PROFESSIONAL RESPONSIBILITY

Presettlement Funding Agreements: Benefit or Burden?

By Kenneth L. Jorgensen

Generally, lawyers are prohibited from providing financial assistance to clients. *See* Rule 1.8(e), Minnesota Rules of Professional Conduct. An exception to this rule permits lawyers to advance the costs and expenses of litigation and make the repayment contingent upon the outcome of the client's case.[1] Although lawyers cannot directly lend money to clients, another exception authorizes lawyers to guarantee a client loan from a third party in certain limited circumstances including: (1) that the lawyer refrains from promising financial assistance prior to being retained by the client; (2) the client remains ultimately liable for repayment of the loan regardless of the litigation's outcome; and (3) the loan is necessary to enable the client to withstand litigation delay that would otherwise substantially pressure the client to settle because of financial hardship rather than the merits of the litigation.[2]

These exceptions highlight the two different types of financial need faced by litigation plaintiffs. A client whose lawyer is unwilling or unable to advance litigation expenses must look outside the attorney-client relationship for financial assistance. Similarly, in order to recognize the full value of their claim, some plaintiffs may be forced to borrow funds for basic living expenses to withstand litigation delay.

Over the past several years there has been a proliferation of lending organizations actively marketing funding services to plaintiffs and their lawyers.[3] Entrepreneurial lawyers who saw the need for alternative litigation funding sources created some of these organizations. Whether created by lawyers or others, most of these organizations tend to focus upon speculative high-return transactions that traditional lenders either shy away from or refuse to underwrite. These types of lending arrangements are generally referred to as Presettlement Funding Agreements (PSFAs). Like those of any high-risk loan or speculative transaction, the repayment terms tend to be particularly onerous for the borrower. The absence or inapplicability of legal protections afforded to traditional consumer borrowers can further imperil clients entering into such agreements.

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Although most clients (and probably lawyers as well) perceive PSFAs as loans, most are in fact not loans, nor are they subject to federal and state consumer lending laws (*e.g.* usury laws). PSFAs are divided into two categories, those in which the repayment obligation is absolute and those where the repayment obligation is contingent upon the outcome of the litigation. Although both types of PSFAs typically take an assignment in the litigation proceeds to secure the "loan," only those with absolute repayment obligations fall within the ambit of consumer borrowing protections. Because of their contingent repayment nature, the more prevalent nonrecourse PSFAs escape most state usury laws, thereby creating the opportunity for lender rates of return that substantially exceed usury limits.[4]

More often than not, PSFA organizations require lawyer involvement in the transaction to guarantee payment to the lender from litigation proceeds. This is typically accomplished by serving the lawyer with notice of the client's assignment of his or her right to the proceeds. More recently, PSFA lenders began requiring lawyers to sign the transactional documents and undertake an affirmative obligation to protect the lender's interest in any settlement or verdict proceeds.

Treatment of PSFAs by courts and state ethics authorities has been varied and at times somewhat vague. Although one court has found that PSFAs are void as champerty and maintenance,[5] other courts have upheld their enforceability[6] and most state ethics opinions have half-heartedly given them their approval while at the same time including vague cautionary disclaimers about the legality of PSFAs.[7] Nearly all of these opinions caution lawyers about confidentiality and privilege concerns relating to disclosure of confidential information to the lender as well as improperly prohibiting the lender from influencing the lawyer's professional judgment. Other opinions proscribe referring clients to PSFA lenders and most prohibit lawyers from possessing an interest in the PSFA lending organization.

The unwillingness of ethics authorities to wholly embrace PSFAs is understandable. The terms and provisions of PSFAs widely vary. A single provision in a PSFA can render the agreement unconscionable, void, or possibly even illegal. Moreover, the circumstances and timing of funding agreements can also affect their legality and enforceability. *See e.g.*, *Lawsuit Financial, L.L.C. v. Curry*, 2004 WL 224417 (Mich. App. 02/05/04) where a PSFA was found subject to usury laws because at the time it was signed, liability had been admitted and the only litigation question remaining was the amount of damages.

Recently, a PSFA was one factor at issue in the suspension of a Minnesota lawyer. *In re Rhodes*, 2004 WL 583866 (Minn. 03/17/04). Rhodes was financially unable to underwrite the costs and expenses of her client's medical malpractice case. Instead she advised her client to enter into a PSFA that called for the payment of $26,495 to the lender from any proceeds realized in the malpractice case, in exchange for a $7,000 advance to pay litigation costs. This was not, however, the only troubling clause in the agreement. Another arduous term made payment of the $26,495 immediately due if the lawyer were terminated, thereby impeding the client's ability to discharge her counsel. In addition, a choice of law clause specified Nevada as the

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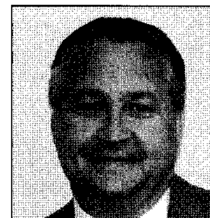

venue for resolution of any and all disputes arising under the agreement even though the client, the lawyer, and the medical malpractice case were all in Minnesota.

