obtain any recovery for the client in the case, then the lawyer owes nothing and is not obligated to pay any amounts advanced by Third-Party Lender.

*Lawyer will not pass Third-Party Lender's fees to client.* The fee for the funding that is owed to Third-Party Lender by the lawyer may not be passed on to the client in any way, nor can the lawyer charge a different fee to the client based upon the fact that the client's case is being funded. The client will also not be held responsible for paying any funding fees owed by the lawyer to Third-Party Lender.

*No solicitation of clients.* Third-Party Lender will have no involvement in soliciting, obtaining or referring any client or in the lawyer's decision to file suit on behalf of the client.

*Lawyer has involvement, interest, and control of litigation.* Third-Party Lender will exercise no control or influence on the lawyer's handling of the case or on any decision that requires the exercise of the professional judgment of the lawyer.

*Client confidentiality is addressed.* Third-Party Lender will require the lawyer to provide to Third-Party Lender limited information about the client or case for the purpose of processing the funding requests, but only with the written consent of the client. This information would include monthly expense statements, copies of pleadings in the case, agreements between the lawyer and the client regarding payment of legal fees and expenses, and a signed statement by the client at the end of the case verifying the total expenses incurred. Although the Third-Party Lender retains the right to audit the litigation expenses of the lawyer, the Third-Party Lender may not obtain information relating to the representation beyond that authorized by the client.

**27. Analysis:** The Committee addressed third-party lending agreements in two previous opinions. In Opinion 97-11,<sup>14</sup> we considered whether a lawyer could finance the expected costs of a case by borrowing money from a third-party lender pursuant to a non-recourse promissory note, where the note was secured by the lawyer's interest in a contingent fee in the case. In that opinion, we did not approve of the non-recourse loan and concluded that because a security interest in the recovery of contingent fees from a particular case was to be granted, Rule 5.4 <sup>15</sup> was implicated. We stated: "Upon that grant, Lender has an interest in the attorney's contingent-fee award, which Lender has the right

to attach upon a default in payment on the loan."16 Accordingly, the lawyer's grant of a security interest in a contingent fee to secure a loan constituted the sharing of fees with a non-lawyer in violation of Rule 5.4(a).

28. In contrast, the Committee has approved a third-party lending agreement involving a low-interest, recourse loan to the lawyer who used the potential fees from the case as collateral. In Opinion 02-01, we concluded that the proposed financial arrangement did not have the objectionable features found in Opinion 97-11:

Here, the lending institution has no interest in the lawyer's contingent-fee award because, under the separate loan agreement between the lawyer and the lender, the lawyer is obligated to repay the loan whatever the outcome of the case. Because this obligation is not contingent, the lawyer is not compromised, as was the lawyer under the arrangement described in Opinion 97-11. Similarly, in this case, the client, by separate agreement, remains obligated to the lawyer for the payment of litigation costs. The lawyer is not compromised because the client's obligation is not contingent upon the outcome of litigation. The arrangement described above simply makes it easier for clients and attorneys to finance litigation and is mutually beneficial to both.17

29. The requestor here contends that, because Third-Party Lender will not receive a security interest in the client's recovery or in the lawyer's contingent fee, Opinion 97-11 is not applicable. However, in light of Opinion 02-01, ethical issues regarding the lawyer's professional independence of judgment are not so easily satisfied. The Agreement provides Third-Party Lender with a return of the amount funded, but not to exceed the recovery, plus a funding fee based on the amount funded 18 if the lawyer receives a recovery for the client. If the lawyer receives no recovery for the client, the non-recourse nature of the loan absolves the lawyer of any liability to repay the amount funded or to pay a funding fee. The economic aspects of the Agreement may impair the lawyer's independence of judgment and may materially limit the lawyer's representation of the client. Similar impairments and limitations were the thrust of the Committee's conclusion in Opinion 02-01.

