



Legal Ethics
Ethics Opinions

LEGAL ETHICS

OPINION 1981-1

It is ethically improper under Rules 2-108 (regarding financial arrangements among lawyers) and 3-102 (regarding financial arrangements with non-lawyers) for an attorney who is a member of an organization to provide, or for an attorney to receive, funds for costs, when the repayment and compensation to the lender is a percentage of the legal fees received by the borrowing attorney.

QUESTION:

We have been asked to pass on the propriety of a financing program having the stated purpose of funding litigation costs. It is proposed to form an organization (the "lender") to provide funds, probably in the form of loans to attorneys who provide legal services on a contingent-fee basis. The funds would be used by that attorney solely for the purpose of paying costs advanced by him or her.

Where an attorney desires financing from the lender, it is contemplated that the lender would review each case on an individual basis in order to make an independent assessment of the probable financial outcome of the case. In the event that the lender determines that a case is likely to proceed satisfactorily, the lender would establish a limited line of credit against which the attorney could draw to pay for costs related to the case. The funds advanced would be repaid and the lender would be compensated solely as follows:

1. In the event the case is successfully resolved, either by settlement or by trial, the funds previously advanced would be repaid from the proceeds of the settlement or judgment. Compensation to the lender for the use of the funds would be paid solely out of the fee charged by the attorney and would take the form of an agreed upon percentage of such fee;
2. In the event the recovery is insufficient to pay the costs advanced, the repayment of costs advanced would be the first priority of distribution, with any shortfall being forgiven and the attorney having no further obligation to the lender;
3. In the event the case is unsuccessfully resolved, and there is no recovery, the amount of all funds advanced would be forgiven.

OPINION:

It is our opinion that the proposed arrangement violates one or both of California Rules 3-102 (regarding financial arrangements with nonlawyers) and 2-108 (regarding financial arrangements among lawyers).

DISCUSSION:

Rule 3-102 prohibits the direct or indirect sharing of legal fees with a person not licensed to practice law (with certain limited exceptions that are inapplicable in this case). Since the lender would be compensated for the use of its funds by payment to it of a percentage of the lawyer's fee, the arrangement amounts to impermissible fee-splitting.

We are further of the opinion that the proposed arrangement is impermissible, even if the lender is licensed to practice law. Rule 2-108(A) governs fee division between lawyers, and reads as follows:

"(A) A member of the State Bar shall not divide a fee for legal services with another person licensed to practice law who is not a partner or associate in the member's law firm or law office, unless:

1. The client consents in writing to employment of the other person licensed to practice law after a full disclosure has been made in writing that a division of fees will be made and the terms of such division; and
2. The total fee charged by all persons licensed to practice law is not increased solely by reason of the provision for division of fees and does not exceed reasonable compensation for all services they render to

the client."

As a threshold matter, there is a question whether the lender's activity should properly be considered under this Rule. We are of the opinion that the lender, even if licensed to practice law, is not acting in a legal capacity, and therefore should be considered under Rule 3-102 dealing with nonlawyers. However, the proposed arrangement is impermissible, even if considered directly under Rule 2-108. More particularly, the lender is the "other person licensed to practice law" and would not be employed by the client. It would thus be impossible for the client to consent to employment of the lender. Accordingly, even if the total fee charged is not increased solely by reason of the provision for division of the fee, the attorney would still be in violation if he or she divided the legal fee with the lender.

We are also concerned with additional ethical issues that are raised by the proposed financing arrangement. Foremost among these problems is that the nature of the lender's financial interest in the litigation inherently compromises the attorney's ability to exercise independent professional judgment on behalf of the client. For example, a settlement offer at a relatively early stage of the proceedings could minimize the lender's exposure while providing substantial compensation to the lender for the use of the funds advanced. Even if the arrangement between the attorney and the lender expressly disavows any control on the part of the lender, there is considerable incentive for the lawyer to maintain a favorable "track record" with the lender so that future credit will be available. Although circumstances will vary greatly, it is not unreasonable to imagine the lawyer under subtle pressure to act in a manner that is more closely aligned with the lender's interests than with the client's.

A further set of problems may arise in connection with the attorney's initial approach to the lender. We are concerned, for example, with the fact that in order for the attorney to properly advise the lender of the facts necessary for the lender to make an informed decision as to whether to establish a line of credit, it is necessary for the attorney to disclose client confidences relating to the case. Since disclosure may have adverse effects on the privilege attaching to the original client attorney communications, the lawyer's duty to the client would dictate extreme caution in this regard. At the same time, however, the attorney would be under pressure to disclose to the lender all relevant facts, including those potentially adverse to the client's interest; both to maintain a good relationship with the lender, and to avoid possible civil liability in the event that material facts were withheld.

We are also concerned with the effect that the proposed financial arrangement might have on the resolution of a fee dispute between the attorney and the client. In such a dispute, the lender becomes a true co-party with the attorney, and could well behave in a manner that interfered with the normal procedures (including fee arbitration) that are invoked to settle fee disputes.

It has been suggested that the proposed arrangement should not be viewed as a fee arrangement at all, but rather that it should be viewed purely as a loan arrangement. According to this rationale, the proposed arrangement, while perhaps falling within the literal wording of the Rules, does not fall within the policy of the Rules and is therefore exempt. More particularly, one of the main purposes behind Rules 2-108 and 3-102 was to control strictly the payment of so-called referral fees wherein the agreements between the referring party (attorney or lay person) and the attorney provides a monetary incentive for the referral, not because of the attorney's competence, but simply because of the financial benefit to the referring party. Thus, it is suggested that since the proposed arrangement does not necessarily give rise to the particular problems the above cited Rules were meant to avoid, the arrangement is not subject to the Rules' prohibitions. This argument is not completely without merit, and we further recognize that the financing alternative of the proposed arrangement may provide a number of benefits to the Bar. However, since, as discussed above, the arrangement seems prone to a number of abuses as well, there is no evidentiary basis to afford more weight to the supposed benefits than to the potential abuses. Therefore, there is no clear policy basis for excluding the proposed arrangement from the prohibition of the Rules.

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