

**KENTUCKY BAR ASSOCIATION**  
**Ethics Opinion KBA E-432**  
Issued: May 20, 2011

***The Rules of Professional Conduct are amended periodically. Lawyers should consult the current version of the rules and comments, SCR 3.130 (available at <http://www.kybar.org/237>), before relying on this opinion.***

- Subject:** Third-party litigation financing
- Question I:** May a lawyer assist a client in obtaining funds to cover the client's personal expenses during the pendency of an action?
- Answer:** See the discussion in Section I.
- Question II.** If a lawyer assists a client in obtaining funds from a lender, what are the lawyer's ethical responsibilities?
- Answer:** See the discussion in Section II.
- Questions III.** May a lawyer charge a client for facilitating the financial transaction?
- Answer:** See the discussion in Section III.
- Question IV.** If there is a recovery and funds are delivered to the lawyer for disbursement, is the lawyer ethically obligated to honor the client's agreement to repay the lender from the funds recovered?
- Answer:** See the discussion in Section IV.
- References:** SCR 3.130 (1.0), (1.1), (1.2),(1.5), (1.6), (1.7), (1.8), (1.15), (7.01-7.50), (8.3); SCR 3.530; KBA E-420 (2002); KBA E-416 (2001); KBA E-375 (1995); KBA E-297 (1984); Fla. Op. 00-3 (2002, revised June 23, 2009); Me. Op. 191 (2006); N.Y. Op. 769 (2003); Pa. Comm. on Prof. Resp. Informal Op. 99-107 (1999); N.Y. Bar Ass'n Op. 666 (1994); Oh. Ethics Op. 94-11 (1994); S.C. Ethics Op. 94-04 (1994); S.C. Ethics Op. 92-06 (1992); Az. Ethics Comm.Op. 91-22 (1991).

## **Introduction**

In recent years, there has been a substantial increase in the number of lenders<sup>1</sup> promoting what is sometimes referred to as “third-party litigation financing.”<sup>2</sup> In the typical case, the lender offers funding to an injured plaintiff to help pay the plaintiff’s personal expenses during the pendency of the action. The funds are usually offered to the plaintiff at a very high interest rate and often have large application or transactional fees. It is possible that the interest on a modest provision of funds will compound so that unless the case is resolved quickly, the entire recovery will be consumed by the client’s obligation to the lender. However, unlike traditional loans, repayment is due only if there is a recovery in the case. Before agreeing to advance funds, the lender usually requires some type of case evaluation from the lawyer and may require periodic up-dates on the litigation. In addition, as a condition of receiving funds, the lender normally requires the client to sign an agreement providing that, in the event of a recovery, the client will repay the lender from the funds recovered; the lender expects the lawyer to honor the client’s agreement. In some cases, the lender may ask the lawyer to acknowledge the lender’s arrangement with the client or issue some type of letter<sup>3</sup> promising to protect the lender’s interest in any recovery on behalf of the client. While the financial transaction is between the client and the lender, the lawyer may play a substantial role in the arrangement, which may trigger ethical obligations to the client as well as to the third-party lender.

### **I. May a lawyer assist a client in obtaining funds to cover the client’s personal expenses during the pendency of an action?**

Clients needing financial assistance during litigation often obtain loans from family members, banks or other institutions. Such loans are either unsecured or secured by real or personal property owned by the client. The arrangement is exclusively between the client and the lender. When those options are not available, clients often turn to their lawyers for assistance. Once the lawyer becomes involved, ethical issues arise.

The initial concern arises from the Rules of Professional Conduct, SCR 3.130 (1.8(e)),<sup>4</sup> which prohibits the lawyer from providing financial assistance to a client.<sup>5</sup> The ethical

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<sup>1</sup> Although the arrangements described in this opinion are not like traditional loans, the opinion refers to the provider of funds as “lenders.” In addition to the term “lender,” commentators have used other terms, including “investor,” “financer,” “alternative litigation funder” and “advance litigation funder.”

<sup>2</sup> The financing arrangement discussed in this opinion is referred to as “third-party litigation financing.” These arrangements are also referred by other terms, including “alternative litigation funding,” “advance funding” and “pre-settlement funding.”

<sup>3</sup> Sometimes these letters are referred to as “letters of protection” and they represent the lawyer’s written promise to protect the third person’s interest in any recovery obtained on behalf of the lawyer’s client.

