

UNCHARTED TERRAIN:

Pondering Ethical Challenges Posed by Third-Party Litigation Funding


BY THEODORE P. STEIN, ESQ.

AS THE COST OF LITIGATION has mushroomed in recent years, litigants and their counsel have increasingly considered retaining a third-party funder to underwrite the cost of prosecuting their lawsuits. Nevertheless, although billions have flowed from litigation funders, in Maryland, the terrain facing an attorney who seeks such funding is largely uncharted. A range of ethical questions must be considered:

Should litigation funding be structured as an investment or a loan?

- Will the attorney be able to exercise independent judgment and preserve client control of the litigation?
- Will communications with the funder risk the loss of confidentiality protected by the attorney-client and work product privileges?
- What are the best practices to ensure compliance with ethics requirements?

In the brave new world of third-party litigation funding, the litigation funder is a commercial



entity. The funder supplies the legal fees and costs of pursuing a lawsuit upfront. In return, the funder receives either a share of the recovery or repayment of its loan with the recovery serving as collateral. If there's no recovery, then the funder customarily receives nothing.

The most complete statement of the ethical pitfalls that a Maryland attorney faces in representing a client who retains a litigation funder is set forth in *Ethical Implications of Loans by Private Entity to Personal Injury Plaintiffs*, an opinion of the MSBA's Committee on Ethics issued on December 12, 2000 (Ethics Docket No. 2000-45).

According to the Opinion, the distinction between the purchase of an interest and providing a loan to finance litigation secured by a lien on a potential recovery is “material.”

Investor or Lender

In its Opinion, the Ethics Committee considered the case of a private entity seeking to purchase an interest in a personal injury plaintiff's case as opposed to lending money to the plaintiff. The requesting attorney asked whether a Maryland attorney could ethically refer a personal injury plaintiff in need of litigation funding to a private entity desiring to purchase an interest in the client's case.

According to the Opinion, the distinction between the purchase of an interest and providing a loan to finance litigation secured by a lien on a potential recovery is “material.” In the case of a purchase, the funder acquires an interest in the litigation. In the case of a loan, the funder acquires a lien on the plaintiff's potential recovery.

According to the Ethics Committee, the purchase of an investment in litigation raises the potential application of the common law bans on third-party involvement in lawsuits known as champerty and maintenance.

Champerty and Maintenance

At common law, two doctrines barred a third-party from acquiring an interest in a plaintiff's lawsuit. “Champerty” is found “where one upholds a controversy under a contract to have part of the property or subject in dispute.”¹

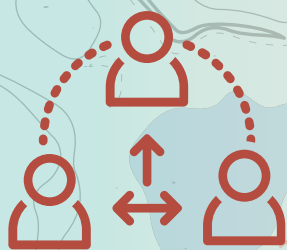
“Maintenance” applies “where one officiously and without just cause intermeddles in and promotes the prosecution or defense of a suit in which he has no interest by assisting either party with money or otherwise.”² The Ethics Committee stated that the agreement considered did not constitute champerty and that champerty

in Maryland may be obsolete. Nevertheless, the Committee counseled attorneys to exercise caution. The Committee observed that neither the Court of Appeals (now, Supreme Court) of Maryland nor the Maryland General Assembly “has given its authorization to a proposal that allows investment in lawsuits by strangers to the suit.” Thus, the Committee expressed “substantial concerns” about the “structure” of an arrangement in which a third-party funder acquired an interest as an investor in the lawsuit it financed.

By contrast, the Ethics Committee, in Docket No. 2000-45 and prior Opinions, has approved financing where the third party is a lender whose loan is secured by a lien on a plaintiff's potential recovery. Nevertheless, an attorney must ensure that ethical obligations are satisfied. Specifically, in the context of a funder that makes loans to finance litigation, the client's attorney must meet the following requirements: (1) the attorney's independent

1 *Wheeler v. Harrison*, 94 Md. 147 (1901).

2 *Id.*



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judgment and the client's control of the case must be preserved; (2) the attorney must protect the client's attorney-client and work product privileges (and inform the client regarding the potential limitations of privilege); and (3) the lender must abide by Maryland lending and usury law.

Attorney's Exercise of Independent Judgment and Client's Control of Case

In Maryland, a client is entitled to an attorney's independent professional judgment.

