A Great and Profitable Clause: Why the New York City Bar Association Says It Is Time To Pay Attention to Investors Behind the Curtain*

Litigation finance has rapidly evolved into a contemporary form that has become a multi-billion-dollar business in the United States. The rise of commercial litigation funding has led to the creation of finance firms with the specific intent to generate extreme profits from the American legal system. As the practice continues to experience exponential growth, it is increasingly important to ensure there are sufficient controls over the industry. Though there is currently little to no regulatory oversight, the American Bar Association's Model Code of Responsibility suggests that the rule prohibiting fee sharing between lawyers and nonlawyers should limit litigation finance arrangements that utilize contingent funding agreements. This Comment explores that suggestion and seeks to introduce other regulatory considerations through an analysis of an advisory opinion issued by the New York City Bar Association.

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INTRODUCTION

In the United States, one hundred years of ethical standards have shaped fee sharing arrangements between lawyers and nonlawyers.[1] Under the American Bar Association's *Model Code of Professional Responsibility*, the general standard demands that "[a] lawyer or law firm shall not share legal fees with . . . [nonlawyers]."[2] In other words, lawyers are prohibited from splitting client fees with anyone who is not a lawyer, such as a lender or financier.[3] Presently, all fifty states have adopted similar provisions.[4] The purpose of this rule is to ensure that lawyers are not tempted to act under the guise of client interest when their motivations have actually been improperly influenced by fee sharing arrangements.[5] Thus, the question becomes: What constitutes the undue influence that can ultimately create an impermissible fee sharing arrangement?

Over the last decade, commercial litigation funding[6] has expanded to the United States after its overseas growth in Australia and the United Kingdom.[7] As this contemporary investment practice has continued to rapidly expand, so too have the concerns about the potential for a new age of undue influence controlling modern fee sharing arrangements. The New York City Bar

1. *See generally* ABA CANONS OF PROF'L ETHICS Canon 6 (1908) (requiring lawyers to represent their clients with "undivided fidelity," including limiting their ability to enter into subsequent arrangements).

2. MODEL CODE OF PROF'L RESPONSIBILITY DR 3-102(A) (AM. BAR. ASS'N 1980).

3. Throughout this Comment, "financiers" is used to refer to the third-party individuals who provide capital contributions to fund litigation.

4. All fifty states have a Rule of Professional Conduct specifying a degree of professional independence for lawyers. *See, e.g.*, N.Y. RULES OF PROF'L CONDUCT r. 5.4(a) (2019); N.C. RULES OF PROF'L CONDUCT r. 5.4(a) (2019); VA. RULES OF PROF'L CONDUCT r. 5.4(a) (2019); WIS. SUP. CT. R. 20:5.4(a).

5. *See generally* N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2018-5, at 3 (2018) ("The purpose of the rule against fee sharing is to remove any incentive for nonlawyers to engage in undesirable behavior such as (1) interfering with a lawyer's professional judgment in handling of a legal matter, (2) using dishonest or illegal methods . . . in order to win cases . . . or (3) encouraging or pressuring a lawyer to use such improper methods." (quoting ROY D. SIMON & NICOLE HYLAND, SIMON'S NEW YORK RULES OF PROFESSIONAL CONDUCT ANNOTATED 1420 (2017))).

6. Generally, commercial litigation funding arrangements involve investment commitments ranging from $500,000 to upwards of $20 million with the expectation of payouts exceeding $25 million. STEVEN GARBER, ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWNS, AND UNKNOWNS 16 (2010).

7. *See* Damian Grave & Helen Mould, *Litigation Funding on the Rise*, HERBERT SMITH FREEHILLS (May 23, 2018), https://www.herbertsmithfreehills.com/latest-thinking/litigation-funding-on-the-rise [https://perma.cc/D25E-7Z24].

Association ("NYCBA") recently issued an advisory opinion that called for an examination of these influences and suggested expanding the definition of impermissible arrangements. The NYCBA stated that fee sharing is not permissible when the "lawyer's future payments to the [litigation] 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."[8] Although merely an advisory opinion, the NYCBA's recent interpretation of its version of Rule 5.4(a)[9] spotlights a growing, potential ethical issue in today's legal system.[10]

This Comment describes the rise in litigation finance and analyzes how one bar association—the New York City Bar Association—has characterized this modern investment structure as an impermissible fee sharing arrangement due to the inherent ability of investors to influence litigation and the present lack of sufficient regulatory structures.[11]

Analysis will proceed in four parts. Part I details the rise of litigation finance in the American legal system and the emergence of commercial litigation-finance firms. Part II examines the historical development of the professional responsibility standard for impermissible fee sharing. Part III describes why modern litigation financing should be considered an impermissible nonrecourse loan[12] subject to fee sharing restrictions due to the inherent influence modern-day funders retain over the cases they finance and the lack of regulation of the industry. Finally, Part IV evaluates funders' criticism of this interpretation and argues that such criticism overlooks the idea that investment analysts at these contemporary finance firms are former lawyers whose previous knowledge and experience provide the potential to manipulate litigation in the American legal system.

I. THE DEVELOPMENT OF LITIGATION FINANCE IN THE UNITED STATES

In its most basic sense, litigation finance, or litigation funding, is a loan in which a third party provides financing in exchange for a share of any recovery earned from an underlying lawsuit.[13] Litigation finance is not a new

8. N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2018-5, at 1 (2018).

9. N.Y. RULES OF PROF'L CONDUCT r. 5.4(a) (2019) ("Professional Independence of a Lawyer").

10. Unless otherwise specified, this Comment primarily focuses on the New York City Bar Association's analysis of the State of New York's *Rules of Professional Conduct*.

11. *See infra* Part III.

12. *Non-Recourse Loan*, BUS. DICTIONARY, http://www.businessdictionary.com/definition/non-recourse-loan.html [https://perma.cc/2VPD-LX5F] (defining "non-recourse loan" as a loan secured only by the collateral lent to the borrower which prevents the lender from holding the borrower personally liable upon default).

13. *See* John Freund, *Everything You Ever Wanted To Know About Litigation Finance*, LITIG. FIN. J. (Dec. 27, 2017), https://litigationfinancejournal.com/litfin101/everything-ever-wanted-know-litigation-finance/ [https://perma.cc/9XUY-UEBW].

phenomenon and is not inherently bad. In fact, the NYCBA specifically acknowledged that a traditional recourse loan[14] is a completely valid form of a financing arrangement between a lawyer and nonlawyer.[15] Issues arise when financing arrangements are structured with contingent repayment obligations based on the outcome of the underlying litigation. Thus, the purpose and structure of a loan determines whether a fee sharing arrangement is permissible. The evolution of litigation financing provides greater insight into the distinction between permissible and impermissible arrangements.

A. *The Beginning and Early Evolution*

The earliest recorded instance of litigation financing occurred during the sixth century B.C.E. in Athens, where third-party financiers intervened to help injured parties that could not effectively represent themselves against more powerful entities.[16] Originally, the process was motivated by altruistic intentions to further the public welfare, but over time, abusive practices by private individuals corrupted this original intent.[17] As legal financing began to spread to other civilizations, the practice expanded in scope. The rise of "calumniators"[18] in Ancient Rome created disinterested litigation financiers analogous to modern-day third-party funders.[19] In the Middle Ages, however, rule makers questioned the underlying iniquities of litigation finance and intervened.

In medieval England, feudal lords began taking advantage of their ability to finance lawsuits. These lords would use their financial resources to sponsor lawsuits against their enemies with the hope of receiving an opportunity to gain joint ownership over land in dispute.[20] If financiers were successful, they essentially achieved two victories. First, they obtained power through the acquisition of additional land interests; second, they stripped power from their adversaries. Because of this unfairness, the common law doctrines of barratry, maintenance, and champerty were formed, and these activities were deemed illegal.[21] To understand these rules, a brief summary of important terminology used will help explain how these rules have changed over time. "Barratry is the

14. N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2018-5, at 2 ("[A] traditional recourse loan requir[es] the lawyer to repay the loan at a fixed rate of interest without regard to the outcome of . . . any particular lawsuit or lawsuits.").

15. *See id.*

16. *See* Max Radin, *Maintenance by Champerty*, 24 CALIF. L. REV. 48, 49 (1935).

17. *See id.*

18. *See id.* at 53 (defining "calumniator" as a person who brings an "unnecessary or baseless action[]" or a person "who without authorization bring[s an] action[]. . . with which they have no concern").

19. *See id.* at 52 (describing the Romans' takeover of third-party litigation financing).

20. *See id.* at 60.

