The Paper Chase: Fee-Splitting vs. Independent Judgment in Portfolio Litigation Financing of Commercial Litigation

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INTRODUCTION

Lawyers serve justice and clients. The seemingly complicated legal practice is comprised of a simple relationship between lawyers—the zealous advocates—and clients—the people who seek out legal advice.[1] However, a new and potentially disruptive player has emerged in the legal field: the investor, and in particular, litigation finance firms. Litigation finance is a business transaction where a third-party investor provides capital to fund a lawsuit in exchange for a certain preset percentage of final judgment or settlement.[2] The invisible hand of the capital market is guiding an increasing number of venturers to the legal market. Some lawyers and their clients—both in need of capital—have rolled out the red carpet for the investor, while other practitioners are questioning the legality and ethics behind this burgeoning practice.[3]

There has been rapid growth in litigation finance in the last twenty years.[4] As most major law firms started to collaborate with litigation finance firms,[5] and as

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1. *See* MODEL RULES OF PROF'L CONDUCT pmbl. (1980) [hereinafter MODEL RULES] ("A lawyer's responsibilities as a representative of clients, an officer of the legal system and a public citizen are usually harmonious. Thus, when an opposing party is well represented, a lawyer can be a zealous advocate on behalf of a client and at the same time assume that justice is being done.").

2. *See* AM. BAR ASS'N, AM. BAR ASS'N BEST PRACTICES FOR THIRD-PARTY LITIGATION FUNDING 2 (2020), https://www.americanbar.org/content/dam/aba/directories/policy/annual-2020/111a-annual-2020.pdf [https://perma.cc/9SBY-BUBC] [hereinafter BEST PRACTICES REPORT].

3. Annie Pavia, *ANALYSIS: Firm Lawyers Wary of Portfolio Litigation Financing*, BLOOMBERG LAW (Mar. 5, 2020), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-firm-lawyers-wary-of-portfolio-litigation-financing [https://perma.cc/4Z6Y-W5SV].

4. *See* CHARLES AGEE & GRETCHEN LOWE, WESTFLEET ADVISORS LITIGATION FINANCE BUYER'S GUIDE 5 (2020); N.Y.C. Bar Ass'n. Comm. on Prof'l Responsibility, Formal Op. 2018-5: Litigation Funders' Contingent Interest in Legal Fees 1 (2018) ("The number of lawyers and clients benefitting from litigation funding has increased substantially over the last several years. It is now common for litigants and their lawyers to contemplate or obtain litigation funding.") [hereinafter NYCBA Formal Op. 2018-5].

5. *See* CHARLES AGEE & GRETCHEN LOWE, *supra* note 5, at 7; BURFORD CAPITAL, BURFORD INTERIM REPORT 2020 8 (2020), https://www.burfordcapital.com/media/1810/hy-2020-report.pdf [https://perma.cc/EL4D-BEA] ("93 AmLaw 100 and 89 of the 100 largest global law firms have sought our capital and services."). Burford Capital is one of the leading litigation finance firms. *Id.*

the economic uncertainty caused by COVID-19 has persisted,[6] litigation finance firms have become more creative, shifting from their traditional case-by-case investment with clients to portfolio financing with law firms.[7]

Portfolio financing involves funding arrangements between third-party litigation funders and lawyers where funders invest in a portfolio of cases managed by one law firm.[8] Under portfolio financing, there is a separation between the funder and the client.[9] This direct funding from a third party to law firms creates a new ethical dilemma about whether attorneys can actually use independent judgment when they engage in fee-splitting of their lawsuits.[10] The question here is how the legal field should resolve the ethical dilemma between fee-splitting and lawyers' independent judgment obligation in portfolio financing of commercial litigation,[11] which the present Note explores.

As litigation finance industry becomes more creative and plays an increasingly important role in the legal industry, this Note addresses a new ethical concern arises of portfolio financing.[12] This Note focuses on portfolio financing as a subset of litigation finance and attempt to resolve the conflict between fee-splitting arrangements in portfolio financing and the *Model Rules* of Professional Conduct ("*Model Rules*"), specifically Rule 5.4's requirement on lawyers' independent judgment.[13] Previous researches focus on evaluating benefits and costs of

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6. *See* Eva Shang & Robert Li, *INSIGHT: Litigation Finance Could Be a Lifeline During Pandemic,* BLOOMBERG LAW (May 26, 2020), https://news.bloomberglaw.com/us-law-week/insights-litigation-finance-could-be-a-lifeline-during-pandemic [https://perma.cc/TMY2-N9GG] (As a result of COVID-19, "[m]any legal professionals are finding themselves furloughed or laid-off. Even more are waking up to pay cuts and hiring freezes. The industry-wide cost-reducing efforts suggest that law firms are wary of the economic outlook, and some are already scrambling for cash").

7. BLOOMBERG LAW, LITIGATION FINANCE SURVEY 2020 (2020), https://aboutblaw.com/T7l [https://perma.cc/2PX7-F2AM]. In case-by-case investment, litigation finance firms directly contracted with clients. *See* NYCBA Formal Op. 2018-5, *supra* note 4, at 2 ("Client-funder arrangements . . . do not implicate Rule 5.4, . . . because the lawyer is not a party to the arrangement and payments . . . do not affect the amount of the lawyer's fee.").

8. AM. BAR ASS'N, *supra* note 2, at 4.

9. *See id*. Katherine Tommey states as follows:

> [O]rdinary litigation funding . . . is usually a contract that is executed on a single-case basis between a client and a funder[.] . . . [I]n a portfolio funding arrangement with a law firm, the funder provides financing to the firm, secured by a portion of the law firm's own right to contingency fees obtained in specified portfolio of cases agreed upon by the law firm and the funder.

Katherine Toomey, *Law Firms Must Beware Risks in Nontraditional Financing*, LAW360 (June 5, 2020), https://www.law360.com/articles/1280209/law-firms-must-beware-risks-in-nontraditional-financing [https://perma.cc/N8YG-B3CX]).

10. Fee-splitting refers to situations where attorneys share their fees with other parties. *See* Katherine Toomey, *supra* note 9.

11. *See* Annie Pavia, *supra* note 3.

12. *See supra* notes 4–7 and all accompanying text.

13. MODEL RULES R. 5.4 cmt. 2 ("[L]awyer may accept compensation from a third party as long as there is no interference with the lawyer's independent professional judgment and the client gives informed consent") (citing to R. 1.8(f)).

litigation finance,[14] or impacts of litigation finance as a whole.[15] However, litigation financing has moved from the fringe of the practice to the mainstream discussion. In August 2020, the American Bar Association ("ABA") issued *Best Practices for Third-Party Litigation Funding* report, signaling that third-party litigation funding is here to stay, but ultimately failing to provide a clear instruction on portfolio funding.[16] This Note takes a closer look at portfolio financing and builds upon recent statutory developments in different jurisdictions.

This Note argues that the interpretation of Rule 5.4 should be flexible, instead of formalistic, focusing on whether the funding arrangement impacts attorneys' independent professional judgment. If the courts and bar associations demand a bright-line rule on portfolio financing practice and independent professional judgment requirement, Rule 5.4 should be modified to accommodate the needs for portfolio financing in the legal industry.