30. For example, assume the lawyer funds litigation costs of \$100,000 under a net-recovery contingent fee of one-third, 19 borrowing \$80,000 from Third-Party Lender under Option 1, and obtaining a recovery of \$100,000 for the client. The lawyer would be obligated to pay Third-Party Lender the original \$80,000, plus the funding fee of the same amount, for a total of \$160,000. This would result in a net, out-of-pocket loss to the lawyer of \$80,000, for which the client would have no liability. 20 More significantly for our analysis, \$60,000 of the out-of-pocket loss to the lawyer is avoided under the Agreement if there is

no recovery by the client. The outcome is similar under Option 2. 21

31. Rule 1.7 is implicated by such an arrangement, as is made clear by Comment [1] to the rule, "Loyalty and independent judgment are essential elements in the lawyer's relationship to a client. Concurrent conflicts of interest can arise from the lawyer's responsibilities to another client, a former client *or a third person or from the lawyer's own interests.*" (Emphasis added.) Comment [10] to Rule 1.7 further states, "The lawyer's own interests should not be permitted to have an adverse effect on representation of the client." We must examine whether the lawyer's potentially large debt obligation in this arrangement would have an adverse effect on his representation of the client.

32. Rule 1.5 is also implicated by the proposed funding arrangement: "(a) A lawyer shall not make an agreement for, charge or collect an unreasonable fee, or an unreasonable amount for expenses." Comment [5] of Rule 1.5 further provides: "An agreement may not be made whose terms might induce the lawyer improperly to curtail services for the client or perform them in a way contrary to the client's interest."

33. Because under Options 1 and 2 the payment of the funding fee is the personal obligation of the lawyer and is based on the amount funded and not on the amount of the recovery ultimately obtained, there is potential that the lawyer will have financial incentives that are, or may be, adverse to the client's best interests. First, the lawyer has an incentive to set a very high percentage retention to the contingent-fee arrangement with the client, which, in turn, might be "unreasonable" under Rule 1.5.

34. Second, even if the contingent fee is reasonable, a lawyer who participates in a nonrecourse, contingent loan will be vulnerable to several potential ethical dilemmas. The lawyer's personal financial obligations to Third-Party Lender potentially could place the lawyer's financial interests in conflict with the client's interests and affect the exercise of the lawyer's independent judgment on behalf of the client, especially in situations where the lawyer learns during the course of the case that the amount of the potential recovery is likely to be small. 22 It is possible that the amount of the funding and funding fee owed to Third-Party Lender, which is a personal obligation of the lawyer, might exceed the lawyer's contingent fee interest in the recovery. 23 The lawyer could be faced with the unusual predicament of being tempted to intentionally abandon the case or lose the case at trial to circumvent the personal financial consequences from receiving insufficient recovery.

35. Option 3 may not create the same potential that the lawyer is advantaged by obtaining no recovery for the client

in a case where an insubstantial recovery is probable. Under Option 3, the funding fee that is the personal obligation of the lawyer is not based on the amount funded, but is based on the net recovery (gross recovery minus litigation expenses). Assuming that the funding recoverable by the Third-Party Lender under Option 3 is the lesser of the amount funded or the recovery (as it is under Options 1 and 2), it is mathematically impossible for the lawyer to be able to reduce the lawyer's losses by obtaining no recovery for the client. This is because the funding fee, being a percentage of the net recovery, does not become a positive number until the gross recovery exceeds the funding plus the litigation expenses directly paid by the lawyer. 24

36. Rule 1.7(a)(2) states that a lawyer has a concurrent conflict of interest if there is a significant risk that the representation of the client will be materially limited by the lawyer's responsibilities to a third party Lender or by the personal interest of the lawyer. We conclude that under Options 1 and 2, the lawyer's personal interest involving the potentially large funding and funding fee payment obligations combined with the potential that the financial risk to the lawyer of the lending arrangement is lessened if the lawyer obtains no recovery for the client, present a significant risk of compromising the lawyer's ability to provide independent counsel and of materially limiting the lawyer's representation of the client. We conclude that when a lawyer may have a financial incentive under the terms of a lending arrangement to obtain no recovery for the client, that the conflict of interest is not consentable. 25 The lawyer's original analysis of the case may be that such a risk is not "material" and that, should the analysis of the case change at a later time, the conflict analysis would be re-visited. But, we think that is an unrealistic view of the dynamic of such a contingent-fee case. As the probability of a large recovery might diminish over time to a point where the lawyer's interests become significantly different from the client's, there will be no light bulb that goes on in the attorney's head to induce a reassessment of the conflict. 26 We conclude that the overall framework of Options 1 and 2 of the litigation-funding Agreement presents a conflict of interest to which the lawyer may not seek the client's consent.