21. *See id.* at 64–67.

vexatious incitement to litigation, especially by soliciting potential legal clients."[22] "[M]aintenance is helping another prosecute a suit" and "champerty is maintaining a suit in return for a financial interest in the outcome."[23] These doctrines became the basis for the present-day fee sharing rules.[24]

Today, third-party funding of lawsuits has evolved into four distinct forms: (1) the client-funder arrangement, (2) the lawyer-funder fixed recourse loan, (3) the contingent fixed loan, and (4) the contingent sliding-scale loan. In its advisory opinion, the NYCBA found two of these forms—now commonplace in the modern legal scheme—to be permissible financing arrangements.[25] First, the client-funder arrangement involves a structure where the funder contracts directly with the client, and the client agrees to pay the funder a percentage or set amount if the client wins his or her case.[26] This approach is permissible because the lawyer and nonlawyer share no actual fees; the "Professional Independence of a Lawyer" rule is not implicated because the lawyer is not a party to the arrangement.[27] The second common arrangement is the traditional recourse loan, which has also been established as a permissible form of fee sharing.[28]

In contrast, the two fee sharing arrangements with repayment obligations contingent on a lawyer winning a case have been condemned as impermissible. The first—contingent fixed loan—sets a percentage or fixed fee "that the lawyer will pay . . . only if the lawyer receives legal fees in the matter."[29] The second—contingent sliding-scale loan—is also dependent on the lawyer winning the case, but the amount to be paid is determined after the fact based on an undetermined amount.[30] While litigation funding appears in multiple varieties, the underlying structure is usually based, to some degree, on one of these four methods.

22. *Barratry*, BLACK'S LAW DICTIONARY (11th ed. 2019).

23. *See* Jason Lyon, Comment, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 579 (2010) (internal quotation marks omitted) (quoting *In re* Primus, 436 U.S. 412, 424–25 n.15 (1978)).

24. *See* Robert Barton & Wendy Walker, *Alternative Litigation Finance, Part 2*, 29 PROB. & PROP. 50, 50–51 (2015).

25. *See* N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2018-5, at 2 (2018).

26. *See id.* at 1–2.

27. *See id.* at 2.

28. *See supra* notes 14–15 and accompanying text (determining that the traditional recourse loan is the most commonly used permissible method of fee sharing today).

29. *See* N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2018-5, at 2.

30. *See id.*

B. *Recent History*

Under the newest form of third-party litigation funding, financiers have expanded the practice to unprecedented levels.[31] Today, funders use portfolio investments[32] to mitigate risk and generate multi-million-dollar gains.[33] Financiers "back[] plaintiffs with individual cases as well as portfolios of cases being pursued by a single law firm."[34] While the practice began abroad,[35] it has slowly become part of contemporary litigation practice in the United States.

1. Development in Australia

Investment procedure in Australia has shaped the most recent form of litigation finance in the United States. In the mid-1990s, Australia passed legislation allowing "practitioners to enter into contracts to finance litigation characterized as company property," setting the stage for the present-day financing of litigation.[36] The legislation led to the creation of the first litigation-finance firms, which originated with the specific intent of seeking out profitable lawsuits.[37] Initially, the growth of litigation finance was relatively slow because funders were concerned about the parameters of the insolvency legislation and the ethical boundaries of litigation finance.[38] In 2006, these concerns were cast aside when the "Australian High Court held that third-party litigation funding arrangements served a legitimate purpose in lawsuits and were not an abuse of process or contrary to public policy."[39] After the High Court legitimized these arrangements, the growth of litigation finance exploded.[40] In 2015, third-party funding in Australia accounted for over $3 billion of the $21.1 billion litigation

31. *See* Lake Whillans, *The History and Evolution of Litigation Finance*, ABOVE L. (Jan. 27, 2017), https://abovethelaw.com/2017/01/the-history-and-evolution-of-litigation-finance/?rf=1 [https://perma.cc/3JVR-52UV].

32. "A portfolio investment is a hands-off or passive investment of securities in a portfolio, and it is made with the expectation of earning a return." James Chen, *Portfolio Investment*, INVESTOPEDIA, https://www.investopedia.com/terms/p/portfolio-investment.asp [https://perma.cc/XC3T-SMS9].

33. Sara Randazzo, *The New Hot Law Job: Litigation Finance*, WALL ST. J. (July 5, 2018), https://www.wsj.com/articles/the-new-hot-law-job-litigation-finance-1530783000 [https://perma.cc/EF7Y-AND2 (dark archive)] [hereinafter Randazzo, *The New Hot Law Job*] (reporting that a $12.8 million investment resulted in a $107 million payout).

34. *See id.*

35. *See* Whillans, *supra* note 31.

36. *See id.*

37. *See id.*

38. *See id.*

39. *See id.* The case was *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd*. [2006] 80 ALJR 1441, 1462 (Austl.) ("The Abolition Act abolished the crimes, and the torts, of maintenance and champerty. By abolishing those crimes, and those torts, any wider rule of public policy . . . lost whatever narrow and insecure footing remained for such a rule.").

40. *See id.* ("Today, nearly all major class actions in Australia are funded by private litigation finance companies.").

market.[41] Australia's insurgence of this new-age funding was a significant contributing factor to the creation of litigation finance in the United States.

2. Development in the United Kingdom (UK)

The UK's implementation of funding arrangements was another key reason for the rise of third-party funding in the United States. Two specific events opened the door for litigation finance in the UK. First, the UK's Criminal Law Act of 1967 decriminalized the "doctrines of maintenance," which had prevented uninterested third-party individuals from prosecuting the case of another; and "champerty," which was maintenance in expectation of a profit[42] that had previously prevented third-party funding arrangements.[43] Second, Parliament enacted the Courts and Legal Services Act ("CLSA").[44] The CLSA paved the way for litigation funding by legalizing conditional fee agreements.[45] Although this legislation made it possible for litigation funding to begin, it was not until the late 1990s that the UK saw a proliferation of litigation-finance firms.[46]

In 1999, litigation funding was not a prevalent practice in the UK. With the passage of the 1999 Access to Justice Act ("AJA"),[47] there was an extensive increase in funding, as a central purpose of the AJA focused on expanding the scope of funding arrangements.[48] Prior to the AJA, litigation funding was limited because the practice was confined to conditional fee agreements between a client and lawyer.[49] The AJA sought to change this with three modifications. First, conditional fee agreements were endorsed between parties that were not subject to the lawyer-client relationship and consequently became the sole method for obtaining third-party funding in personal injury cases.[50]

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41. Jason Geisker & Jenny Tallis, *Litigation Funding in Australia: A Year of Review and Change?*, CLAIMS FUNDING AUSTRL. (July 24, 2018), https://claimsfundingaus.com.au/news/litigation-funding-australia-year-review-and-change [https://perma.cc/GW7S-PS6E]; *Litigation Finance in the United States: How It Started*, YIELDSTREET, https://www.yieldstreet.com/resources/article/litigation-finance-in-the-united-states [https://perma.cc/AG9X-BFB9].

42. *See supra* note 22–24 and accompanying text.

43. *See* Criminal Law Act 1967, c. 58, § 14 (Eng.) (failing to change "any rule of law as to the cases in which a contract is to be treated as contrary to public policy or otherwise illegal"); Whillans, *supra* note 31.

44. Courts and Legal Services Act 1990, c. 41, § 58 (Eng.).

45. *See id.* ("A conditional fee agreement which satisfies all of the conditions applicable to it by virtue of this section shall not be unenforceable by reason only of its being a conditional fee agreement.").

46. CHRISTOPHER HODGES, JOHN PEYSNER & ANGUS NURSE, LITIGATION FUNDING: STATUS AND ISSUES 18 (2012), https://www.law.ox.ac.uk/sites/files/oxlaw/litigation_funding_here_1_0.pdf [https://perma.cc/VMR6-3CT8] (detailing how the 1999 AJA led to an increase in litigation funding by making the practice more accessible to the general public).

47. Access to Justice Act 1999, c. 22, §§ 27–28 (Eng.).

48. Whillans, *supra* note 31.

49. *See id*.

50. *See id.*

After the AJA was passed, litigants were no longer permitted to receive civil legal aid in an attempt to increase the use of fee sharing agreements in personal injury cases.[51] Second, the UK's "loser pays" policy[52] was extended so that litigants could "pass . . . fees and insurance premiums associated with [conditional fee agreements] on to their opponents."[53] Finally, the AJA created a new type of insurance which sought to protect litigants from having to pay their opponents' legal fees under the "loser pays" rule in the event that they lost their case.[54] These changes led to a new age in litigation funding.

These remolded fee sharing arrangements, paired with the newly established "after the event" insurance, created a unique situation.[55] Petitioners were now able to find third-party funders to cover all of their cases and insurance companies to cover their losses.[56] Thus, there was very little risk for petitioners, and lawyers had the possibility of reaping huge rewards. As if this was not enough to kickstart the litigation funding revolution, a 2002 opinion found third-party funding to be lawful and ethical in all situations except for when the funding was specifically meant to "undermine the ends of justice."[57] Today, litigation funding in the UK has been referred to as a "feature of modern litigation."[58] The rise in third-party funding created an influx of specific litigation-finance firms, and these firms have ultimately expanded into the United States.