Part I of this Note first introduces the concepts of litigation financing and portfolio financing, briefly discussing recent developments in this area. Next, Part II provides background on fee-splitting as set forth in the *Model Rules*, as well as the various interpretations and approaches toward fee-splitting utilized by different jurisdictions. Part III then argues that portfolio financing and fee-splitting do not impact law firms' independent judgment and will address relevant counterarguments. Finally, Part IV concludes by discussing policy implications and suggestions for the legal field moving forward.

I. INTRODUCTION TO LITIGATION FINANCE AND PORTFOLIO FINANCING

Litigation finance, particularly portfolio financing, was once a foreign concept, but it has become omnipresent in the legal field, particularly among big law firms.[17] A 2020 study conducted by Bloomberg Law sought to understand litigation finance industry under COVID-19's impact and revealed that 60% of lawyers who participated in the Bloomberg Survey indicated that their main concern was "maintaining control of litigation," and that 47% of them are concerned with ethical implications.[18]

14. *See, e.g.,* Jarret Lewis, Note, *Third-Party Litigation Funding: A Boon or Bane to the Progress of Civil Justice?*, 33 GEO. J. LEGAL ETHICS 687 (2020).

15. *See, e.g.,* Douglas R. Richmond, *Other People's Money: The Ethics of Litigation Funding*, 56 MERCER L. REV. 649 (2005).

16. *See* AM. BAR ASS'N, *supra* note 2, at 4.

17. *See id. at 8; BURFORD CAPITAL,* supra *note 5, at 8; Roomy Khan,* Institutionalize Litigation Funding: Ethics Rules Need to Be Revised, Clarified and Legislated, *FORBES (Aug. 2, 2019),* https://www.forbes.com/sites/roomykhan/2019/08/02/institutionalize-litigation-funding-ethics-rules-need-to-be-reviewed-clarified-and-legislated/?sh=6b4f92037d79 [https://perma.cc/H34H-REQW]; BLOOMBERG LAW, LITIGATION FINANCE SURVEY 2020 (2020), https://aboutblaw.com/T7l [https://perma.cc/2PX7-F2AM].

18. BLOOMBERG LAW, *supra* note 17.

A. LITIGATION FINANCE

Litigation finance, also known as litigation funding, is defined as the financing of litigation by third parties on a non-recourse basis, meaning that lender only demands repayment and interest payment when there are profits.[19] Non-recourse financing, such as litigation finance, allows borrowers to not repay the funder if the borrowers receive no profit from the lawsuit in which they invested.[20] Litigation finance firms typically enter into an agreement with one party to a lawsuit and invest by providing funding to cover initial legal expenses in exchange for gaining a certain percentage of the final proceeds if the party wins.[21] Thus, strong legal claims become a rewarding "asset class" akin to gold or stocks.[22]

Supporters of litigation finance believe that it helps plaintiffs who lack funding to pursue meritorious claims against better-capitalized defendants, overcoming the "David and Goliath" problem and "leveling the playing field."[23] However, more companies use litigation finance as a "corporate finance tool" such that large, well-financed companies work with litigation finance firms to avoid cash and other traditional corporate assets being tied up during litigation proceedings.[24] Without paying out-of-pocket money for their expenses, corporations ultimately show more cash on the balance sheet during litigation, which is particularly beneficial for publicly traded companies, as the cash-rich balance sheet makes the corporations more attractive to investors.[25]

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19. *See* Ronen Avraham & Anthony Sebok, *An Empirical Investigation of Third Party Consumer Litigant Funding*, 104 CORNELL L. REV. 1133, 1133–34 (2019); DAVID J. KERSTEIN & WENDIE CHILDRESS, BLOOMBERG LAW PRACTICE GUIDANCE OVERVIEW LITIGATION FINANCE INDUSTRY 2:

> Litigation finance encompasses any transaction in which a legal claim is used as collateral to secure financing from an outside party. The financing party (or funder) provides capital to the claimant in exchange for an interest in the outcome of the case. Financing is usually provided on a non-recourse basis, meaning that the funder receives a return only if the case is successfully settled or results in a collected judgment. If the case is unsuccessful, the claimant has no obligation to repay the funder.

Cf. Julia Kagan, *Non-Recourse Finance*, INVESTOPEDIA (Dec. 1, 2020), https://www.investopedia.com/terms/n/non-recoursefinance.asp [https://perma.cc/9CV7-HWMS].

20. *See* N.Y.C. BAR ASS'N, REPORT TO THE PRESIDENT BY THE N.Y.C. BAR ASS'N WORKING GROUP ON LITIGATION FUNDING 4 (2020), http://documents.nycbar.org/files/Report_to_the_President_by_Litigation_Funding_Working_Group.pdf [https://perma.cc/96W4-P7ES] [hereinafter 2020 NYCBA REPORT].

21. *See id.*

22. *See* Drew Hasselback, *The Gavel Gamble: Litigation Emerges as An Asset Class*, FINANCIAL POST (Apr. 29, 2016), https://financialpost.com/legal-post/the-gavel-gamble-litigation-emerges-as-an-asset-class [https://perma.cc/X8LZ-SJTJ] ("Lawsuits are emerging as a distinct asset class, just like real estate, private equity, precious metals or stocks and bonds.").

23. DAVID J. KERSTEIN & WENDIE CHILDRESS, *supra* note 19, at 3; Roomy Khan, *supra* note 17 ("[Third-Party Litigation Funding] levels the playing field between the plaintiffs and defendants in all forms of litigation, thereby facilitating David to fight Goliath.").

24. DAVID J. KERSTEIN & WENDIE CHILDRESS, *supra* note 19, at 3.

25. *See id.*

B. PORTFOLIO FINANCING

The increasing demand for cash and innovative financing options has led to changes in the traditional mode of investing in the legal market, which raises further ethical questions in a system that is already an ethical landmine. In recent years, portfolio financing has arisen as a new method of litigation financing.[26] Portfolio financing accounts for almost half of litigation finance firms' capital in the United States.[27] Through portfolio financing, third-party litigation finance firms contract with law firms directly and then provide funding for a portfolio of litigation or arbitration matters that range from three to forty cases at a time.[28]

Notably, litigation finance firms do not retain any contractual relationship with law firms' clients—the actual parties of the lawsuits.[29] To mitigate their risk, the third-party litigation finance firms conduct their own due diligence, analyzing the underlying merits of the cases on their own.[30] During this process, they obtain information from the law firms.[31] After information collection, the firms conduct an analysis based on facts, arguments, track record, and regulatory diligence, and then make a decision on whether they will enter into a financing agreement with the law firm.[32]

The separation between the profits and the parties to the case, as well as the extensive exchange of information about the case to secure litigation finance, complicates lawyers' ethical obligations to their clients.

C. LITIGATION FINANCE'S HISTORY AND CURRENT MARKET IN THE U.S.

The litigation finance market, which became popular in the United Kingdom and Australia in 1990s, has grown exponentially in the last few decades, entering corporate America in 2006.[33] Because of the opacity of litigation finance

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26. *See* Annie Pavia, *supra* note 3.

