MASSACHUSETTS
LAWYERS WEEKLY

Volume 45
Issue No. 30
July 25, 2016

Litigation finance enterprises: some further words to the wise

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In our first column in this series, which appeared in the April 25 issue, we discussed the explosive rise of the so-called litigation finance industry in the context of consumer/personal injury litigation and, more recently, in large commercial cases.

This burgeoning industry, which consists of a number of deep-pocketed entities, has the potential to change the litigation landscape. The industry is not without its enemies. For example, according to the New York Times, the Institute for Legal Reform, an affiliate of the U.S. Chamber of Commerce, has called it "the biggest single threat to the integrity of our justice system."

Lawyers who involve themselves in such arrangements must be wary of ethical issues presented by them. In particular, we discussed a lawyer's duty to provide competent representation by determining whether such arrangements are champertous or otherwise inappropriate in a particular jurisdiction.

We also cautioned lawyers to understand and fully explain the terms of any such arrangement to any client considering entering into such an arrangement.

In this installment, we drill down into two additional ethical issues — confidentiality and conflict of interest — that may be presented by such arrangements. These issues are presented whether the transaction is consumer or commercial in nature.

In the typical arrangement under consideration, a "litigation finance" entity advances the client the fees and expenses necessary to prosecute the case in exchange for a share of any proceeds. The client benefits from the arrangement by being spared the outlay and by, in effect, "laying off" a portion of the risk of an adverse result.

The litigation finance entity hopes for a return in excess (frequently far in excess) of its investment.

Most lawyers understand the strict limits on disclosure of confidential client information, but compliance with this duty may be challenging when a litigation finance entity is involved.

Rule 1.6(a) of the Massachusetts Rules of Professional Conduct sets forth the following flat command:

"A lawyer shall not reveal confidential information relating to 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) [listing exceptions inapplicable in the litigation financing context]."

As the Comments to Rule 1.6 make clear, the purpose of the rule is to encourage full and frank disclosure from the client as to a particular matter, even if those facts are unflattering.

The rule applies not only to information imparted by the client, but also to information acquired by the lawyer in the course of the representation, from whatever source, and the protections afforded by Rule 1.6 are broader than those afforded by the attorney-client privilege or work product doctrine. Rule 1.6, Comment [3A] (providing examples of information that may be confidential, even if disclosed in a public record).

How is this obligation reconciled with the existence of a "litigation" finance relationship, in which the financing entity may wish to be apprised of the lawyer's opinion as to various aspects of the matter in order to make an investment decision that is beneficial to the client?

Further complicating matters, the lawyer often may be asked to disclose confidential information about a client matter during negotiations leading up to the execution of a litigation financing agreement, at a time when the lawyer's client and the funding entity essentially are adverse.

Rule 1.6 permits the disclosure of confidential information, of course, with the client's informed consent. An attorney who is dealing with a funding entity, therefore, would be well-advised to explain to the client the risks of disclosing confidential information to a third party, and to obtain the client's consent in writing to the disclosure of any information required by the funding entity.

Rule 1.6 also permits a disclosure "impliedly authorized by the representation." If the scope of representation includes the negotiation of a funding agreement, the lawyer's provision of information required by the funding

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entity arguably falls within this clause.

Regardless, the lawyer's duty of competence likely requires:

(1) that the lawyer provide only the information specifically required by the funding entity as a condition of entering into the agreement, as opposed to everything the lawyer has in her file; and

(2) that the lawyer require the funding entity to agree to maintain all of the information in confidence, with strict limitations on the allowable use and distribution of the information, and provisions for the destruction or return of the information if a funding agreement is not executed.

The cautious lawyer also will want to document that the client, by providing the information to a third party, does not intend a waiver of any applicable privileges or work product protection. (We discuss the possible waiver of those protections in our next installment.)

Rule 2.3 also may come into play if the lawyer is asked to provide an "evaluation" of the client's claims to a funding entity. The rule provides that a lawyer may provide an evaluation of a matter affecting a client for the use of someone other than the client if: (1) the lawyer reasonably believes that such an evaluation is compatible with other aspects of the lawyer's relationship with the client, and (2) the client gives informed consent or the evaluation is impliedly authorized to carry out the representation.