3. Progression to the United States

It is difficult to find exact numbers or figures to explain the growth of litigation finance in the United States because the industry has never been regulated in a fashion comparable to Australia or the UK.[59] However, the practice has been on the rise since the early 1990s,[60] and the first litigation

51. *See id.*

52. Peter Karsten & Oliver Bateman, *Detecting Good Public Policy Rationales for the American Rule: A Response to the Ill-Conceived Calls for Loser Pays Rules*, 66 DUKE L.J. 729, 736 (2016) (establishing that "the 'loser pays' . . . rule may have begun in 1278" and directs defendants to pay costs to successful plaintiffs (citing Statute of Gloucester 1278, 6 Edw., c. 1)).

53. Whillans, *supra* note 31.

54. HODGES ET AL., *supra* note 46, at 18.

55. *See id.* ("[Because of the AJA] in 1999, . . . the full [conditional fee agreement] fee and [after-the-event insurance] premium [became] recoverable from the defendant.").

56. *See id.*

57. *See* R. (Factortame Ltd.) v. Sec'y of State for Transp., [2002] EWCA (Civ) 932 (Eng.).

58. Excalibur Ventures v. Texas Keystone, [2016] EWCA (Civ) 1144 [1] (Eng.).

59. *See* Ronen Avraham & Anthony Sebok, *An Empirical Investigation of Third Party Consumer Litigant Funding*, 104 CORNELL L. REV. 1133, 1139–40 (2019).

60. Jenna Wims Hashway, *Litigation Loansharks: A History of Litigation Lending and a Proposal To Bring Litigation Advances Within the Protection of Usury Laws*, 17 ROGER WILLIAMS U. L. REV. 750, 753–54 (2012).

financers were influenced by the success of the practice in those countries.[61] In the early days, lenders led grassroots efforts all over the country, attempting to find deserving plaintiffs and generate promising returns.[62] The first expansion efforts were often referred to as the "Wild West" period because there were few rules combined with many people seeking the lucrative cases.[63] Perry Walton, sometimes called the "godfather" of American litigation finance, was one of the first funders to capitalize on this movement.[64] Walton opened a second business where he loaned plaintiffs money for litigation as "contingent obligations" and also began leading seminars where he trained hundreds of people on how to find cases that would generate these returns.[65]

By the mid-2000s, underhanded lending tactics raised ethical concerns about the process of funding litigation.[66] In 2004, these concerns led to proactive self-regulation and the creation of the American Legal Finance Association with the purpose of "promoting fair, ethical, and transparent funding standards to protect legal funding consumers."[67] These proactive efforts marked a turn where the industry, through self-regulation, began to make small compromises or changes in order to stay ahead of legislative reform.[68] However, this self-regulatory framework also prevented the industry from expanding too quickly.[69] Over time, three periods of development have shaped modern litigation funding.

First, the early days of litigation finance were controlled by individual investors funding single personal injury claims.[70] As the industry evolved, the cases and stakes grew.[71] The more prominent financiers began to focus on "one-off tort suits" with possible payouts in the millions; as the payouts increased, institutional investors began to take notice, which ultimately led to the second large development—commercial litigation funding.[72] Commercial litigation

61. *See* Marco de Morpurgo, *A Comparative Legal and Economic Approach to Third-Party Litigation Funding*, 19 CARDOZO J. INT'L & COMP. L. 343, 360 (2011).

62. *Litigation Finance in the United States: How It Started*, *supra* note 41.

63. *See* Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 FORDHAM J. CORP. & FIN. L. 55, 55 (2004).

64. Hashway, *supra* note 60, at 754 ("Walton made his first foray into extortionate lending with a business he named Wild West Funding.").

65. *See id.* (approximating that Walton had trained over 400 people by the year 2000).

66. *See id.* at 768 (highlighting a court's concern over the ability of litigation finance companies to victimize plaintiffs).

67. *About ALFA*, AM. LEGAL FIN. ASS'N, https://americanlegalfin.com/about-alfa/ [https://perma.cc/7ZJ6-CCR6].

68. *See* Hashway, *supra* note 60, at 774.

69. *See Litigation Finance in the United States: How It Started*, *supra* note 41.

70. Tara E. Nauful, *Third-Party Litigation Financing: Do We Need It? Is It Worth the Risks?*, AM. BANKR. INST. J., May 2016, at 16.

71. *See id.*

72. *See id.*

funding[73] was created as a result of the newfound interest in higher payouts.[74] By 2000, "large banks, hedge funds, pension funds, and insurance companies" were all funding litigation.[75] This development led to a paradigm shift where institutional investors turned away from the one-off tort suits and began to focus on corporate commercial litigation.[76] The final shift, which has led to a massive increase in litigation funding, was the establishment of the contemporary litigation-finance firms.[77] Utilizing portfolio investing, these firms have been able to raise hundreds of millions of dollars from outside investors to generate massive returns with very little risk.[78]

4. Recent Explosion in the United States

What started out as a modest practice has escalated quickly in recent years.[79] Firms raise pools of funding, consisting of hundreds of millions of dollars, to invest in corporate litigation.[80] Between 2013 and 2016, the number of lawyers who reported having used litigation finance in their practice is said to have increased by 400%.[81] Originally, these firms funded cases in the same way that Perry Walton backed personal injury cases in the early 1990s.[82] Firms raised money and made payments to corporations and other institutions to be used for individual cases. However, the practice evolved into its newest form

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73. *See id.* ("In [consumer litigation funding], funders provide corporate plaintiffs with financing to pursue potentially lucrative—but costly—litigation without a corresponding risk to the company's bottom line.").

74. *See id.*

75. *Litigation Finance in the United States: How It Started*, *supra* note 41; Sara Randazzo, *Litigation Financing Attracts New Set of Investors*, WALL ST. J. (May 15, 2016), https://www.wsj.com/articles/litigation-financing-attracts-new-set-of-investors-1463348262?mod=article_inline [https://perma.cc/BFS4-59SA (dark archive)] [hereinafter Randazzo, *Litigation Financing*] ("Pension funds, university endowments, family offices and others have collectively pumped more than a billion dollars into the sector in recent years.").

76. *See* Nauful, *supra* note 70, at 16 (defining corporate litigation as an amount so significant it would negatively impact a "company's bottom line"); Grave & Mould, *supra* note 7.

77. *See* Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1269, 1277 (2011).

78. Sara Randazzo, *Investors Flock To Back Lawsuits in Exchange for a Cut of Settlements*, WALL ST. J. (Sep. 18, 2017), https://www.wsj.com/articles/litigation-funder-longford-raises-500-million-as-industry-surges-1505707261?mod=article_inline [https://perma.cc/2W4G-AF5V (dark archive)] [hereinafter Randazzo, *Investors*].

79. *See* Randazzo, *Litigation Financing*, *supra* note 75 (detailing how one litigation-finance firm provided a single law firm over $100 million).

80. *See* Ralph Lindeman, *Third-Party Investors Offer New Funding Source for Major Commercial Lawsuits*, FULBROOK CAP. MGMT., LLC, (Mar. 5, 2010), http://fulbrookmanagement.com/third-party-investors-offer-new-funding-source-for-major-commercial-lawsuits/ [https://perma.cc/LX5D-35KN].

81. *See* Joshua Hunt, *What Litigation Finance Is Really About*, NEW YORKER (Sept. 1, 2016), https://www.newyorker.com/business/currency/what-litigation-finance-is-really-about [https://perma.cc/93Q7-ABE6].

82. *See* Steinitz, *supra* note 77, at 1277.

where litigation-finance firms fund portfolios of cases within a specific institution or law firm.[83] The shift from stand-alone investments to portfolio investments has expanded rapidly. In 2017, a leading litigation-finance firm invested "$726 [million] into portfolio deals, compared with [its] $72 [million investment] into stand-alone suits."[84] The newest form of litigation funding presents even less risk to investors while still maintaining the ability for firms specializing in litigation finance to secure massive rewards.[85]

Over the last few years, roughly thirty new litigation-finance firms have opened their doors in the United States.[86] During the same period, these new firms have raised over $2 billion to fund litigation with the intent of "packaging lawsuits into portfolios."[87] Because of the recent success, funders are raising more and more capital so that they can expand portfolios while generating quicker returns for their investors.[88] This strategy offers two immense benefits for funders. First, it allows firms to mitigate risk because multimillion-dollar investments are no longer tied to the all-or-nothing investment format.[89] Instead, investors provide larger capital contributions to the law firm or institution to distribute among a variety of cases and, thus, maximize the chance to recoup their investments.[90] Second, because funders are dispersing larger amounts of money, they are generating returns much more quickly, which has ultimately allowed them to raise capital at an unprecedented rate.[91]

Lawyers are leaving top-paying legal jobs and flocking to coveted positions in litigation finance[92] because of the extreme profits and the serious demand for knowledgeable employees.[93] The newest litigation-finance firms are full of attorneys, many of whom are former partners at some of the most respected law firms in the country, such as Wachtell, Lipton, Rosen & Katz; Latham &

83. *See* Randazzo, *Litigation Financing*, *supra* note 75 ("Rather than betting on one-off lawsuits, today's funders are scaling up and backing large portfolios of cases to deploy money faster and create more consistent returns for their own investors.").