Maryland Rule 19-305.4 provides:

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

Maryland Rule 19-302.1 provides:

[A]n attorney shall abide by a client's decisions concerning the objectives of the representation and, when appropriate, shall consult with the client as to the means by which they are to be pursued.

Maryland Rule 19-301.2 provides:

In representing a client, an attorney shall exercise independent professional judgment and render candid advice.

These rules require an attorney to exercise independent judgment and avoid a conflict between the client's interest and the funder's interest.

One area cited by the Ethics Committee in Docket No. 2000-45 is the need for the client to determine who will represent them. The comment to Rule 19-301.16 clearly states that the client has a right to discharge an attorney "with or without cause." According to the Committee, if the agreement with the funder does not allow the client to terminate their attorney, that would pose a "significant" issue. An attorney would be unable to represent a client if the client's agreement with a funder allowed the funder to fire the attorney. The Opinion states that "entering into such an agreement with the knowledge that it is non-binding on you [attorney] would be unethical in and of itself."

Effect on Confidentiality and the Attorney-Client and Work Product Privileges

The use of a third-party funder for litigation raises significant issues relating to the confidentiality of communications between client and attorney and the application of the attorney-client and work product privileges. A funder may seek the attorney's confidential assessment of the litigation's chances for success. That may require divulging information and documents protected by the attorney-client and work product privileges.

In disclosing privileged information and documents to a funder, the attorney should limit such disclosures to minimize the potential waiver of privilege. A non-disclosure agreement signed by the funder also should be obtained.

In addition, the attorney should explore the use of the "common interest" exception and obtain agreement from the funder that there is a "common interest" shared by the client and the funder. Any limitations on confidentiality and privilege should be documented in writing to the client so that the client has provided his "informed consent."

Usury

Maryland regulators have exercised their authority to regulate third-party funder loans in the context of regulating consumer loans. Such loans must meet the Maryland Consumer Loan Law³ and the Interest and Usury Law.⁴ In *In the Matter of Plaintiff Funding Holding, Inc. d/b/a LawCash*,⁵ the Commissioner of Financial Regulation entered into a Settlement Agreement and Consent Order with LawCash, having alleged that LawCash was "in the business of making litigation funding advances or other loans to Maryland consumers." The Order stipulated, among other agreed relief, that the lender would refund any interest or other charges above the 24% annual interest rate cap mandated by Maryland usury law.

³ Md. Code Fin. Inst. Art. §11-201 *et seq.* and Md. Code Com. Law. Art. §12-301 *et seq.*

⁴ Md. Code Com. Law Art. §12-101 *et seq.*

⁵ No. CFR-FY2014-0052 (Md. Dep't of Labor July 18, 2016).

Best Practices

Based on the limited authority in Maryland governing third party funding of litigation, these best practices should be followed:

1 Structure funding as a loan rather than an investment.

Neither the Maryland Supreme Court nor the Ethics Committee has determined that allowing a third-party investor in litigation is per se unethical. But the Ethics Committee, in Docket No. 2000-45, stated that it has “substantial concerns” with structuring third-party funding as an investment. The Ethics Committee in the past has sanctioned funding in the form of a loan provided that the arrangement complies with Maryland usury and other lending laws. Thus, an attorney should advise their client to select funding structured as a loan rather than an investment.

2 Ensure that the funder agreement protects the client’s right to the attorney’s independent judgment and to control the case and limits the risk of waiving confidentiality privileges.

States differ on the issue of whether an attorney can represent a client in negotiating an agreement with a third-party funder. In Maryland, Docket No. 2000-45 implies that the attorney’s involvement is essential because any agreement that allows the funder to terminate an attorney over a client’s objection is deemed to be “unethical in and of itself.” The funder agreement should safeguard the independence of the attorney and the client’s control of the case. The client should be informed of and consent to any limits to the attorney-client and work product privileges. An attorney should ensure that an agreement between client and funder contains non-disclosure and common interest provisions and spells out any limits of privilege and risks of disclosure and waiver.

3 Ensure that the funder agreement complies with Maryland lending and usury laws.

As a lender, a third-party funder must comply with all state lending and usury requirements.

The funder agreement should safeguard the independence of the attorney and the client’s control of the case.

Conclusion

The terrain for third-party funding in Maryland is still in a formative stage. Given the growing importance of such lenders, however, Maryland attorneys should carefully review the applicable ethical rules to ensure that any agreement with a funder satisfies all ethical and legal requirements.



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