27. CHARLES AGEE & GRETCHEN LOVE, *supra* note 4, at 7

> The numbers suggest that funders are drawn to the efficiency of these transactions, and pricing competition for the larger portfolio deals has increased significantly now that hedge funds are more actively involved. Law firms are using these structures to establish, expand, and/or hedge risk in their contingent fee litigation practice areas.

28. *See Portfolio Funding: A Creative Approach to Managing* Risk, Blog, OMNI BRIDGEWAY (Sept. 15, 2016), https://omnibridgeway.com/insights/blog/blog-posts/blog-details/global/2016/09/14/portfolio-funding-a-creative-approach-to-managing-risk [https://perma.cc/26X4-K5TE]. Omni Bridgeway is a litigation finance firm. *Id.* In some scenarios, unrelated cases can be preferable because they can minimize risks and uncertainty. *See also 5 Minutes on . . . Portfolio Finance*, BURFORD CAPITAL (Apr. 17, 2019), https://www.burfordcapital.com/insights/insights-container/5-minutes-on-portfolio-finance/ [https://perma.cc/A36P-4QRE].

29. *See* Jason Lyon, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 578–79 (2010).

30. *Id.* at 592, 594.

31. *See Six Common Questions about Diligence*, VALIDITY, https://validity-finance.com/insights/6-common-diligence-questions/ [https://perma.cc/PJ4M-XH82] (last visited Mar. 25, 2021). Validity is also a litigation finance firm. *Id.*

32. *See id.*

33. DAVID J. KERSTEIN & WENDIE CHILDRESS, *supra* note 20, at 2 ("Litigation finance became available to corporate America in 2006 when Credit Suisse founded a group devoted to helping clients manage litigation risk.").

industry, practitioners do not have a consensus on how many litigations are funded by third-party funders in the United States.[34] Still, one 2019 study suggested that there were at least 41 commercial litigation finance firms active in the U.S. that together raked in $9.5 billion.[35] The 41 firms committed $2.3 billion in litigation related to U.S. companies within 2019.[36]

On October 19, 2020, Burford Capital, the leading litigation finance firm in the world, went public in the New York Stock Exchange ("NYSE"), debuting as the first litigation finance firm in the NYSE.[37] Burford Capital's Initial Public Offering brought the litigation finance industry into the limelight by inviting the general public in the United States to invest in litigations, demonstrating the upward trajectory of the industry.[38]

Amidst the COVID-19-fueled economic downturn, law firms and clients who seek to monetize their meritorious claims but are concerned with the liquidity of their assets have increasingly turned to litigation finance firms.[39] Although uncertainties riddled the legal market at the beginning of the pandemic,[40] the size of the litigation finance market increased in 2020.[41] Given the increased demand in litigation finance firms, it is even more crucial to explore this ethical landmine.

II. FEE-SPLITTING IN THE MODEL RULES AND RECENT CHANGES

Fee-splitting is not a defined term[42]: It can simply refer to sharing legal fees with any party, or refer exclusively to impermissible fee-sharing schemes.[43] To clarify, the Note defines fee-splitting as the division of legal fees between a law

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34. *See* Jay Greenberg, *Four Trends That Should Define Litigation Finance in 2021*, N.Y. LAW JOURNAL (Dec. 23, 2020), https://www.law.com/newyorklawjournal/2020/12/23/four-trends-that-should-define-litigation-finance-in-2021/ [https://perma.cc/FKJ6-QSXF]

> The requisite confidentiality of most transactions precludes the public from knowing which parties have received funding, and at what price and structure. The bespoke nature of litigation finance agreements further complicates matters, as deal terms vary significantly depending on the type of legal claim, the risk associated with the individual matter, and the funder's investment approach.

35. CHARLES AGEE & GRETCHEN LOVE, *supra* note 4, at 6.

36. *Id.*

37. *See* Stephanie Russell-Kraft, *Burford Capital Makes Debut on New York Stock Exchange*, BLOOMBERG LAW (Oct. 19, 2020), https://news.bloomberglaw.com/business-and-practice/burford-capital-makes-debut-on-new-york-stock-exchange [https://perma.cc/2U4E-9D62]; *cf.* BURFORD CAPITAL, *supra* note 5, at 8 (stating Burford successfully recovered $1.6 billion from its $0.8 billion investment).

38. *See id.*

39. BLOOMBERG LAW, *supra* note 7, at 2 ("Of lawyers who have previously obtained funding, nearly half report they are more likely to seek litigation financing as a result of the economic downturn.").

40. *See* Eva Shang & Robert Li, *supra* note 6 and accompanying text.

41. BLOOMBERG LAW, *supra* note 7, at 2 (Under the question that "[h]ow has the current economic downturn impacted your business," the most popular selection among lawyers was "decreased somewhat" (40%), and the one among litigation finance funders was "increased somewhat" (44%)).

42. Anthony J. Sebok, *Selling Attorneys' Fees*, 2018 U. ILL. L. REV. 101, 112–13 (2018) (". . . [T]he term fee-splitting . . . is not, in fact, a term of art or a defined term. In fact, the term fee-splitting does not appear in any statute or in any of the rules of professional conduct regulating lawyers.") (internal quotations omitted).

43. *Id.* at 113; *see* MODEL RULES R. 5.4 & R. 5.4 cmt. 1 (AM. BAR ASS'N 1980).

firm, the recipients of the legal fees, and another outside party, such as another law firm or a litigation finance firm.[44]

Rule 1.5(e) allows fee-splitting between law firms and lawyers when the division of legal fees is proportionate to the services performed or when "each lawyer assumes joint responsibility for the representation[.]"[45] In practice, fee-splitting occurs when law firms work collaboratively for the same client, or when one law firm refers a case to another "in return for a percentage of any contingency fees."[46]

This Note focuses on fee-splitting between law firms and finance litigation firms—the cornerstone of portfolio financing. Rule 5.4 addresses fee-splitting with non-lawyers. However, some jurisdictions, including New York and Arizona, have questioned the efficacy of Rule 5.4, and have attempted to modernize the Rule in light of the growing litigation finance market.[47] Sections II.A.–II.B. below will explore Rule 5.4 and recent developments in some jurisdictions that have attempted reform.

A. FEE-SPLITTING IN THE ABA *MODEL RULES* AND INDEPENDENT PROFESSIONAL JUDGMENT

Rule 5.4, although it does not outright prohibit fee-splitting, limits its application to a narrow scope.[48] The rationale for this *Model Rules*' skepticism towards fee-splitting is the *Model Rules*' independent professional judgment requirement.[49] Although the implications of Rule 5.4 have been unclear, particularly regarding the scope of allowable fee-splitting, the ABA does not address this issue effectively in its *Best Practice* report and leaves to each jurisdiction to deliver its own interpretations.[50]

1. INTRODUCTION TO RULE 5.4 AND INDEPENDENT PROFESSIONAL JUDGMENT

Rule 5.4, titled "Professional Independence of a Lawyer," addresses fee-splitting with non-lawyers and the regulation of the business interaction between lawyers and non-lawyers.[51] The Rule seemingly prohibits fee-splitting in Rule 5.4(a), stating that, "a lawyer or law firm shall not share legal fees with a nonlawyer" in

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44. Sebok, *supra* note 41, at 113.