84. *Appealing Returns: Litigation Finance Offers Investors Attractive Yields*, ECONOMIST (Aug. 18, 2018), https://www.economist.com/finance-and-economics/2018/08/18/litigation-finance-offers-investors-attractive-yields [https://perma.cc/5A2T-ZLSU].

85. Randazzo, *Investors*, *supra* note 78.

86. *Appealing Returns: Litigation Finance Offers Investors Attractive Yields*, *supra* note 84.

87. *See id.*; Randazzo, *Investors*, *supra* note 78.

88. *See* Randazzo, *Litigation Financing*, *supra* note 75.

89. Christopher P. Bogart, *The Case for Litigation Financing*, LITIG., Spring 2016, at 46, 48.

90. *See id.*

91. *See* Thomas J. Salerno & Jordan A. Kroop, *Third-Party Litigation Funding: Where Do We Go Now?*, 37 AM. BANKR. INST. J., Mar. 2018, at 3.

92. Randazzo, *The New Hot Law Job*, *supra* note 33.

93. *See id.* The average expected return for every dollar invested is roughly $2.70 within thirty months. Randazzo, *Litigation Financing*, *supra* note 75. Likewise, in 2017, the largest litigation-finance firm in the industry experienced a 170% increase to their six-month profits. Randazzo, *Investors*, *supra* note 78 (finding also that Buford Capital earned $142.7 million in profit during the first half of 2017).

Watkins LLP; and Proskauer Rose LLP.[94] Looking at the websites of the top litigation-finance firms, it is often difficult to determine whether one is looking at a law firm or an investment firm because so many employees are advertised in their respected legal capacities.[95] These finance firms have been so successful at raising capital that they have had to turn away potential investors.[96] The new influx in capital is giving firms the freedom to adapt and develop new, creative investment strategies within the industry.[97] While some firms have used the newly acquired funds to expand their investment strategies through the development of boutique firms and the acquisition of new lawyers-turned-investors, others have employed more unique methods, such as using a potential litigation proceeding to leverage an acquisition.[98] Because of the recent growth in the industry, litigation-finance firms now have a freedom and opportunity to manipulate American litigation that they did not have in the past.[99]

II. HISTORY OF PROFESSIONAL FEE-SHARING PROHIBITIONS

The origin of the American Bar Association ("ABA") implementing rules to protect against fee sharing can be traced back to the 1908 *Canons of Professional Ethics*.[100] However, the basis for Disciplinary Rule ("DR") 3-102(A) dates back to the common law doctrines of barratry, maintenance, and champerty that were created in the Middle Ages to protect clients against interference from third parties who had a superior knowledge of the legal system.[101] Although some scholars argue the original purposes of these doctrines may be antiquated,[102] the

94. Randazzo, *The New Hot Law Job*, *supra* note 33.

95. *See, e.g.*, *Meet the IMF Bentham Team, United States*, IMF BENTHAM, https://www.imf.com.au/about/meet-the-team [https://perma.cc/Y8R7-E2QZ] (listing "legal counsel" as an employee title for all United States employees but one); *Search the Team*, *United States*, BURFORD CAP., http://www.burfordcapital.com/directory/?location=1 [https://perma.cc/S3AV-VVJM] (advertising employees' former legal titles and positions on the biographies home page).

96. *See* Randazzo, *Investors*, *supra* note 78 ("Longford [Capital Management LP] said it attracted enough interest from investors to raise $1 billion for the recently closed fund, . . . but decided to cap it at half that.").

97. *See* Randazzo, *Litigation Financing*, *supra* note 75.

98. *See id.*

99. *See id.*

100. While Disciplinary Rule 3-102(A) is the ABA's first specific rule prohibiting fee sharing, the "undivided fidelity" required by the 1908 *Canons of Professional Ethics* is thought to be the first barrier to such arrangements. *See infra* text accompanying note 104; *see also* Edward S. Adams & John H. Matheson, *Law Firms on the Big Board?: A Proposal for Nonlawyer Investment in Law Firms*, 86 CALIF. L. REV. 1, 4 (1998) (suggesting that, although the original *Canons of Professional Ethics* did not specifically account for "whether practicing lawyers could enter into business associations with nonlawyers," the foundation for future developments was laid in 1908).

101. *See* Lyon, *supra* note 23, at 580.

102. *Cf. id.* at 579–80 ("[T]he evolution of the doctrines from the common law to the modern day . . . shows that they are out of step with our contemporary beliefs about litigation.").

guiding principles maintain their roots in the present-day rule against fee sharing with nonlawyers.[103]

As fee-sharing arrangements have progressed over the last century, lawyers have consistently been required to pledge fidelity to their clients by avoiding any "matters adversely affecting any interest of the client with respect to which confidence has been reposed."[104] The original *Canon of Professional Ethics* advised lawyers to avoid all undue influence from third parties and to remain impartially dedicated to their clients' interests. With the adoption of Canon 34 two decades later, the ABA specifically prohibited fee sharing between a lawyer and a nonlawyer for the first time[105] and thereby solidified the previous beliefs that such fee sharing would constitute an adverse client interest.[106] In 1969, the ABA modified Canon 34 by adopting the *Model Code of Professional Responsibility* and codifying DR 3-102(A).[107] Today, the rule against fee sharing generally protects against three undesirable behaviors: "(1) interfering with a lawyer's professional judgment in handling of a legal matter, (2) using dishonest or illegal methods . . . in order to win cases[,] . . . or (3) encouraging or pressuring a lawyer to use such improper methods."[108] The implicit influence associated with the first behavior seems to have been the most prevalent concern when the ABA created rules prohibiting fee-sharing arrangements; however, the explicit influence underlying the second and third behaviors has gained more attention in recent years.

A. *The Modern Standard for Prohibiting Fee Sharing*

When lawyers represent clients, they are bound by a fiduciary duty "of the highest degree;"[109] therefore, lawyers must exercise their professional judgment solely on behalf of their clients.[110] Today, the profession assumes fee sharing with a nonlawyer splits a lawyer's interests and interferes with a lawyer's professional judgment with regard to his or her clients.[111] More specifically,

103. *See* 14 AM. JUR. 2D *Champerty, Maintenance, and Barratry* § 1, Westlaw (database updated Nov. 2019) (citing Hardick v. Homol, 795 So. 2d 1107, 1110–11 (Fla. Dist. Ct. App. 2001)).

104. *See* CANONS OF PROF'L ETHICS Canon 6 (AM. BAR ASS'N 1908).

105. *See* CANONS OF PROF'L ETHICS Canon 34 (AM. BAR ASS'N 1928).

106. *See* Roy D. Simon, Jr., *Fee Sharing Between Lawyers and Public Interest Groups*, 98 YALE L.J. 1069, 1079–80 (1989) ("[N]o division of fees for legal services is proper, except with another lawyer, based upon a division of service or responsibility." (internal quotation marks omitted) (quoting CANONS OF PROF'L ETHICS Canon 34 (AM. BAR ASS'N 1928))).

107. *See id.* at 1082.

108. SIMON & HYLAND, *supra* note 5, at 1420.

109. *See* Lisa Miller, *Perils of Third-Party Funding*, L.A. LAW., Mar. 2017, at 19.

110. *See, e.g.*, ABA Comm'n on Ethics 20/20, Informational Report to the House of Delegates 4 (Feb. 2012) (citing MODEL RULES OF PROF'L CONDUCT r. 2.1 (AM. BAR ASS'N 2011)) https://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111212_ethics_20_20_alf_white_paper_final_hod_informational_report.pdf [https://perma.cc/GV8S-PK6P (staff-uploaded archive].

111. *See id.* at 29.

when bar associations attempt to protect against fee sharing, they seem to enact such policies under the belief that when a lawyer engages in fee sharing, he or she—either directly or indirectly—sacrifices some degree of judgment to ensure that his or her funders will recoup their investment.[112] The current rules in the *Rules of Professional Conduct* pertaining to fee sharing are designed to protect a number of client interests,[113] and a fee-sharing arrangement that results in a lawyer surrendering any portion of their earnings to a third party could potentially jeopardize those interests.