As noted in the comments, when providing such an evaluation to a third party, the lawyer may "in no circumstances" make a false statement of material fact or law. Thus, an attorney may not be in a position to provide an unduly rosy assessment of a client's chances as part of a client's effort to obtain financing on the best possible terms. Rule 2.3, Comment [4].

The next ethical issue is whether the conflicts of interest provision set forth in Rules 1.7-1.10 are implicated in such an arrangement.

For example, to whom do the lawyer's fiduciary and other duties lie? Of course, the lawyer has such duties to the client, but do those duties also extend to the "investors" in the litigation? In addition, do any of the other conflicts provisions in Rule 1.8 apply?

Rule 1.7 describes two types of conflicts, one involving the representation of one client against another, and the other more general. It is the latter type of conflict that may be implicated by a litigation financing arrangement.

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Rule 1.7(a)(2) provides that a lawyer has a conflict if there is a "significant risk" that the attorney's representation of a client will be "materially limited" by the lawyer's own interests, or the lawyer's responsibility to other clients, former clients or other third parties.

While the lawyer may under some circumstances take on such a conflicting representation with the client's informed consent, in other circumstances the conflict is not waivable. Rule 1.7(b).

It is not difficult to identify areas in which the interests of a client in a litigation matter may differ from those of an "investor." Many litigation financing entities employ a stable of skilled and experienced litigators to advise it as to "investments."

For example, Burford Capital's executive team consists of a number of corporate general counsel and a number of current or former partners in major law firms. Those individuals may have tactical or other recommendations that differ from the client's or from the lawyer's. How does the lawyer reconcile those differences, especially when the lawyer may feel pressed to favor the entity, which is, in effect, paying her fee?

The tension here is most likely to arise when settlement is being considered. The interests of the client and the investor may be in sync in terms of maximizing recovery, but the client may have other interests as well — vindication of a property right or its reputation in the marketplace — that are not shared by the investor.

In the situation in which a counterclaim has been asserted, the investor obviously does not have the same interest that the client does. Moreover, a litigation funding agreement typically is different from a contingency fee agreement, in that the funding entity usually recovers its investment "off the top."

Thus, a funding entity that has invested money in a litigation will be interested in any settlement offer that results in a full repayment of principal and interest, even if the net result leaves the plaintiff (and plaintiff's counsel) with a negligible recovery.

Ethical issues also arise if the funding agreement provides the funding entity with control over or input into litigation decisions other than settlement. Rules 1.8(f) and 5.4(c) prohibit the lawyer from allowing any third party to direct, regulate or interfere with the lawyer's professional judgment.

Additionally, Rule 1.16 sets out the circumstances in which lawyers must or may withdraw from a representation. Some funding agreements provide as a condition of the funding that the client use a particular law firm to prosecute the action. Those provisions may be in conflict with Rule 1.16.

At least one major litigation funding entity, Chicago-based Gerchen Keller Capital, appears to understand the issues presented by these rules of professional conduct. Its website declares that it never intrudes on the client's tactical decisions or its relationship with its counsel. "Frequently Asked Questions," Gerchen Keller, http://www.gerchenkeller.com/what-we-do/frequently-asked-questions/.

What do these ethical constraints mean for the practicing lawyer?

First, as noted above, if the attorney's scope of representation includes negotiation of the financing agreement, the lawyer must advise the client of the risks and benefits of litigation financing, including the possibility that confidential information shared with a third party (despite contractual protections) will nevertheless leak into the public domain, and the possibility that the ultimate settlement or judgment might be far more advantageous to the funder than to the client.

Second, the lawyer should strive to ensure that the litigation finance agreement:

(1) provides maximum protection for the client's confidential information;

(2) reserves to the client the right to make all litigation decisions, including decisions regarding settlement and the selection of counsel; and

(3) expressly states that each party has its own counsel, and disclaims any attorney-client or fiduciary relationship between the client's attorney and the litigation funding entity.

In the third and final installment in this series, we will consider some further strategic considerations in advising the client on these arrangements, and make some practical recommendations on how to deal with them. MLW