45. MODEL RULES R. 1.5(e)(1). Two additional requirements for fee-sharing between lawyers are client's written consent and reasonableness of the fees. R. 1.5(e)(2)-(3).

46. Evan Robinson, *Fee Splitting: The Ethical Implications of Non-Lawyer Involvement*, U. MIAMI L. REV. (Apr. 18, 2020), https://lawreview.law.miami.edu/fee-splitting-ethical-implications-non-lawyer-involvement/ [https://perma.cc/DUZ8-6DDS].

47. *See infra* notes 59–78 and accompanying text.

48. *See* MODEL RULES R. 5.4(a).

49. MODEL RULES R. 5.4 cmt. 1.

50. *See infra* notes 58–60 and accompanying text.

51. *See* MODEL RULES R. 5.4(a) (generally prohibiting a lawyer from sharing legal fees with a nonlawyer); R. 5.4(c) (prohibiting a lawyer from allowing a litigation finance firm to "direct or regulate the lawyer's professional judgment in rendering legal services"). *See also* NYCBA Formal Op. 2018-5, *supra* note 4, at 2–3.

order to protect lawyers' independent professional judgment.[52] Notably, the Rules have not provided definitions of "share" and "legal fees."[53]

Model Rules has discussed independent professional judgment in other rules too: Rule 1.8(f) addresses independent professional judgment and prohibits lawyers from accepting funding that may interfere with their professional judgment without client's consent.[54] Additionally, Rule 2.1 requires lawyers to exercise their professional judgment, stating that "[i]n representing a client, a lawyer shall exercise independent professional judgment and render candid advice."[55] Thus, the definition of professional judgment, and more specifically what constitutes *independent* professional judgment, will be determinative in evaluating when lawyers are allowed to split their fees with non-lawyers, such as litigation finance firms.

2. RULE 5.4 ALLOWS RECOURSE LOAN BUT MAY PROHIBIT NON-RECOURSE PORTFOLIO FINANCING

Law firms have different fee-splitting arrangements with litigation finance firms. Rule 5.4 allows recourse arrangements in which the funder requires the law firm to repay the funds provided regardless of the outcome of the litigation, acknowledging the fact that the repayment amount and the initial financing process do not actually impact the result of litigation.[56]

However, there are two other forms of financing arrangements that may implicate Rule 5.4. First, law firms repay the funds with pre-negotiated interest to litigation finance firms only when law firms receive their own legal fees, which is a non-recourse fee-splitting structure.[57] Second, law firms still need to repay the loan, but their payment rates vary based on total recovery in the case or portfolio and a pre-negotiated sliding scale.[58] While the New York City Bar Association ("NYCBA") Committee on Professional Ethics issued a non-binding opinion, distinguishing between a recourse loan with a pre-negotiated rate with the other two forms of financing agreement,[59] litigation funders argued that the opinion has broken the New York courts' precedents, "which have uniformly accepted and enforced precisely the kinds of nonrecourse financing arrangements that the

52. MODEL RULES R. 5.4 & cmt; *see also* Jacoby & Meyers LLP v. President Justices, 852 F.3d 178, 191 (2d Cir. 2017) (holding Rule 5.4 was constitutional and did not violate law firms' first amendments because of New York State's interest in "maintaining [attorney's] ethical behavior and independence").

53. Formal Op. 2018-5, *supra* note 4, at 4; *see* MODEL RULES R. 5.4.

54. MODEL RULES R. 1.8(f) ("[A] lawyer shall not accept compensation for representing a client from one other than the client unless: (1) the client gives informed consent; (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and (3) information relating to representation of a client is protected as required by Rule 1.6.").

55. MODEL RULES R. 2.1 ("In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.").

56. *See* Formal Op. 2018-5, *supra* note 4, at 2.

57. *Id.*

58. *Id.*

59. *See id.*

opinion address."[60] New developments in some jurisdictions also posed further questions on the absoluteness of Rule 5.4, casting doubts on the formalistic distinction between Rule 5.4's treatment to recourse loan and non-recourse finance.[61]

3. THE AMERICAN BAR ASSOCIATION'S AMBIVALENCE TOWARDS PORTFOLIO FINANCING

The ABA has not explicitly taken a supportive or disapproving stance on third-party litigation financing, leaving practitioners without clear guidance.

The ABA's August 2020 Resolution 111A set forth some basic guidelines regarding the various forms of third-party litigation financing in its publication, *"The ABA Best Practices for Third-Party Litigation Funding*" ("Best Practices Report" or "the Report").[62] The Best Practices Report emphasized the importance on clients having control over their own case and recommended that attorneys evaluate funders' transparency.[63]

However, the Report did *not* take an explicit stance on fee-splitting, nor did it address the issue of whether law firms can engage with third-party financiers directly through portfolio funding. In fact, the Report asked law firms to refer to "local law and ethics rules regarding fee splitting with a non-lawyer."[64]

B. SOME JURISDICTIONS SOUGHT TO MODERNIZE OR ABROGATE RULE 5.4

Some jurisdictions, such as New York and Arizona, have recognized the necessity of litigation finance and portfolio financing in light of the current legal market, despite the inherent ethical conflict posed by Rule 5.4 and its vague wording.[65] Thus, both states resolved or proposed to resolve the legal constraints posed by Rule 5.4 through changes or abrogation of the Rule.[66]

1. NYCBA'S OPINION IN 2018 AND ITS CHANGED POSITION IN 2020

a. The 2018 NYCBA Opinion

In May of 2018, NYCBA issued an opinion entitled "*Litigation Funder's Contingent Interest in Legal Fees*" ("Formal Opinion 2018-5").[67] The Best

60. Andrew Cohen, *ABA's New Guidance on Litigation Funding*, BURFORD (Aug. 6, 2020), https://www.burfordcapital.com/insights/insights-container/abas-new-guidance-on-litigation-funding-misses-the-mark/ [https://perma.cc/H7NT-DRLC].

61. *See infra* notes 65–83 and accompanying text; *e.g.,* SCF Consulting v. Barrack, Rodos & Bacine, 175 A.3d 273, 277 (Pa. 2017) (holding the fee-splitting agreement between lawyers and lay entities are not unenforceable per se) ("The ultimate outcome of this case may turn on factual findings concerning [non-lawyer's] culpability, or the degree thereof, relative to the alleged ethical violation.").

62. *See* BEST PRACTICES REPORT, *supra* note 2.

63. *Id.* at 2.

64. *Id.* at 4.

65. *Cf.* MODEL RULES R. 5.4; *supra* note 51 and accompanying text.

66. *See* Jay Greenberg, *supra* note 34.