Legal scholars have expanded on these concerns by highlighting situations where fee sharing with nonlawyers will do more harm than simply requiring a lawyer to sacrifice some level of judgment.[114] In these situations, the fear is that these relationships with a third party incentivize lawyers to act dishonestly or even illegally. The concern over this more explicit manipulation is not unfounded. In *Rancman v. Interim Settlement Funding Corp.*,[115] the Supreme Court of Ohio found that this type of manipulation had occurred when it held that a settlement offer presented to the client was beneficial to the client's lawyer and financier but was detrimental to the client.[116] A lawyer should not be influenced by a third party's desire to impact a case because of "political, ideological, or personal beliefs."[117] In theory, fee sharing is supposed to create disinterested investors; in practice, the arrangements create extraneous relationships between lawyers and financiers that can supersede the relationships between clients and attorneys.[118]

All fifty states have adopted or expanded the ABA's DR 3-10(A) to provide a rule of conduct similar to New York's Rule 5.4(a) stating that "[a] lawyer or law firm shall not share legal fees with a nonlawyer."[119] While state bar associations have issued countless informal opinions commenting on the scope of impermissible fee sharing, ethics committees from only a few state bar associations have concentrated specifically on litigation funding.[120] States

112. *See id.* at 22 (suggesting that the funder's goal of maximizing their investment cannot be entirely isolated from the litigation proceeding).

113. *See id.* at 15 (stating that the rules are designed to protect a client's "confidentiality of information . . . , the reasonable expectation of loyalty of counsel, and the interest in receiving candid, unbiased advice").

114. *See, e.g.*, Victoria Shannon Sahani, *Judging Third-Party Funding*, 63 UCLA L. REV. 388, 401–02 (2016) (indicating that undisclosed funding opens the door for "disastrous" manipulation).

115. 789 N.E.2d 217 (Ohio 2003).

116. *Id.* at 220.

117. W. Bradley Wendel, *Paying the Piper but Not Calling the Tune: Litigation Financing and Professional Independence*, 52 AKRON L. REV. 1, 4 (2018).

118. *See id.*

119. *See* N.Y. RULES OF PROF'L CONDUCT r. 5.4(a) (2019) ("Professional Independence of a Lawyer"). This Comment specifically highlights New York's rule of conduct because of its importance in Formal Opinion 2018-5 issued by the NYCBA.

120. *See, e.g.*, ABA Comm'n on Ethics 20/20, *supra* note 110, at 24–25.

disagree as to what constitutes impermissible fee sharing with regard to litigation funding under a contingent interest.[121] Some states consider it to be a violation of the *Rules of Professional Conduct* for a litigation funder to take a contingent interest in a case where the lawyer has a contingent fee agreement with the client.[122] However, other states have been more lenient on this position.[123] The NYCBA appears to be one of the first bar associations to focus on the magnitude of fee sharing stemming from modern litigation funding. Its recent opinion is an attempt to specifically interpret how the practice should be governed under the *Rules of Professional Conduct*.[124]

B. *The Progression of the Rule Against Fee Sharing in New York*

The New York State Bar Association has actively attempted to define the scope of impermissible fee-sharing arrangements under its rules. To date, the state bar association has deemed numerous activities impermissible under the prohibition against fee sharing. Such activities include client recruitment and the solicitation of services,[125] determining marketing fees based on fees generated from individual clients,[126] and crowdfunding or other fundraising activities.[127] Furthermore, the NYCBA has expanded on the tenets underlying these bans by further prohibiting fee-sharing arrangements with nonlawyers who provide administrative services[128] and for arrangements with a landlord for rental payments.[129] The New York State Bar Association has made it clear that arrangements of these types are only impermissible when they are arranged under certain contingencies related to specific clients.[130] For example, New York allows lawyers to pay for particular services.[131] However, under Rule 5.4(a), a lawyer must consider two issues in order to ensure compensation agreements

121. *See id.* at 29.

122. *See e.g.*, Va. State Bar Ass'n Standing Comm. on Legal Ethics, Legal Ethics Op. 1764 (2002).

123. *See* Ky. Bar Ass'n Ethics Comm., Ethics Op. KBA E-432, at 7 (2011).

124. N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2018-5 (2018).

125. *See* N.Y. State Bar Ass'n Comm. on Prof'l Ethics, Op. 917, ¶ 4 (2012) ("[T]he law firm [can] not pay a bonus to an employee-marketer that is based on the referral or recommendation of specific clients.").

126. N.Y. State Bar Ass'n Comm. on Prof'l Ethics, Op. 992, ¶ 16 (2013) ("Payment of a percentage of firm profits for a specific matter is tantamount to fee sharing and is not permitted.").

127. N.Y. State Bar Ass'n Comm. on Prof'l Ethics, Op. 1062, ¶ 17 (2015) ("Any form of fundraising that gives the investor an interest in a law firm or a share of its revenue would be prohibited.").

128. N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2015-1, at 6 (2015) ("[A]ny payment arrangement with a [professional employer organization] must be structured so it complies with the rule against fee-sharing.")

129. N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2018-5 (2018) ("[A] lawyer may not agree to pay [a] landlord [with a] percentage of [the] firm's revenues as office rent." (citing N.Y. County Lawyers Ass'n Comm. on Prof'l Ethics, Formal Op. 697 (1993))).

130. N.Y. State Bar Ass'n Comm. on Prof'l Ethics, Op. 992, ¶ 16.

131. *See id.* ¶ 10 ("[T]he lawyer may enter into an agreement to compensate the business owner for marketing or other services.").

are permissible. First, nonlawyers may not be paid a "commission or percentage based upon the volume of business developed."[132] Second, a nonlawyer may only receive a percentage of a lawyer or law firm's overall profits.[133] Thus, it is considered impermissible fee sharing for a lawyer and nonlawyer to enter a compensation agreement based on fees earned from a specific client associated with the service provided by the nonlawyer.[134] In its recent opinion on the subject, the NYCBA decided that funding a case on a contingent interest is essentially taking a percentage of an all-or-nothing stake in a client and should be considered impermissible.[135] Thus, the litigation-finance practices employed by firms operating under the contemporary contingency standards should likely be considered impermissible under Rule 5.4(a).

III. WHY NON-RECOURSE INVESTMENT POOLING IS IMPERMISSIBLE

Not all fee-sharing arrangements between a lawyer and nonlawyer are impermissible.[136] Instead, issues arise when fee-sharing arrangements are structured in a way that the funder receives a contingent interest in the stakes of the litigation because there is no way to ensure that lawyers will remain loyal to their clients.[137] According to the NYCBA in Formal Opinion 2018-5, the New York Rule of Professional Conduct prohibiting a lawyer (or law firm) from sharing legal fees with a nonlawyer[138] "is equally applicable when the lawyer's payment to the funder is based on the recovery of legal fees in multiple matters . . . as opposed to a single matter."[139] The NYCBA's underlying theory is based on the central prohibition against fee sharing. When funders provide financing to a lawyer for more than one matter, the funder still retains the incentive to improperly influence and might even retain the ability to manipulate. In Opinion 2018-5, the NYCBA acknowledged that its interpretation of Rule 5.4(a) could be considered overly expansive;[140] however, it unequivocally determined that "[n]othing in the language, history or prior interpretations of Rule 5.4(a) supports an interpretation carving out litigation funding arrangements."[141]

132. *See* N.Y. State Bar Ass'n Comm. on Prof'l Ethics, Op. 565, ¶ 9 (1984).

133. *See* N.Y. State Bar Ass'n Comm. on Prof'l Ethics, Op. 887, ¶ 11 (2011).

134. *See* N.Y. State Bar Ass'n Comm. on Prof'l Ethics, Op. 992, ¶ 14.

135. *See* N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2018-5 (2018) ("A nonrecourse financing agreement secured by legal fees in a matter . . . constitutes an impermissible fee-sharing arrangement regardless of how the lawyer's payments are calculated.").

136. *See supra* text accompanying notes 25–30.

137. *See* N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2018-5, at 5–6 ("[W]hen nonlawyers have a stake in legal fees from particular matters, they have an incentive or ability to improperly influence the lawyer.").

138. N.Y. RULES OF PROF'L CONDUCT r. 5.4(a) (2017).

139. N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2018-5, at 5.

140. *See id.* at 6.

141. *See id.*

Opinion 2018-5 is important because it sheds light on how a rapidly growing component of the modern legal culture might actually be unethical and ultimately impermissible. Today, there are a few reasons to be concerned with the ability of litigation funders to exert improper influence on the cases they finance. One of the biggest concerns is that the modern system of litigation finance is dominated by former lawyers with a working knowledge of how to control the financed cases. The current litigation funding system is structured such that, technically, nonlawyers lend money to lawyers. However, because of funders' previous experience in the legal field, the modern application of the rule might be more effective if the rule actually protected against outside lawyers lending to other lawyers.