Another Minnesota disciplinary matter involves an injury lawyer's attempt to hide his involvement and participation in a PSFA lender that advanced funds to his client and secured the advance with a contingent lien upon the client's injury proceeds. This agreement called for repayment of the principal amount of the advance plus interest of 15 percent per month until the client's case was resolved. In this scenario, when the client discharged the lawyer because she was dissatisfied with his services, a $2,000 client "loan" triggered a repayment demand of $4,400 only seven months after the client received the loan.

PSFA boilerplate commonly recites that counsel has advised the client in entering into the PSFA agreement. More often than not, this reference refers to the lawyer representing the client in the contingent case. Because of such provision, lawyers who refer clients to PSFA lenders should recognize their potential liability for "advising" clients to enter into agreements with unconscionable or unduly onerous provisions. This is especially true where it can be argued that the lawyer benefited from the agreement by not having to advance litigation costs and expenses.

The safest course for lawyers is to refrain from referring clients to organizations offering PSFAs and to discourage clients who inquire about them. That may not be possible, however, where the client has already obtained the advance and is now asking for the lawyer's advice and participation (*e.g.*, agreeing to protect the lender's lien or assignment in the proceeds).

Advising clients about PSFAs requires comparison of the risks as well as the immediate benefits. Beyond the terms of repayment, clients should be alerted to other perils associated with PSFAs, which include:

- The effect of clauses providing for immediate payment upon termination of counsel.
- Clauses permitting the lender to inspect all records, including privileged records, and their potential effect upon the attorney-client privilege.
- Terms that obligate the client to continue to litigate the case, despite their personal desires, and accelerate payment if the case is voluntarily dismissed.

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- Clauses stating that all other forms of financing have been exhausted and that the PSFA is the "provider of last resort."
- Any term obligating the lawyer to withhold from the settlement proceeds all amounts claimed due by the lender until such time as the dispute is resolved.
- The disadvantages associated with choice of law provisions that require disputes to be resolved in another jurisdiction.

Lawyers should also appreciate the practical consequences and effects of PSFAs on the attorney-client relationship. A critical juncture in many plaintiff cases is advising a client to settle. Every plaintiff lawyer's nightmare includes the client who unreasonably, irrationally or unjustifiably rejects a worthy settlement offer. Even without the complications of PSFAs, lawyers are already forced to grapple with clients who snub respectable offers due to their belief that litigation costs have disproportionately reduced their distributive share. One needs little insight to gauge how the repayment of a PSFA loan could diminish client willingness to settle or cause clients to reject offers that otherwise should be accepted. PSFA repayments, which substantially exceed the amounts advanced, only increase the likelihood of an obdurate client during settlement negotiations.

Lawyers should proceed with caution in the area of PSFAs. Clearly, PSFAs are not the panacea for impoverished or financially distressed clients. At a minimum, lawyers should make an effort to explore alternative, less burdensome financial solutions. Where litigation costs and expenses are the basis for the financial need, such alternatives can include associating with another lawyer possessing the financial wherewithal to advance expenses without requiring the windfall repayment obligation associated with PSFAs.[8]

Clients who insist upon signing a PSFA should be fully apprised of the agreement's consequences, the potential effect upon the lawyer-client relationship during settlement negotiations, and the obligations, if any, imposed upon the lawyer. Written consent is desirable where the agreement obligates the lawyer to protect the lender's interest in settlement or verdict proceeds. Finally, lawyers must also consider whether the existence of the PSFA and its obligations will materially limit the lawyer's ability to adequately represent the client. If so, the lawyer should decline the representation or obtain the client's written consent to the conflicts created by the agreement.[9] ☐

NOTES

1. *Rule 1.8(e)(1). Subdivision 2 of this rule allows lawyers representing indigent clients to "pay" the costs and expenses of litigation.*
2. *Rule 1.8(e)(3). This rule permitting lawyers to guarantee loans is not contained in the* ABA *Model Rules of Professional Conduct, but is unique to Minnesota and only a few other states.*
3. See e.g., *Libby, "Whose Lawsuit Is It?"* 89 ABA Journal 36 *(May 2003).*
4. See e.g., Kraft v. Mason, 668 *So.2d 679 (Fla. Ct. App. 1996).* See also Anderson v. Scandinavian U.S. Swim and Fitness, *1998* WL *747297 (Minn. App.), citing* Ordway v. Price, *194 N.W. 321 (Minn. 1923).*
5. Rancman v. Interim Settlement Funding Corp. et al., 99 *Ohio St.3d 121, 789 N.E.2d 217 (2003). The common law doctrines of champerty and maintenance prevented officious intermeddlers from stirring up strife through speculative litigation.*
6. See e.g., Kraft v. Mason, *footnote 4* supra.
7. See e.g., *Florida Bar Opinion 00-3 (March 2002) which permits lawyers to assist clients with* PSFA *transactions, but prohibits the lawyer from signing the* PSFA, *and discourages the use of nonrecourse funding companies. Cf. Michigan Ethics Opinion RI-321 (06/29/00) holding that the depths of the conflicts of interest created by the funding agreement make it highly unlikely that client waiver could cure the conflicts.*
8. See e.g., *Rule 1.5(e) which permits lawyers from different firms to split fees on a disproportionate basis provided the client consents and both lawyers assume joint responsibility for the representation.*
9. See *Rule 1.7(b).*