67. NYCBA Formal Op. 2018-5, *supra* note 4.

Practices Report cited the Formal Opinion 2018-5 to demonstrate that New York City has found portfolio financing to be "impermissible fee splitting[,]" forbidden by the *Model Rules*.[68] However, the NYCBA entirely reversed course in portfolio financing its later report.[69]

In Formal Opinion 2018-5, NYCBA addressed the following question:

> May a lawyer enter into a financing agreement with a litigation funder, a non-lawyer, under which the lawyer's future payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters?[70]

The NYCBA answered this question in the negative, claiming that certain litigation finance deals violated the state's equivalent to Rule 5.4.[71]

In its opinion, the NYCBA reaffirmed its previous prohibition on fee-splitting with landlords, donors, marketing agencies, or non-legal employees, but not with collection agencies hired after verdicts to collect legal fees.[72] This characterization demonstrates that the NYCBA would allow post-verdict fee-splitting.[73] The NYCBA suggests that law firm portfolio funding arrangements violate Rule 5.4 because the NYCBA prohibits lawyers from entering into financial agreements with litigation funders "under which the lawyer's *future* payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters."[74] The emphasis on a temporal element is likely an attempt to minimize third-party influence and eradicate any possibility of contaminating independent professional judgement.

As an opinion, the Formal Opinion 2018-5 was advisory in nature, meaning it was not binding in New York or any other jurisdiction.[75] Its interpretation of Rule 5.4, however, demonstrates a clear conflict between portfolio litigation financing and Rule 5.4 because its interpretation is strict and textual, focusing solely on whether the source of the money is from non-lawyers, instead of whether the effect of fund impacts independent judgment.

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68. BEST PRACTICES REPORT, *supra* note 2, at 4–5.

69. 2020 NYCBA REPORT, *supra* note 20, at 22–23 (characterizing the NYCBS Formal Op. as "advisory" and non-binding and finding "it would be beneficial for the Rule [5.4] to be revised" because "lawyers and the clients they serve will benefit if lawyers have less restricted access to funding").

70. NYCBA Formal Op. 2018-5, *supra* note 4, at 1.

71. *Id.*

72. *See id.* at 4–6.

73. *See, e.g., id.* at 5, n.10 ("We do not question . . . that a lawyer employing a collection agency to collect earned but unpaid legal fees may compensate the collections agency based on a percentage of the recovery.").

74. *Id.* at 6 (emphasis added).

75. 2020 NYCBA REPORT, *supra* note 20, at 22–23.

b. 2020 NYCBA Working Group on Litigation Funding's *Report to the President*

In February of 2020, the NYCBA abandoned its previous stance that Rule 5.4 prohibited portfolio finance.[76] Three months after the Formal Opinion 2018-5, the NYCBA formed the litigation funding working group, comprised of practitioners, ethics professors, and litigation funder firms' executives.[77] The litigation funding working group was tasked with the question of "whether Rule 5.4, as interpreted in [NYCBA Formal Opinion 2018-5], well serves the professional community and the public, or whether the Rule should be revised to reflect contemporary commercial and professional needs and realities."[78]

After much deliberation and research, the working group proposed two versions of revisions to Rule 5.4.[79] Either version aims to enable law firms to receive portfolio litigation financing, since both lawyers and clients benefit when "lawyers have less restricted access to funding."[80] The working group added safeguards to protect lawyers' professional judgement in portfolio financing arrangements—Both revision prohibit litigation funder's direct or indirect participation in the decision-making process of funding entities, require explicit consent from clients, and refer to other safeguards created by the Rules, such as Rule 1.6 and Rule 1.7, to address potential conflicts of interests between attorneys and funders.[81]

The drastic shift in position of NYCBA, a popular jurisdiction for litigation finance, is perhaps indicative of the legal field's increasingly open mindset when it comes to issues of portfolio funding.

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76. *Id.* ("We find it would be beneficial for the Rule [5.4] to be revised. The consensus of the Working Group is that lawyers and clients they serve will benefit if lawyers have less restricted access to funding.").

77. *Id.* at 1.

78. *Id.* at 23.

79. The working group proposed two alternatives that share similar content, including litigation finance arrangement as one of the exceptions. Proposal A is as follows:

> A lawyer or law firm shall not share legal fees with a nonlawyer, except that:
> . . .
>
> (4) a lawyer or law firm may share legal fees with an entity in exchange for the entity's providing financial assistance to the lawyer specifically for use with respect to a legal representation of one or more clients, provided that:
>
> (i) the entity and its representatives do not participate, directly or indirectly, in the decision-making regarding the representation;
>
> (ii) the lawyer or law firm maintains professional independence;
>
> (iii) the client provides written informed consent to the financial arrangement; and
>
> (iv) the lawyer or law firm complies with all other applicable Rules, including Rule 1.6 and Rule 1.7.

Id. at 24.

80. *Id.* at 23.

81. *See id.*; 2020 NYCBA REPORT, *supra* note 20, at 24, 29.

2. ARIZONA ABROGATED RULE 5.4

By comparison, Arizona took a more drastic approach to Rule 5.4. The Arizona Supreme Court abrogated Ethics Rule 5.4, effective January 1, 2021, becoming the first state to officially abrogate Rule 5.4.[82]

Arizona's decision recognized the unnecessary restraints Rule 5.4 imposed on lawyers and law firms and reflected the legal markets' desire for more accessible legal services, technological advances, and third-party funding from litigation finance firms.[83]

3. OTHER MOVEMENTS

Other states, although they did not directly challenge Rule 5.4, allowed or considered actions that conflict with Rule 5.4.[84] For example, the Utah Supreme Court allowed nonlawyers ownership of law firms through a regulatory sandbox[85] used to "oversee and evaluate nontraditional legal services providers and entities offering new types of legal services."[86] Justice Deno Himonas specifically emphasized that the COVID-19 pandemic showcased the necessity for reforms that could facilitate low-cost legal services.[87]

As indicated by the preceding discussion, various jurisdictions are trying to relax Rule 5.4 and to welcome the new player in town.[88]

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82. Ariz. S. Ct. RPC R. 42, ER 5.4, Ariz. Rev. Stat. Ann. (effective Jan. 1, 2021); *see* Jay Greenberg, *supra* note 34 (The decision allowed non-lawyers to hold economic interests in law firms) ("The Arizona rule is a further endorsement of [portfolio] financing models, providing greater momentum to other states seeking to liberalize their legal industries.").

83. Sam Skolnik, *Arizona First State to OK Nonlawyer Ownership of Law Firms*, BLOOMBERG (Aug. 28, 2020), https://news.bloomberglaw.com/business-and-practice/arizona-first-state-to-allow-nonlawyer-co-ownership-of-law-firms?context=article-related [https://perma.cc/WXT3-QJBG] (Arizona Supreme Court Chief Justice Robert Brutinel states, "[The changes] will make it possible for more people to access affordable legal services and for more individuals and families to get legal advice and help"); William C. Marra, *Arizona Law Firm Ownership Rule Change is a Win for Clients*, VALIDITY (Sept. 3, 2020), https://validity-finance.com/insights/az_rule_change_law360/ [https://perma.cc/U5T4-846A].