A. *Influences Elicited by the Modern Investor*

Ethical standards and expertise are foundational barriers to becoming a lawyer. As American lawyer and legal scholar John Wigmore wrote, "The Law as a pursuit is not a trade. It is a profession. It ought to signify for its followers a mental and moral setting apart from the multitude,—a priesthood of Justice."[142] For decades, being a lawyer has been a revered career characterized by certain occupational expertise and status. Because of this, lawyers—or "litigation engineers"[143]—are expected to provide a specialized service unique to any other individual.[144] When examining the potential variables and outcomes of a case, lawyers are "best able to assess [the] merits and probable outcome[s]."[145] Thus, the current wave of litigation-finance firms, comprised of former lawyers with decades of experience, would appear to have an inherent advantage when investigating which cases to fund because these lawyers have insight into the effect that their investments might ultimately have on the funded litigation.[146]

Although employees of these firms understand that they are not practicing law, there is no doubt that a thorough knowledge of the legal profession is seen as a decisive factor for being successful within the industry.[147] The current landscape of litigation funding allows investors to use their unparalleled,

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142. John H. Wigmore, *Introduction* to ORRIN N. CARTER, ETHICS OF THE LEGAL PROFESSION, at xxi (1915).

143. *See* Radek Goral, *Justice Dealers: The Ecosystem of American Litigation Finance*, 21 STAN. J.L. BUS. & FIN. 98, 119 (2015).

144. *See id.* ("[Lawyers] put the facts together, evaluate them, and build a case for the represented client.").

145. *Id.*

146. *See* Randazzo, *The New Hot Law Job*, *supra* note 33; *see also infra* note 150–54 and accompanying text.

147. *See* Randazzo, *The New Hot Law Job*, *supra* note 33 ("I understand I'm not going to be practicing law, but there's nothing to stop me from being able to share my knowledge to help achieve a great result in these cases.").

practical knowledge of the legal industry and apply their knowledge to an investment setting through the litigation proceedings of a third party.[148] The results of the cases backed by modern funders are illustrative of the fact that former-lawyers-turned-investors are well versed in picking which cases will yield successful outcomes for their firms. For example, over the last decade, Longford Capital, a leading private investment company, has invested nearly $150 million into 102 separate lawsuits; of these cases, forty-three settled or were resolved without having to go to court, thus generating quick and efficient returns for the firm.[149] While these figures do not support the causal inference that financiers are forcing settlements, the continued growth of litigation finance and the more than 40% settlement rate in the preceding example, taken together, indicate a strong correlation between third-party funders and a propensity towards settlement.

Presently, these nonpracticing attorneys spend their days combing through court records and soliciting legal contacts from their prior professions.[150] However, because investors have very specific criteria for choosing cases, they select only a small number of cases to finance.[151] Certain firms have even been able to code these specifications into algorithms that flag potential cases based on profitability factors, such as a specific law firm or the type of claim being filed.[152] In a sense, these investors are using their expertise as lawyers to continuously search for cases that, if funded, will ultimately generate a favorable return from a settlement, judgment, or fee award.[153] Investors are acutely aware that third-party funding can impact litigation by actually "mak[ing] it harder and more expensive to settle cases."[154] Thus, when a third party finances a case, the actual act of funding the proceeding can have a determinative outcome on the result of the case—such as whether or not it will settle. This is ultimately a form of manipulation or, at the very least, some level of influence.

Again, the purpose of the rule against fee sharing is to protect against "(1) interfering with a lawyer's professional judgment in handling of a legal matter,

148. *See Why Big Law Litigators Are Making the Move to the Litigation Finance Industry*, BENTHAM IMF (Sept. 6, 2017), https://www.benthamimf.com/blog/blog-full-post/bentham-imf-blog/2017/09/06/why-big-law-litigators-are-making-the-move-to-the-litigation-finance-industry [https://perma.cc/2Y5G-N2LM].

149. *See* Randazzo, *Investors*, *supra* note 78.

150. *See* Randazzo, *The New Hot Job*, *supra* note 33.

151. *See* Lindeman, *supra* note 80 (detailing the process and selectivity of choosing which cases to fund).

152. Randazzo, *Investors*, *supra* note 78 (suggesting that "creditworthiness of [a] defendant" is another factor that an algorithm might flag).

153. *See* Jacob Gershman, *Lawsuit Funding, Long Hidden in the Shadows, Faces Calls for More Sunlight*, WALL ST. J. (Mar. 21, 2018 8:00 AM), https://www.wsj.com/articles/lawsuit-funding-long-hidden-in-the-shadows-faces-calls-for-more-sunlight-1521633600 [https://perma.cc/S93P-YC9V (dark archive)].

154. *See id.* (quoting the chief investment officer of IMF Bentham's U.S. division).

(2) using dishonest or illegal methods . . . in order to win cases . . . or (3) encouraging or pressuring a lawyer to use such improper methods."[155] It could easily be considered a dishonest or encouraging method to provide financing for a litigation proceeding with the understanding that the funds will elicit a certain outcome. This becomes even clearer when investors operate under the appearance of being uninvolved third-party investors but have the knowledge to understand and anticipate that their contributions will likely have a significant and profitable impact.

B. *Recent Attempts at Reformation*

The idea that litigation funders are able to manipulate the American litigation system through third-party financing is not new. In 2017, the U.S. Chamber of Commerce petitioned to change the Federal Rules of Civil Procedure regarding the disclosure of third-party financing arrangements.[156] The organization made the same requests in both 2014 and 2016 but was denied.[157] The latest request was based on the idea that disclosure of the source of funding is necessary to ensure impartiality in light of the industry's exponential growth in recent years.[158] In its letter to the U.S. Courts' Committee on Rules of Practice and Procedure Committee, the Chamber urged for change on the basis that third-party litigation is currently able to skirt the ethical boundaries of the law due to a lack of regulators and disclosure regulations.[159] Its request argued that the current system creates an inherent conflict of interest by concealing the "real party . . . interest[s] that may be steering a plaintiff's litigation strategy and settlement decisions."[160]

155. SIMON & HYLAND, *supra* note 5, at 1420.

156. Alison Frankel, *Business Lobby Calls for Federal Rules To Require Litigation Funding Disclosure*, REUTERS (June 2, 2017), https://www.reuters.com/article/us-otc-funding/business-lobby-calls-for-federal-rules-to-require-litigation-funding-disclosure-idUSKBN18T2QR [https://perma.cc/5SEQ-VHLA]. The petition seeks to change Rule 26 of the Federal Rules of Civil Procedure by requiring disclosure of "any agreement under which any person, other than an attorney permitted to charge a contingent fee representing a party, has a right to receive compensation that is contingent on, and sourced from, any proceeds of the civil action, by settlement, judgment or otherwise." Garrett Ordower, *Update: Rules Governing Disclosure of Litigation Finance*, ABOVE L. (Feb. 12, 2018), https://abovethelaw.com/2018/02/update-rules-governing-disclosure-of-litigation-finance/?rf=1 [https://perma.cc/YGS2-LR65].

157. *See* Ordower, *supra* note 156.

158. *See* Frankel, *supra* note 156. ("The business groups contend that the increased prevalence, profitability and diversification of outside funding arrangements prove the need for a rule change to require robust disclosure.").

159. Letter from Lisa A. Rickard, President, U.S. Chamber Inst. for Legal Reform, to Rebecca A. Womeldorf, Sec'y of the Comm. on Rules of Practice and Procedure of the Admin. Office of the U.S. Courts (June 1, 2017), http://filehost.thompsonhine.com/uploads/Proposal-to-Amend-Rule-26-for-Third-Party-Litigation-Funding-Disclosure_53eb.pdf [https://perma.cc/5KWM-8XPU].

160. *See id.*

The Chamber is not the only institution attempting to initiate change to the regulation of litigation finance. In February of 2019, U.S. Senators Chuck Grassley (Iowa), John Cornyn (Texas), Ben Sasse (Nebraska), and Thom Tillis (North Carolina) reintroduced a bill which would require disclosure of third-party litigation financing.[161] The Litigation Funding Transparency Act of 2019 would require disclosure of "the identity of any commercial enterprise, other than a class member or class counsel of record, that has a right to receive payment that is contingent on the receipt of monetary relief . . . by settlement, judgment, or otherwise."[162] Senator Grassley's proposal would require only the disclosure of third-party funding for class action and multidistrict litigation.[163] Both proposals seem to advance the notion that increased transparency would allow clients to see who is pulling the strings behind the curtain and ultimately avoid any possible influence from a party operating outside of the actual proceeding. Although the proposed bill's reform efforts do not encompass the full scope sought by the U.S. Chamber of Commerce, the underlying reasons for Senator Grassley's suggested reformation parallel those driving the U.S. Chamber of Commerce in its efforts for litigation-finance reform.[164]

Senator Grassley and the Chamber emphasize another reason in their requests for the disclosure of third-party funding arrangements: the total lack of regulation of the industry.[165] It is indisputable that litigation-financing arrangements constitute some form of an investment product. Funders supply capital to lawyers with an expectation of taking a portion of the profits and generating large returns.[166] Yet, these arrangements are not regulated the same as comparably structured investments.[167] At a minimum, modern funding arrangements should be subject to some form of financial regulation.