<sup>4</sup> Rule 1.8(e) provides as follows:

prohibition on financial assistance is long-standing and deeply rooted in history.<sup>6</sup> It is based on a common law rule and reflects the concern that “if a lawyer acquires a stake in the outcome his or her ability to exercise independent judgment on behalf of the client may be impaired.”<sup>7</sup> Further, as Comment 10 to SCR 3.130(1.8)<sup>8</sup> notes, lawyers may not make loans to clients because such loans might encourage clients to bring suits they might not otherwise bring. In addition, permitting lawyers to provide financial assistance to clients for living expenses could result in lawyers bidding for clients and investing in the causes of action.<sup>9</sup>

Although a lawyer may not provide a client with financial assistance, it is the Committee’s opinion that the Rules of Professional Conduct do not prohibit the lawyer, under certain limited circumstances, from assisting the client in identifying possible third-party lenders or facilitating the client in obtaining funds. This does not, however, end the inquiry, as there are many other ethical and legal issues that must be considered.

In addition to the issues described in Questions II, III and IV, lawyers are cautioned to carefully consider their role in assisting the client in obtaining funding, as the lawyer’s role may be unclear, at least to the client. Although the lawyer may, at the request of the client, help identify pre-settlement lenders, the lawyer should advise the client of the possible disadvantages of such transactions and the lawyer should make clear that he is not endorsing a particular lender. Once the client has decided to pursue a loan, the lawyer will most likely be involved to some degree, but his role may not be clear. Is the lawyer merely facilitating the transaction or is the lawyer actually taking on the role of advisor and advocate? While the lawyer might view his role as that of a facilitator, merely providing information at the client’s request, the client may believe that the lawyer is assuming a far greater role as counselor, advising the client about the terms of the contract, the advantages and disadvantages of the transaction and possible alternatives. It is important to make these distinctions as the two roles carry different

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(e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

(1) a lawyer may advance court costs and expenses of litigation, the

repayment of which may be contingent on the outcome of the matter; and

(2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.

<sup>5</sup>Rule 1.8(e)(1) and (2) contain limited exceptions permitting a lawyer to either advance or pay court costs and litigation expenses.

<sup>6</sup> KBA E-375 (1995).

<sup>7</sup> KBA E-420 (2002).

<sup>8</sup> Financial Assistance

Lawyers may not subsidize lawsuits or administrative proceedings brought on behalf of their clients, including making or guaranteeing loans to their clients for living expenses, because to do so would encourage clients to pursue lawsuits that might not otherwise be brought and because such assistance gives lawyers too great a financial stake in the litigation. These dangers do not warrant a prohibition on a lawyer lending a client court costs and litigation expenses, including the expenses of medical examination and costs of obtaining and presenting evidence, because these advances are virtually indistinguishable from contingent fees and help ensure access to the courts. Similarly, an exception allowing lawyers representing indigent clients to pay court costs and litigation expenses regardless of whether these funds will be repaid is warranted.

<sup>9</sup> KBA E-375 (1995).

ethical responsibilities. There must be a clear understanding between the lawyer and the client as to the precise responsibilities of the lawyer in connection with the financial transaction. SCR 3.130(1.5) requires the lawyer to communicate about both the scope of the representation and the basis for the fee. It states that it is preferable for such communications to be in writing.<sup>10</sup> Lending arrangements are normally available only in contingent-fee cases and SCR 3.130(1.5) requires contingent-fee agreements to be in writing, signed by the client.<sup>11</sup> It is therefore the Committee's view that, as a matter of good practice, the agreement regarding the lawyer's role in the financial transaction should also be in writing.

In assessing the lawyer's role in the transaction between the client and the lender, the lawyer should be aware that certain legal questions may arise, such as whether the arrangement complies with applicable regulatory laws or violate prohibitions on champerty or maintenance. These are legal questions beyond the jurisdiction of the Committee, and the Committee expresses no opinion as to the legality of these arrangements.<sup>12</sup> However, if the lawyer knows that the transaction is illegal, the lawyer may not participate in any way, other than to advise the client of the illegality.<sup>13</sup>

## **II. If a lawyer assists a client in obtaining funds from a lender, what are the lawyer's ethical responsibilities?**

In reviewing third-party litigation financing arrangements, a number of issues have arisen regarding the impact that the financing arrangement may have on the lawyer-client relationship. Each will be discussed briefly.

First, any time a third party becomes involved in the attorney-client relationship, there is a risk that the lawyer's independent professional judgment will be compromised or that the lawyer-client relationship will be impaired. The lender might, in the course of seeking updated information, attempt to exercise influence over the handling of the case, either in terms of strategy or settlement. Both the Rules of Professional Conduct and the opinions of this Committee have recognized such risks in various contexts. For example, SCR 3.130(1.8(f)) provides that a lawyer may accept compensation for representing a client from a third-party only where "there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship." Numerous KBA Ethics Opinions have emphasized the importance of independent professional judgment and the prohibition on third-party influence, even where the third-party has a financial interest.<sup>14</sup>

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<sup>10</sup> Rule 1.5(b) provides, in part: "The scope of the representations and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation....".