84. Gerald Knapton, *Finding a Path Forward to Regulate the Legal Industry*, LAW360 (Oct. 22, 2020), https://www.law360.com/articles/1316389/finding-a-path-forward-to-regulate-the-legal-industry [https://perma.cc/S6X7-NY83] (Utah, California, District of Columbia, and Oregon have experimented with programs that would be undermined by Rule 5.4).

85. *To Tackle the Unmet Legal Needs Crisis, Utah Supreme Court Unanimously Endorses a Pilot Program to Assess Changes to the Governance of the Practice of Law,* UTAH COURTS RECENT PRESS NOTIFICATIONS, http://www.utcourts.gov/utc/news/2020/08/13/to-tackle-the-unmet-legal-needs-crisis-utah-supreme-court-unanimously-endorses-a-pilot-program-to-assess-changes-to-the-governance-of-the-practice-of-law/ [https://perma.cc/3UEJ-E4WS]. A regulatory sandbox is "an authorized approach allowing a safe space for that which would have been prohibited by existing rules." Knapton, *supra* note 85.

86. Lyle Moran, *Utah's High Court Proposes Nonlawyer Ownership of Law Firms and WideRanging Reforms*, ABA JOURNAL (Apr. 27, 2020), https://www.abajournal.com/news/article/utahs-high-court-proposes-wide-ranging-legal-industry-reforms [https://perma.cc/U5QR-JMQ6].

87. *See id.*

88. *See supra* notes 65-87 and accompanying text.

III. PORTFOLIO FINANCING DOES NOT VIOLATE RULE 5.4 BECAUSE IT DOES NOT VIOLATE THE INDEPENDENT PROFESSIONAL JUDGMENT REQUIREMENT

The triangular relationships among lawyers, funders, and clients create ethical concerns. However, Rule 5.4's analysis should focus on whether a funding arrangement impacts contracting lawyers' independent professional judgment. Using independent judgment as a standard and taking into account alternatives to litigation finance, such as recourse loans and contingency fees, indicate that portfolio financing not only does not undermine lawyers' independent professional judgment, but also helps to alleviate some lawyers' temptation to make a decision for themselves at the expense of their clients.

A. THE ETHICAL DILEMMA THAT ARISES FROM FEE-SPLITTING AND PORTFOLIO FINANCING

The emphasis of Rule 5.4 should be on independent judgment rather than involvement of a non-legal party.[89] The term "non-legal party" derives from the controversial Medieval English doctrines of champerty and maintenance.[90] These doctrines were designed to outlaw feudal lords in Medieval England from using litigations as revenges and financing claims against their personal enemies.[91] The goal of champerty and maintenance was based on feudal society and the ruling class' interests:

> Efforts to prevent champerty and maintenance were grounded in several concerns: the king's desire to prevent litigation involving his own interests or those of his supporters; clerical opposition to litigation generally, especially in secular courts; a general dislike of usury, or the practice of loaning money at

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89. *See supra* notes Section II.A. and accompanying text.

90. Champerty is "a bargain by a person with a plaintiff or a defendant for a portion of the matter involved in a suit in the event of a successful termination of the action, which the person undertakes to maintain . . . at his own expense." Osprey, Inc. v. Cabana Ltd., 532 S.E.2d 269, 273 (S.C. 2000). *See* St. Bar of Cal. Standing Comm. on Prof'l Responsibility and Conduct, Formal Op. No. 2020204, 3 (2020), https://www.calbar.ca.gov/Portals/0/documents/ethics/Opinions/Formal-Opinion-No-2020-204-Litigation-Funding.pdf [https://perma.cc/K5KF-DYSX]

> [A]greements between a litigant and a stranger to the litigation by which the stranger pursues or assists in pursing the litigant's claim and in return receives part of any recovery are prohibited under laws against champerty and maintenance. These are legal doctrines dating from the Medieval England that developed to prevent feudal lords from financing other individuals' legal claims against the financer's political or personal enemies.

91. *See id;* Steven K. Davidson, Michael J. Baratz, Jared R. Butcher, Molly Bruder Fox, Chris Paparella & Sara Faber, *Litigation Funding Update – Abolishing Common Law Champerty*, Steptoe (July 7, 2020), https://www.steptoe.com/en/newspublications/litigation-funding-update-abolishing-common-law.html [https://perma.cc/B9AV-97XD]; *e.g., Osprey*, 532 S.E.2d at 273 (rejecting champerty in South Carolina); Maslowski v. Prospect Funding Partners LLC., 944 N.W.2d 235 (Minn. 2020) (abolishing Minnesota's prohibition of champerty because of "changes in legal profession and in society") (stating litigation finance agreement "may increase access to justice").

> interest; and the belief that litigation was, in itself, an undesirable and distasteful affair, regardless of the merits of a lawsuit.[92]

Portfolio litigation financing from litigation funders is the opposite of frivolous personal vendetta from feudal lords. It is a calculated business decision made by sophisticated profit-driven entities. Feudal lords have been long gone and become a distant history.[93] Because the context of Rule 5.4 is no longer present, the interpretation of Rule 5.4 should avoid a formalistic bright-line rule, and it instead should focus on the purpose and the goal of the Rule: independent professional judgment.

Rule 5.4's comment states, in relevant part:

> [1] The provisions of this Rule express traditional limitations on sharing fees. These limitations *are to protect the lawyer's professional independence of judgment*. Where someone other than the client pays the lawyer's fee or salary . . . that arrangement does not modify the lawyer's obligation to the client.
>
> [2] This Rule also expresses traditional limitations on *permitting a third party to direct or regulate the lawyer's professional judgement* in rendering legal services to another. See also Rule 1.8(f) (lawyer may accept compensation from a third party as long as there is no interference with the lawyer's independent professional judgement and the client gives informed consent).[94]

The comment demonstrates that the ban of third-party litigation finance is not absolute; the analysis focuses on the impact of the fund on lawyers' independent professional judgment and other obligations owed to their clients.

Third-party funding still poses a threat to the relationship between attorneys and clients, given its potential to cloud attorneys' independent judgment in the "triangular attorney-client-funder relationship."[95] Practitioners appear to share this concern: Some law firm lawyers who were interested in using portfolio financing felt hesitant due to concerns about ethical implications.[96]

The root of this concern is the fact that litigation funders, unlike lawyers, are profit-driven and not bound by any ethical obligations or standards. Litigation funders, like stockholders in a publicly traded corporation, are only bound by contractual obligations and do not have fiduciary duties to a financed party.[97] Their only incentive is to maximize their investment return.[98]

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92. *Osprey*, 532 S.E.2d at 274.
93. *Feudalism*, THE COLUMBIA ENCYCLOPEDIA (8th ed. 2018) ("The process [of feudalism's decline] was greatly accelerated in the 14th [century] and did much to destroy the feudal classifications of society.").
94. MODEL RULES R. 5.4 cmt. 1 (emphases added).
95. MODEL RULES R. 5.4; Maya Steinitz, *The Litigation Finance Contract*, 54 WM. & MARY L. REV. 455, 482 (2012).
96. BLOOMBERG LAW, *supra* note 17, at 4.
97. 2020 NYCBA REPORT, *supra* note 20, at 40.
98. *Id.* ("Accordingly, the profit motive of the funder may trump the interest of a particular financed party in a particular situation.").