C. *An Overlooked Method of Regulation*

Classifying third-party funding as a security is one potential mechanism for regulatory oversight. The Securities Act of 1933 defines what constitutes a security[168]: "any note, stock, treasury stock, . . . or participation in *any profit-*

161. Litigation Funding Transparency Act of 2019, S. 471, 116th Cong. (2019).

162. *Id.*

163. *See id.*

164. *See Grassley, Tillis, Cornyn Introduce Bill To Shine Light on Third Party Litigation Financing Agreements*, CHUCK GRASSLEY (May 10, 2018), https://www.grassley.senate.gov/news/news-releases/grassley-tillis-cornyn-introduce-bill-shine-light-third-party-litigation [https://perma.cc/6SXC-P9XB] ("[L]itigation funding agreements have secretly funneled money into our civil justice system, all for the purpose of profiting off someone else's case.").

165. *Compare id.* ("Third party litigation funding . . . is largely unregulated and subject to little oversight."), *with* Letter from Lisa A. Rickard to Rebecca A. Womeldorf, *supra* note 159 ("Absent robust disclosure requirements, TPLF will continue to operate in the shadows.").

166. *See* Randazzo, *Investors*, *supra* note 78.

167. *See infra* Section III.C.

168. 15 U.S.C. § 77b(a)(1) (2018).

sharing agreement . . . ."[169] Although there has been some disagreement as to whether litigation funding should be classified as a loan or equity arrangement,[170] the language of the Act should presumably apply to either classification. Because these new-age funding arrangements constitute some type of profit sharing, the statutory provision appears to apply to any practical interpretation of litigation finance.

To date, there has been little to no consensus as to whether litigation funding should constitute a security under the Act. However, when comparing the statutory construction of profit sharing to other terms from the Act, there is a clear argument that these agreements should be presumed to be securities unless proven otherwise. In *Landreth Timber Co. v. Landreth*,[171] the Supreme Court held that "the plain meaning of the statutory definition mandates that the stock be treated as 'securities' subject to the coverage of the Acts."[172] Under its interpretation in *Landreth*, the Court ruled that investment instruments, which are explicitly stated in the definition of a security and conform with the usual characteristics of the instrument, are the "clearest case for coverage by the plain language of the definition."[173]

Shortly thereafter, the Supreme Court expanded on this idea in *Reves v. Ernst & Young*.[174] In *Reves*, the Supreme Court determined that "because the Securities Acts define 'security' to include '*any note*,' we begin with a presumption that *every note* is a security."[175] The Court established that this presumption is rebuttable only by using the four "family resemblance" factors[176] to compare the note against a carefully enumerated list of notes that do not constitute securities.[177] The first factor looks to the buyer and seller's motivations underlying the transaction; the second factor examines the plan of distribution for the note; the third factor analyzes the reasonable expectations of the public investing in the note; while the fourth factor considers whether there is an alternative regulatory structure in place to govern the note if it is not considered a security.[178] In other words, since the statutory language provides

169. *Id.* (emphasis added).

170. *See infra* notes 197–99 and accompanying text.

171. 471 U.S. 681 (1985).

172. *Id.* at 687.

173. *See id.* at 693.

174. 494 U.S. 56, 62–63 (1990).

175. *Id.* at 65 (emphasis added).

176. *See id.* at 66–67.

177. *See id.* at 65 (establishing the list of nonsecurity notes, including "the note delivered in consumer financing, . . . the note secured by a mortgage on a home, . . . the short-term note secured by a lien on a small business or some of its assets, . . . the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business" (quoting Exch. Nat'l Bank of Chi. v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976))).

178. *Id.* at 66–67.

for "*any* note," the Court reasoned that all notes should be considered securities except for a very small carve out of investment instruments. These investment instruments technically may be called notes, but—when analyzed under the family resemblance factors—they are actually more analogous to notes that have been expressly excluded from being classified as securities as they are notes only in title.[179] Because the Act explicitly provides the same statutory language for "*any profit-sharing agreement*,"[180]—until proven otherwise—the presumption established in *Reves* should seemingly be extended to all profit-sharing arrangements unless the arrangement is sufficiently shown to be a profit-sharing agreement in title only.

Although modern litigation funding inherently involves some level of profit sharing, the dispute between investors and judiciaries[181] over the most applicable investment structure opens the door for the possibility of circumventing the profit-sharing presumption. If, and only if, litigation financiers are able to sufficiently convince the judiciary that their modern funding arrangements are able to overcome this significant presumption, they likely face yet another hurdle in regard to securities regulation.[182] Under the Securities Act of 1933, "investment contract[s]" are also considered securities.[183] In *SEC v. W.J. Howey Co.*,[184] the Supreme Court defined an investment contract as any "transaction . . . whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[185] With this definition, the Court ultimately created another four-element test used to classify investment products as securities.[186] Since the inception of this definition, investment contracts have served as the catchall for establishing securities by allowing for the inclusion of unique investment opportunities not explicitly stated in the definition of a "security" under the Act.[187]

Of the four investment contract elements defined in *Howey*, litigation finance arrangements appear to clearly satisfy two of the elements, but the other

179. *See supra* notes 174–78 and accompanying text.

180. Securities Act of 1933 § 2, 15 U.S.C. § 77b(a)(1) (2018) (emphasis added).

181. *See infra* notes 188–89 and accompanying text.

182. *See Reves*, 494 U.S. at 64 (finding that if an investment structure qualifies as a note within the statutory language, it would be superfluous and inconsistent with Congress' intent to require that it also satisfy the test for an investment contract).

183. § 77b(a)(1).

184. 328 U.S. 293 (1946).

185. *Id.* at 298–99.

186. *Id.* at 301 (defining the four elements as: (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profits, (4) solely from the efforts of others).

187. Over time, the statutory interpretation of an investment contract has been construed broadly, as "oil and gas drilling programs," "farm lands," and even "whiskey warehouse receipts" have all been found to be investment contracts subject to securities regulation. THOMAS LEE HAZEN, SECURITIES REGULATION: CASES AND MATERIALS 29 (9th ed. 2016).

two are less definitive. Because a funder contributing money to a lawyer has clearly invested money with an expectation of profits, whether third-party litigation financing should be considered an investment contract depends on if such arrangements form a common enterprise and if the funder's expectation of earning profits is based solely on the efforts of others. Currently, there is a circuit split as to whether horizontal commonality[188] or vertical commonality[189] is the sufficient standard for establishing a common enterprise.[190]

However, in determining whether litigation funding arrangements should be considered investment contracts, more attention should be placed on the "efforts of others" element. Determining whether the expectation of profits is dependent solely on the efforts of others requires examining the transaction realistically but not literally.[191] The predominant test is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[192] When applying this test to litigation finance arrangements, nonlawyer funders are placed in a no-win situation. On the one hand, funders can argue the success of the investment is based solely on the effort of the lawyer or law firm. Under this argument, the financing arrangements would move closer to requiring regulation as a security. On the other hand, funders could argue their efforts help to dictate the outcome of the investment agreement because their capital contributions provide necessary financial resources for the proceedings. However, if funders attempt to make this argument, they would be openly acknowledging their expectation to control a litigation proceeding as a third party, thus exerting the *exact* influences prohibited by Rule 5.4(a) of the *Professional Rules of Conduct*.

IV. ADDRESSING CRITICISM BY FUNDERS TO THE NEW YORK CITY BAR ASSOCIATION

There have been many critics of the NYCBA's recent condemnation of third-party funding through portfolio investments. Quite literally, investors have hundreds of millions of dollars invested in the practice, so it makes sense that they would react negatively to an advisory opinion opposing their

188. *See* James D. Gordon III, *Defining a Common Enterprise in Investment Contracts*, 72 OHIO ST. L.J. 59, 61 (2011) (defining "horizontal commonality"). To establish commonality under the horizontal standard, investors are required to participate in the "sharing or pooling of funds." Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101 (7th Cir. 1977).

189. In contrast, vertical commonality can be established so long as there is commonality between the investor and promoter regardless of whether there are multiple investors. Hector v. Wiens, 533 F.2d 429, 433 (9th Cir. 1976).

190. *See generally* Brodt v. Bache, 595 F.2d 459 (9th Cir. 1978) (discussing the differences between different circuits' interpretations to the commonality requirement).

191. *See* SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973).

192. *Id.*

interests.[193] The root of these objections stems from the belief that a lawyer who engages in receiving funds through this new-age financing does not sacrifice any more freedom than a lawyer who borrows funds using a traditional recourse loan.[194] Because the rule against fee sharing between a lawyer and nonlawyer predates the practice of commercial litigation funding, modern investors feel that the prohibition is antiquated and baseless.[195] While it is completely possible to debate the merits of the NYCBA's advisory opinion on certain grounds,[196] many of the self-interested responses from these investors fail to account for the modern progression of commercial litigation funding.