<sup>11</sup> Rule 1.5(c) provides, in part: "A contingent fee agreement shall be in a writing signed by the client and shall state the method by which the fee is to be determined...."

<sup>12</sup> See KBA E-297 (1984). SCR 3.530 authorizes the Committee to issue opinions on ethical questions.

<sup>13</sup> See SCR 3.130 (1.2(d)); Fla. Op. 00-3 (2002), revised June 23, 2009; Me. Op.191 (2006); and N.Y. Op.769 (2003).

<sup>14</sup> See, e.g., KBA E-420 (2002) (lawyer borrowing money from lending institution to underwrite costs and expenses) and KBA E-416 (2001) (limitations on lawyers agreeing to insurance defense guidelines).

The obligation of representation begins and remains with the client, not the lender to whom the client may have granted an interest in the possible proceeds of the client's case. The lender's potential or actual interest in the litigation itself may be limited by other law.<sup>15</sup> Regardless, the lawyer's ethical duty is, by definition, to the client. The lawyer shall not allow the lender to control the representation or interfere with the lawyer's independent professional judgment.

Second, it is the foremost responsibility of the lawyer to represent the client with competence<sup>16</sup> and with loyalty.<sup>17</sup> To that end, the lawyer should advise the client of the known benefits and detriments, including costs and expenses that the client is likely to encounter in the financing arrangement. Otherwise, the client may undertake an obligation which the lawyer believes is not in the best interests of the client.

Third, it is understood that the lender will require information from the client about the case. At the client's request, the lawyer may provide factual information, such as accident reports and pleadings, to the lender, but only after the lawyer has consulted with the client and obtained informed consent. Any consultation should include a discussion of the possible effects of disclosure of confidential information to the non-lawyer, including the risk of waiver of the attorney-client privilege. It is the Committee's opinion that, as a matter of good practice, the informed consent should be confirmed in writing.<sup>18</sup>

Fourth, throughout this discussion, the Committee has assumed that the lawyer has no employment or ownership interest in the lender, nor receives any financial benefit from the transaction.<sup>19</sup> If such a relationship did exist, the lawyer would run afoul of SCR 3.130(1.8(e)), which prohibits financial assistance to a client, and SCR 3.130(8.3(a)), which prohibits a lawyer from providing that assistance indirectly, through a third party.<sup>20</sup> The lawyer's financial involvement with the lender could also violate other ethical rules, including SCR 3.30(1.7) on personal conflicts of interest and SCR 3.130(1.8(a)) on business transactions with clients.

Fifth, the Committee understands that some lenders not only provide financial assistance, but also function as a referral service. At least one company requires a "client" to hire an "approved" lawyer as a condition of receiving financial assistance. If the client's retained lawyer is not on the lender's approved list then the client must terminate that representation in order to obtain funding. Although the Committee has not reviewed the details of all of these arrangements, it is the Committee's view that any lawyer who

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<sup>15</sup> See *Associated Ins. Service, Inc. v. Garcia*, 307 S.W.3d 58 (Ky. 2010).

<sup>16</sup> SCR 3.130 (1.1).

<sup>17</sup> SCR 3.130 (1.7).

<sup>18</sup> SCR 3.130 (1.6(a)); SCR 3.130 (1.0(e)).

<sup>19</sup> Under certain limited circumstances, described in Section III, the lawyer may receive compensation from the client for services provided in connection with the financial transaction.

<sup>20</sup> Rule 8.3(a) provides that "It is professional misconduct for a lawyer to: (a) Violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through the actions of another. See also, Fla. Ethics Op. 00-3 (2002), revised June 23, 2009.

knowingly participates in such a referral arrangement would likely be in violation of the advertising rules,<sup>21</sup> the rules on referral services<sup>22</sup> and the conflicts rules.<sup>23</sup>

### **III. May a lawyer charge a client for facilitating the financial transaction?**

As previously noted, the financing arrangements are generally available in contingent-fee cases. Contingent-fee agreements between the lawyer and the client must be in writing and signed by the client and the scope of the representation would normally be included in the initial engagement letter. If the engagement letter narrowly defines the scope of the representation and the services to be provided by the lawyer to include only the litigation, counseling the client on financing arrangements and providing information to the lender is an expansion of the parties' initial agreement. It would not be improper to charge a client for additional services, not contemplated by the initial agreement, so long as the lawyer fully explains the change in fee and the fee is reasonable under all of the circumstances.<sup>24</sup> Again, because the original agreement was in writing, it is the Committee's opinion that, as a matter of good practice, any addendum should be in writing as well. However, if the amendment involves a change in the contingent fee, it must be in writing, signed by the client, as required by SCR 3.130(1.5).