This profit-driven nature has two primary impacts: First, for a case-by-case finance, litigation finance funders may require a law firm to discuss its litigation strategies or settlement decisions with them, where lawyers may discuss details of their case and involve litigation funders as parts of their decision-making process to secure the initial funding for the case.[99] Second, law firms "may feel pressured to make decisions that are in the funders' best interests" to maintain their relationship with the funder for future collaboration, and this strategy may inadvertently place the funders' interests above those of the client.[100]

By contrast, lawyers do have a fiduciary duty toward their clients and must supply "independent professional judgment and . . . candid advice."[101] Lawyers are required to put their clients' interests before their own, especially those of any other party, and make the best decision for their clients.

Portfolio litigation financing invites a self-interested non-lawyer third party into this sacred attorney-client relationship. However, the following section demonstrates that upon a closer inspection, portfolio litigation financing's format itself actually lowers the risk of undermining lawyers' independent judgment, ultimately strengthening the attorney-client relationship.

B. PORTFOLIO FINANCING SAFEGUARDS LAW FIRMS' INDEPENDENT JUDGMENT

It is important to recognize that parties involved in litigation finance are sophisticated. The entry-level investment is steep. For example, a fund launched by a litigation finance company, LexShares, requires a $250,000 minimum contribution for any investor.[102] The nature of portfolio financing forces its investors and litigation finance firms to anticipate potential losses, and structure and plan for these risks accordingly.[103] Thus, under these arrangements, the funders have less motivation to exert influence and be involved with individual cases.

Investors recognize the high risk in traditional litigation finance and are aware that their end result will either be a "home run" or a complete loss of their principle.[104] Portfolio financing mitigates the risk to this all-or-nothing result hedging on an outcome of one case. A portfolio diversifies business risks, and it provides

99. Robert M. Cary, *Third-Party Litigation Financing: Ethical Issues for Attorneys, Practical Law* Litigation, THOMSON REUTERS PRACTICAL LAW, https://us.practicallaw.thomsonreuters.com/w-011-9173.

100. *Id.*

101. MODEL RULES R. 2.1; *see id.*

102. *See* Roy Strom, *LexShares Opens Books on Litigation Bets to Attract $100 Million*, BLOOMBERG LAW (June 10, 2020), https://news.bloomberglaw.com/business-and-practice/lexshares-opens-books-on-litigation-bets-to-attract-100-million [https://perma.cc/8JUE-5P7F].

103. BURFORD CAPITAL, *supra* note 28.

104. Sarah O'Brien, *Litigation Financing May Tempt Investors with High Returns. What to Know before Buying In*, CNBC (June 25, 2020), https://www.cnbc.com/2020/06/25/litigationfinancingtemptswithhighreturnstipsbeforebuyingin.html [https://perma.cc/97YV-UZDZ].

capital for cases that may otherwise have difficulty receiving funding.[105]

This section explains that portfolio financing safeguards law firms' independent professional judgment because portfolio financing focuses on lawyer over claims, reduces subconscious impacts, and has less impact than contingency fee and recourse loan arrangements.

1. PORTFOLIO FINANCING FOCUSES ON LAWYERS OVER CLAIMS

The "most significant source of uncertainty" in portfolio financing is the litigation itself.[106] Legal probability is "not statistical or objective," but instead "logical and subjective."[107] In portfolio financing, funders provide law firms with a large sum of money in return for a pool of cases.[108] Unlike fund managers who only put the portfolio together, portfolio financing allows funders to evaluate claims, as well as attorneys, their skills, and expertise to win cases.

The base of litigation finance funders' return in a portfolio is the sum of the law firm's contingency fee; in other words, the law firm's own profit.[109] In portfolio financing, funders use their money to give a vote of confidence to the recipient law firm. By contrast, in traditional case-by-case finance, funders have an incentive to select the lawyers and devise strategies.[110] If litigation finance firms think one particular case has a high likelihood of winning, they can invest in that specific case rather than a portfolio. In a portfolio litigation finance, funders' financing does not only represent their faith in one single claim, but also their faith in the ability of the attorneys to reach maximize their profit in the portfolio.

2. PORTFOLIO FINANCING REDUCES LAW FIRMS' SUBCONSCIOUS PRESSURE TO BUILD RELATIONSHIP WITH LITIGATION FUNDERS

When litigation funders contract for their financing agreements, it is unlikely that they include explicit provisions that allow funders to take over the client's

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105. Annie Pavia, *supra* note 3. Similar to Venture Capitalists who invest in entrepreneurs and experience information asymmetries, "one of the key risks associated with a VC portfolio company's investment returns is their variability." Maya Steinitz, *supra* note 95, at 490.

106. Maya Steinitz, *supra* note 95, at 491–92 (New research on intersection between finance and law show that "litigation should be analyzed as an option, because during the course of a case each party has an option to settle or select trial").

107. *Id.* at 492.

108. OMNI BRIDGEWAY, *supra* note 28.

109. Anthony J. Sebok, *supra* note 42, at 108–09.

> By advancing money to an attorney in advance of the attorney receiving a fee, the nonlawyer is providing capital to the attorney. . . . since the amount of capital is linked to the expected earned fees of an attorney (. . . her profits), the investment advanced by the nonlawyer would not include other forms of future equity.

110. *E.g.,* Mica Rosenberg, *Witnesses Say U.S. Lawyer Used Fraud in Chevron Case in Ecuador*, REUTERS (Oct. 16, 2013), https://www.reuters.com/article/us-chevron-ecuador/witnesses-say-u-s-lawyer-used-fraud-in-chevron-case-in-ecuador-idUSBRE99F1C420131017, [https://perma.cc/AQJ4-M5S2] (Burford Capital preselected law firms and engaged in strategy sessions in the Chevron and Ecuador dispute).

control. However, one common concern with litigation finance is the subconscious pressure on lawyers.[111] Law firms may attempt to establish a good rapport to maintain or improve their reputations because most litigation funders are repeat players.[112]

However, there is an increasing number of total players in the litigation financing market. Currently, "there are roughly 40 entities involved in U.S. commercial litigation financing."[113] Thus, if a law firm decides to advise its client to take actions that may undermine the funder's return, the firm later still has the option to collaborate with other litigation financing firms.

Furthermore, litigation funders have different incentives when they invest in a portfolio instead of a single case.[114] The "prize" is not the legal fee in one single case, but rather the revenue the law firm receives in an entire portfolio. Lawyers have more pressure and desire to maximize their own profits in a portfolio than in a single case, naturally aligning their interests with funders' interests. It is difficult to imagine a successful legal practice when the law firm sacrifices its clients' interests in a portfolio of cases. Thus, in portfolio litigation financing arrangements, there is less pressure and incentive for law firms to maintain a good relationship with litigation funders at the cost of their clients' interests in hope of future funding arrangements.