A. *How Funders Have Improperly Characterized Financing Agreements*

Investors primarily object to the recent ethics opinion's sharp contrast between the permissibility of recourse-funding arrangements and the impermissibility of non-recourse lending.[197] The basis for this disagreement comes from the longstanding belief that funders consider present-day litigation funding to be a purchase of equity in the result of litigation rather than a loan.[198] To these funders, traditional recourse loans are seen to exert a greater influence on lawyers and litigation because of the high-interest rates accompanying these transactions. For instance, in *Hamilton Capital VII, LLC, I v. Khorrami, LLP*,[199] a law firm entered into a traditional recourse loan where it received $6 million secured by the firm's property.[200] Within five years and after defaulting on the loan, the firm had accrued an additional $2 million in interest fees.[201] The funders opposing Opinion 2018-5 by the NYCBA have claimed "[it] is difficult to understand how . . . a high-interest loan . . . would have *less* impact on that

193. In 2016, four prominent funding firms had collectively invested well over $1 billion in U.S. and international litigation. Randazzo, *Litigation Financing*, *supra* note 75.

194. *See* Anthony E. Davis & Anthony J. Sebok, *New Ethics Opinion on Litigation Funding Gets It Wrong*, N.Y. L.J. (Aug. 31, 2018), https://www.law.com/newyorklawjournal/2018/08/31/new-ethics-opinion-on-litigation-funding-gets-it-wrong/ [https://perma.cc/2MLZ-YZA8].

195. *See* Allison Chock, Sarah Jacobson & Connor Williams, *Curiouser and Curiouser! A Review of the NYCBA's Ethics Opinion on Litigation Funding*, BENTHAM IMF (Sep. 11, 2018), https://www.benthamimf.com/blog/blog-full-post/bentham-imf-blog/2018/09/11/curiouser-and-curiouser!-a-review-of-the-nycba-s-ethics-opinion-on-litigation-funding [https://perma.cc/LD68-VC9A].

196. Increasingly, case law that supports the opinion "that judges do not believe that contingent financing through fees is a violation of Rule 5.4(a)." *See* Davis & Sebok, *supra* note 194.

197. Chock et al., *supra* note 195 ("The NYCBA's efforts to distinguish non-recourse arrangements for this treatment only highlight the arbitrary nature of its ruling.").

198. N.Y.C. Bar Ass'n Comm. on Prof'l Ethics, Formal Op. 2011-2, at 3 n.7 ("We provide funds by purchasing a small portion of the anticipated proceeds. It is not a loan, so there is no interest, no matter how long it takes for the case to be resolved.").

199. No. 650791/2015, 2015 WL 4920281 (Sup. Ct. N.Y. County Aug. 17, 2015).

200. *See id.*

201. *See id.*

law firm's independence on that matter than a non-recourse loan, which limits the lender's recovery to assets only where the firm is successful."[202]

While this argument may have been appropriate in the early days of commercial litigation funding, these critics seemingly fail to account for the size and expansion of the industry in today's society. Third-party funding may be structured as an equity investment if the investments are limited; however, the modern practice operates on the expectation of returns as if the funds are advanced as a loan. In *Echeverria v. Estate of Linder*,[203] Judge Warshawsky—in reference to the inherent nature of third-party funding—said:

> [I]t is ludicrous to consider this transaction anything else but a loan unless the court was to consider it legalized gambling. Is it a gamble to loan/invest money to a plaintiff in a Labor Law action where there is strict liability? I think not. In fact, it might be considered a "sure thing."[204]

This idea is indicative of what the practice has evolved into today. Rather than funding one-off cases with the hopes of receiving a profit, litigation-finance firms are staffing up with top lawyers who are tasked with using their experience and knowledge to filter through cases to find the "sure thing."[205]

In fact, when these former-lawyers-turned-investors succeed in their attempts to find the type of diamond-in-the-rough case, they can transform their efforts into a science of sorts. As previously mentioned, litigation-finance firms now implement algorithms based on the prior results of their funding ventures to scan thousands of court documents and compute the cases where they can solicit lawyers for the opportunity to invest with a high probability of success.[206] The modern portfolio investment structure also ensures litigation finance firms find the "sure thing." Although every case financed may not yield a favorable return, funding numerous cases within a single firm significantly decreases the risk associated with lending and makes the investment structure more analogous to a loan.

B. *The Inherent Influences in Modern Funding Arrangements*

Even if litigation finance is more analogous to a permissible recourse loan under Rule 5.4(a), the inherent influence exerted by third-party funders is still problematic for two reasons. First, the influx of capital provided to these cases is a form of manipulation in itself because the cases are selected with a

202. Chock et al., *supra* note 195.

203. No. 018666/2002, 2005 WL 1083704 (N.Y. Sup. Ct. Mar. 2, 2005), *judgment entered sub nom.* Echeverria v. Lindner, No. 018666/02, 2005 WL 6050781 (N.Y. Sup. Ct. Mar. 18, 2005).

204. *Id.* at *8.

205. *See* Lindeman, *supra* note 80 (reporting that one firm's average case screening process is so detailed it takes sixty to ninety days and costs $75,000–$100,000 per screening).

206. *See supra* text accompanying note 152.

presumption of how the financing will dictate a favorable outcome for the firm. In other words, the funders' superior knowledge of the legal system allows firms to purchase a theorized degree of control over the outcomes of their investments, as evidenced by one prominent litigation finance firm obtaining settlements in over 40% of the cases its portfolio financed[207] and another firm readily acknowledging the barriers third-party funding places on a litigation proceeding.[208]

The second form of influence is based on the continuing relationships formed between lawyers and funders under the current system. For all intents and purposes, third-party funding is a good deal for the funder and the lawyers receiving the capital. Funders are generating large returns with a high probability of success, and the lawyers or law firms are able to operate without the risk of loss. The current portfolio-funding system, where third-party financers provide funds to be used across multiple cases, is based on continued success between these two parties. As lawyers perform, they are rewarded with more and more capital to use in their pursuits of more litigation.[209] These continuous funding arrangements, backed by unprecedented amounts money, indisputably create a loyalty between funder and lawyer, because the lawyer would like to continue operating risk free. As these relationships grow, the likelihood that lawyers will act in a manner inconsistent with their client's best interest becomes greater and greater. Both forms of influence provide funders with the opportunity to control or manipulate the outcome of cases, the exact type of behavior that the rules prohibiting fee sharing between lawyers and nonlawyers are intended to prevent.

CONCLUSION

Third-party funding is not a new practice but, in fact, has been around for centuries. The NYCBA has not condemned the practice of lawyers receiving money from third parties to finance their cases. Rather, its recent ethics opinion is centered around very specific commercial litigation-funding arrangements. The opinion found that when funders and lawyers enter into contingent fee-sharing agreements, where a funder's recovery is to be determined on the outcome of a single case or multiple cases, the funder has an inherent incentive or ability to exert influence over the lawyer to the detriment of the lawyer's client.

The parties who seem to be the most condemning of the NYCBA's recent ethics opinion are those who are heavily invested in the practice of litigation

207. *See supra* text accompanying note 149.

208. *See supra* note 152 and accompanying text.

209. *See generally* Randazzo, *Litigation Financing*, *supra* note 75 (finding that last year, one third-party funding firm "provided $100 million to an unnamed global law firm").

financing. They argue that third-party financing is a wholly ethical practice that has become a staple of American litigation because it provides greater freedom and access to litigation for all. In addition to the belief that litigation funding should be permissible within the scope of Rule 5.4(a), the proponents of litigation funding also argue that third-party funding is neither a loan subject to usury regulations nor a profit-sharing or investment contract subject to securities regulation. Under the contemporary system of litigation financing, the pseudo lawyer/investment analyst is able to manipulate this lack of regulatory interference to generate large profits at a high probability. In a sense, the modern-day funder uses previous knowledge, experience, and relationships to improperly interfere with litigation in the United States legal system.

Whether one agrees or disagrees with the NYCBA, it is indisputable that litigation finance has evolved into a new, "mainstream"[210] form and is rapidly having a larger and larger effect on the American legal system. Because of the industry's origins and self-governing progression, third-party funders have generated massive returns without encountering much regulatory oversight. As the investing practice continues to experience rapid growth, it is possible that an agency such as the SEC will take over regulation; however, the rule prohibiting fee sharing between lawyers and nonlawyers has been one of the only checks on the industry—and in some cases has gone largely ignored. The NYCBA openly admitted that its advisory opinion might have surpassed the scope of the original rule prohibiting fee sharing; however, it also recognized the deceptive and deceitful dangers underlying contingent funding arrangements. In light of the modern reform efforts to control third-party funding, it is entirely possible that the bar association was attempting to use its only available means to limit the extreme profits resulting from this misleading practice.

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210. Sara Randazzo, *Litigation Funding Moves into Mainstream*, WALL ST. J. (Aug. 4, 2016), https://www.wsj.com/articles/litigation-funding-moves-into-mainstream-1470338402 [https://perma.cc/4Q3G-62M7 (dark archive)].

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