37. Option 3 of the litigation-funding Agreement does not present the potential that the lawyer will have a financial incentive not to obtain a recovery for the client. However, Option 3 of the litigation funding Agreement does involve a non-recourse loan and such arrangements do create a significant risk of compromising the lawyer's duty of independent judgment and duty of client loyalty. 27 Therefore, Option 3 creates a conflict of interest under Rule 1.7 (a) (2), but this conflict of interest may be consented to by the client.

38. Accordingly, a lawyer may not participate in Options 1

or 2 of the contingent, non-recourse loan program described, because the representation will create a significant risk that the representation of the client will be materially limited by the personal interest of the lawyer, who has the potential to reduce the financial risk of the loan program to the lawyer by obtaining no recovery for the client. A lawyer may ethically participate in Option 3 of the contingent, non-recourse loan program described, if the lawyer complies with Rule 1.7 (b) and obtains the informed consent of the client, confirmed in writing.

#### Footnotes

1. We assume, however, that, as the manager of Affiliated Lending, Lawyer would be the principal contact person for the third-party collection agency and would be involved in, or would at least review and approve, decisions about how to prosecute and collect the defaulting client's loans.

2. Typically, this type of arrangement would be used in representing clients where large up-front fees are required, such as bankruptcies, defense of criminal matters and the like.

3. All citations to the "Rules" in this opinion are to the Utah Rules of Professional Conduct, adopted November 1, 2005, by the Utah Supreme Court.

4. None of the exceptions stated in Rule 1.6(b) are applicable to these questions.

5. *See also* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 121 cmt. c(ii) (2000); *see, generally*, GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, *THE LAW OF LAWYERING* § 11.8 *et seq.* (3d ed. 2001).

6. *See In re Bond*, 723 N.Y.S.2d 811 (App. Div. 2001) (conflict of interest when lawyer arranged loan from his wife and mother to clients to enable them to avoid foreclosure action).

7. Rule 1.8(a) provides:

A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the

advice of independent legal counsel on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

8. The recent case of *In re McGregory*, Docket No. 05-6054EM (Bankr. 8th Cir., March 24, 2006), is a good example of the application of this principle. In *McGregory*, a lawyer for a Chapter 13 debtor also was employed as a "home mortgage consultant" for a bank. In this capacity, the lawyer arranged home mortgages for Chapter 13 debtors to enable them to refinance their existing home loans, reduce the interest rates on their mortgages and obtain additional cash from the equity in their homes. While representing a Chapter 13 debtor, and with the written consent of the debtor, the lawyer arranged for such a loan from the bank. The loan benefitted the debtor by reducing the debtor's mortgage interest rate, reduced the debtor's monthly mortgage payments and generated sufficient cash to make a full payment to the debtor's unsecured creditors. Nevertheless, the Bankruptcy Court found the lawyer had an impermissible conflict of interest in representing the debtor while being employed by the debtor's lender, and the 8th Circuit affirmed: "[T]his type of dual representation, particularly in the bankruptcy context, presents such an inherent and impermissible conflict that it cannot be waived." *Id.* at 8.

9. See Rule 1.7, cmt. [22].

10. Rule 1.7(b)(1) and cmt. [2], cl. 3).

11. In light of the risks to Third-Party Lender, a yield equal to 100% or more on the loan may not be unreasonable in the commercial marketplace. We make no comment on the commercial propriety of the funding fees charged by Third-Party Lender.

12. The third option was not included in the sample Agreement submitted by the requestor. Our understanding of Option 3 is based on the narratives provided by the requestor. We have assumed that under Option 3, as under Options 1 and 2, the amount of the funding recoverable by the Third-Party Lender from the lawyer cannot exceed the recovery.

13. If and to the extent that this arrangement gives Third-Party Lender a priority (vis-a-vis general creditors of the lawyer) in the lawyer's rights to recovery from the client of the portion of the litigation expenses funded directly by the lawyer (i.e., the 20% or more of the litigation expenses the Third-Party Lender does not fund), then this arrangement may violate Rule 5.4(a), Utah Rules of Professional Conduct, as explained in Utah Eth. Adv. Op.

97-11, 1997 WL 770890 (Utah St. Bar). Given the Committee's disposition of this request under Rule 1.7 of the Utah Rules of Professional Conduct and the lack of details regarding this "subordination" in the request, the Committee expresses no opinion on whether costs should be afforded different treatment than fees under Rule 5.4(a) and our Opinion 97-11, or on whether this arrangement violates Rule 5.4(a).