3. PORTFOLIO FINANCING EXERTS LESS SUBCONSCIOUS PRESSURE THAN THE CONTINGENCY FEE SYSTEM

A similar kind of pressure also exists in the traditional contingency fee payment system: When attorneys receive a share of proceeds as compensation, they may want to pursue more proceeds, which contradict with their clients' goals.[115]

Rule 1.5(c) expressly allows lawyers to work on a contingency fee.[116] Instead of banning contingency fees, the *Model Rules* sets clear procedural standards and documentary requirements to ensure a fair implementation of the rule.[117]

The portfolios funders invested in comprise of cases with a certain degree of contingency fee arrangement.[118] Omni Bridgeway, a prominent litigation finance firm, states that the cases they are looking for are "plaintiffs-side contingency cases that are compelling on the merits, strong on damages, and have no issues

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111. *See* Maya Steinitz, *supra* note 95, at 481–82.
112. *Id.* at 482.
113. Sarah O'Brien, *supra* note 104.
114. *Supra* notes 95–98 and accompanying text.
115. In early settlements, both funders who invest in one single case and lawyers who have a contingency fee agreement have incentives to settle early to lower the cost and ensure a tangible settlement fee. *See* Maya Steinitz, *supra* note 95, at 489.
116. MODEL RULES R. 1.5(c).
117. *See id.*
118. OMNI BRIDGEWAY, *supra* note 28 ("A portfolio contains multiple contingency or partial contingency matters.").

with collectability."[119] In these cases that funders are interested in investing, law firms have already experienced pressures because of their contingency fee structure. Law firms may want to settle early to avoid further costs and the risk of losing the case. Although funders may have a similar mentality as law firms that have contingency fee arrangements, third-party litigation funding actually alleviates law firms' pressures because the money is provided on a non-recourse basis, shifting the risk posed by contingency fee structure from lawyers to funders. In this way, law firms can better defend their clients' interests without worrying about the economic impacts of their decisions to the firms' income. Thus, it is unreasonable to interpret Rule 5.4 as an outright ban on portfolio financing without evaluating its effects.

4. PORTFOLIO FINANCING HAS LESS STRINGENT CONDITIONS THAN COVENANTS IMPOSED BY LENDERS

Indeed, some litigation finance funders include contractual provisions to restrain or limit future conducts of a law firm and its attorneys. However, research shows that the control exerted by litigation finance funders is "no different" than conditions exerted by the lender of a recourse loan.[120]

According to the New York City Bar Association's interpretation, Rule 5.4 allows recourse loans, requiring lawyers to pay the loan back at a fixed interest regardless of the outcome of litigation.[121] Lenders have the ability to impose restrictions to exercise their property interest when they provide a loan.[122] In portfolio finance, litigation funders' requirements focus on the law firm's general practice instead of specific case strategies.[123] However, covenants in debt agreements may give lenders actual control over attorneys, ranging from their salaries to staffing.[124]

Recourse loans are allowed because law firms need capital to pay for its lawyers and other administrative costs in their preparation for cases. A recourse loan may request law firms to keep a minimum working capital, emphasizing the necessity and importance of immediate income. Thus, recourse loans may deepen

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119. *Id.*

120. Anthony J. Sebok, *supra* note 42, at 108 (citing to Milton C. Regan, Jr., *Lawyers, Symbols, and Money: Outside Investment in Law Firms*, 27 PENN ST. INT'L L. REV. 407 (2008); L. Harold Levinson, *Independent Law Firms That Practice Law Only: Society's Need, the Legal Profession's Responsibility,* 51 OHIO ST. L.J. 229, 248 (1990)).

121. NYCBA Formal Op. 2018-5, *supra* note 4, at 2.

122. Anthony J. Sebok, *supra* note 42, at 106

> The control exercised by a lender can be more than just the power to exercise liens it has on property in the event of default. It could be actively exercised during the life of the loan and in order to govern decisions that are conventionally associated with the management . . . including the deployment of manpower and other resources on behalf of current clients.

123. *See id.*

124. *Id.* ("[F]ailure to comply with the specific payment requirements of bank debt may trigger loan covenants, thus putting the fate of the firm out of the attorneys' hands.").

the perverse incentive that push cash-thirsty law firms to urge their clients to reach an early settlement.

Compared to recourse loans, portfolio financing only includes pre-negotiated terms by two parties that do not undermine the operation of the firm and independent professional judgment of attorneys. Its non-recourse nature, in a way, provides more freedom to law firms and helps them to better serve their clients' interests because they do not worry about the lack of ability to repay a loan.[125]

C. ALTERNATIVELY, STATES SHOULD ADAPT THEIR VERSIONS OF RULE 5.4 TO PROVIDE MORE DYNAMIC FUNDING OPTIONS FOR LAW FIRMS

According to the preceding sections, portfolio funding does not run against with the *Model Rules*. However, bar associations, particularly the ABA, can provide better guidance to lawyers and interested funders to navigate this area through revisions of Rule 5.4.

1. THE LEGAL PROFESSION'S ETHICAL STANDARDS ARE CONSTANTLY EVOLVING

The legal profession is constantly evolving and adapting to the modern world. Finance is an unavoidable issue in the management of a law firm when contingencies cases require risk-taking and upfront investment. New York City Bar Association and Arizona Supreme Court both considered changes to Rule 5.4 to encourage innovation in the legal field.[126] Other Bar Associations across the country should modify or delete Rule 5.4 to unequivocally allow law firms to collaborate with litigation funders through portfolio financing.

2. OTHER MODEL RULES AND TRANSPARENCY SAFEGUARD CLIENTS' INTERESTS

Even if the ABA abrogates Rule 5.4, there are other provisions in the *Model Rules* that safeguard independent professional judgment. For example, Rule 1.8 bars lawyers from accepting compensation from non-clients when there is an interference with lawyers' independent professional judgment.[127]

Rule 1.8 could replace Rule 5.4 to eliminate concerns with third-party interference with lawyer-client while still preserving creative options for law firms to shift their risks and fund their operations.

CONCLUSION

Litigation financing allows "lawsuits to be decided on their merits, and not based on which party has deeper pockets."[128] However, this solution is not

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125. *See id.* at 105 (Portfolio financing helps law firms to spread the risk of failures "over a group of lay investors and not just a portfolio of clients' cases").

126. *Supra* notes 64–85 and accompanying text.

127. MODEL RULES R. 1.8(f)(2).

128. *Hamilton Cap. VII, LLC. I v. Khorrami, LLP*, 22 N.Y.S.3d 137 (N.Y. Sup. Ct. 2015) (citing to *PNC Bank, v. Berg*, 1997 WL 527978, 10 (Del. Super. Ct. 1997).

without its own consequences, many in the form of complex ethical questions. Portfolio financing allows funders to contract directly with law firms. A formalistic and bright-line interpretation of Rule 5.4 does not recognize the shift of history and rejects the possibility for firms to gain this capital without concerning about debt. This Note recommends that the interpretation of Rule 5.4 should focus on whether the funding impacts attorneys' independent professional judgments. Rule 5.4 should still be modified to provide clearer guidance to law firms and their clients, enabling law firms continue their pursuits of meritorious cases.