14. Utah Eth. Adv. Op. 97-11, 1997 WL 770890 (Utah St. Bar).

15. Rule 5.4(a) provides that a lawyer or a law firm "shall not share legal fees with a non-lawyer", except under the limited circumstances authorized in the Rule.

16. *Id.* 14.

17. Utah Eth. Adv. Op. 02-01, at 6, 2002 WL 231939 (Utah St. Bar).

18. The amount of the yield to the lender is irrelevant to the ethical implications of this arrangement.

19. "Net recovery" here means that the client is obligated to repay the costs advanced by the lawyer dollar for dollar from any recovery (but no more than the recovery), with the remainder - the net - subject to the contingent-fee percentage.

20. The lawyer's contingent fee in this example is \$0:  $(100,000 \text{ recovery} - 100,000 \text{ in costs}) \times 1/3 = \$0$ . The lawyer's out-of-pocket loss is  $(\$20,000 \text{ of costs funded directly by Lawyer} + \$160,000 \text{ repayment obligation to Third-Party Lender}) - 100,000 \text{ cost recovery} = \$80,000$  loss. Of this \$80,000 loss, \$60,000 can be avoided by the lawyer under the Agreement if there is no recovery by the client.

21. Assume Option 2 is selected by the lawyer, and the recovery occurs in the 38th month. The lawyer's out-of-pocket loss is \$100,000. The lawyer is obligated to repay Third-Party Lender the funding of \$80,000, plus a funding fee of \$100,000  $(1.25 \times 80,000)$ , for a total of \$180,000. The lawyer has also directly funded \$20,000 of costs. The total costs to the lawyer of \$200,000 minus the \$100,000 cost recovery results in a \$100,000 net loss to the lawyer. Of this net loss, \$80,000 can be avoided under the Agreement if there is no recovery by the client.

22. At inception of the lending arrangement, the lawyer presumably believes that the anticipated recovery would justify the associated loan costs. As the case progresses, however, the likelihood and amount of the recovery may diminish. Nevertheless, the lawyer's obligation to the lender remains the same.

23. In the above example using Option 1 and \$100,000 in litigation costs, assume the actual recovery to be \$250,000 and that the lawyer took the case on a contingent-fee basis calculated on net recovery. The lawyer would still be out-of-pocket a net \$30,000: (\$250,000 recovery - \$100,000 in costs) - \$50,000 contingent fee to the lawyer, or \$30,000 less than the lawyer's net obligation to Third-Party Lender of \$60,000 plus the lawyer's direct payment of costs of \$20,000. Of this \$30,000 loss, the Lawyer avoids \$10,000 of the loss if there is no recovery by the client.

24. Assume Option 3 is selected and the lawyer negotiates a funding fee of 5% of the net recovery (gross recovery minus litigation expenses), subject to a cap of 5 times the funding. Using the hypothetical of a \$100,000 recovery with \$100,000 of litigation expenses, the lawyer's out-of-pocket loss is \$0. The lawyer is obligated to pay Third-Party Lender the funding of \$80,000, plus a funding fee of \$0:  $(\$100,000 \text{ gross recovery} - 100,000 \text{ total costs}) \times .05 = \$0$ . The lawyer has directly paid \$20,000 of costs. The total costs to the lawyer is \$100,000, equal to the \$100,000 cost recovery, resulting in \$0 loss to the lawyer. If the recovery is reduced to \$50,000, the lawyer's out-of-pocket loss is \$20,000: (funding of \$50,000 owed to the Third-Party Lender + funding fee of \$0 + \$20,000 of costs directly paid by lawyer) - \$50,000 cost recovery = \$20,000 net out-of-pocket loss. Lawyer cannot, however, avoid any portion of this net out-of-pocket loss by obtaining no recovery for client.

25. Under these circumstances, the lawyer can not reasonably believe that the lawyer will be able to provide competent and diligent representation to the affected client. See, Rule 1.7(b)(2).

26. Even if that did happen and the lawyer concluded that a nonconsentable conflict had arisen, the prejudice to the client of withdrawing at such a point would be unacceptable.

27. Utah Eth. Adv. Op. 97-11, 1997 WL 770890 (Utah St. Bar); Utah Eth. Adv. Op. 02-01, at 6, 2002 WL 231939 (Utah St. Bar).