### **IV. If there is a recovery and funds are delivered to the lawyer for disbursement, is the lawyer ethically obligated to honor the client's agreement to repay the lender from the funds recovered?**

Even though the lender is not a client, the lawyer may have certain minimum ethical obligations to the lender. Rule 1.15 Comment [3] states the following:

Rule 1.15(c) recognizes that third parties may have lawful claims against specific funds or other property in a lawyer's custody, such as a client's creditor who has a lien on funds recovered in a personal injury action. A lawyer may have a duty under applicable law to protect such third-party claims against wrongful interference by the client. In such cases when the third-party claim is not frivolous under applicable law, the lawyer must refuse to surrender the property until the claims are resolved. Generally if the claim is based upon a contract obligation, writing signed by the client, statutory lien, court order ... the lawyer must refuse to surrender the property until the claims are resolved.

It is beyond the jurisdiction of the Committee to decide whether a particular agreement between a client and a lender is a legally enforceable claim that the lawyer must honor.<sup>25</sup> It is noted, however, if there is a dispute between the client and the lender as to the

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<sup>21</sup> SCR 3.130 (7.01-7.50).

<sup>22</sup> SCR 3.130 (7.20).

<sup>23</sup> SCR 3.130 (1.7).

<sup>24</sup> SCR 5.130(1.5).

<sup>25</sup> It is beyond the jurisdiction of the Committee to answer questions of law. KBA E-297 (1984).

lender's entitlement to any recovery or the amount owed, then the lawyer has an ethical duty to treat the funds as provided by SCR 3.130(1.15) and Comment [3] quoted above.

Although the Committee cannot opine as to the enforceability of the underlying agreement between the client and the lender, or the lawyer's legal obligations, it is the Committee's view that as a matter of ethics the lawyer should not enter into an agreement with the lender promising to protect the lender's interest in any recovery, because to do so would make the lawyer a party to the financial transaction and open the door to potential conflicts of interest. This does not mean that the lawyer, at the client's request, cannot confirm notice of the client's financial arrangement with the lender.

### **Summary**

In the final analysis, the Committee agrees with the numerous other jurisdictions which have concluded that lawyers are not per se prohibited from assisting clients on obtaining funding from a third-party lender.<sup>26</sup> It also agrees that there are serious risks to such participation and that third-party litigation financing frequently does not serve the client's best interest. Lawyers who assist their client in obtaining funding must be particularly sensitive to the various ethical issues, including: confusion as to the lawyer's role in the transaction; whether an additional fee will be charged; possible interference with the lawyer's independent professional judgment by the lender; the need to assist the client in understanding the advantages and disadvantages of the transaction; and the impact that the provision of information to the lender has on the attorney-client privilege and confidentiality. In addition, lawyers can participate in assisting clients only if they have no financial interest in the transaction. Finally, throughout this opinion the Committee has recommended that understandings between the lawyer and the client be in writing. While not always required by the Rules of Professional Conduct, written confirmation will help reduce misunderstandings that might arise in these complex transactions where substantial client interests are involved.

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<sup>26</sup> Fla. Ethics Op. 00-3 (2002), revised June 23, 2009; Pa. Comm. on Prof. Resp. Informal Op. 99-107 (1999). N.Y. Bar Ass'n Op. 666 (1994); Oh. Ethics Op. 94-11(1994); S.C. Ethics Op. 94-04 (1994); S.C. Ethics Op. 92-06 (1992); Az. Ethics Comm. Op. 91-22 (1991).

***Note to Reader***

*This ethics opinion has been formally adopted by the Board of Governors of the Kentucky Bar Association under the provisions of Kentucky Supreme Court Rule 3.530. The Rule provides that formal opinions are advisory only.*



**286.3-280 Maximum debt of persons to bank or trust company.**

- (1) Except as provided in subsection (2) of this section, no bank or trust company shall permit any person to become indebted to it or to become obligated as guarantor or surety to it in an amount exceeding twenty per cent (20%) of its capital stock actually paid in and its actual amount of surplus, unless the person pledges with it good collateral security or executes to it a mortgage upon real or personal property which at the time is of more than the cash value of the indebtedness or obligation above all other encumbrances; but the indebtedness or obligation of any person shall not exceed thirty percent (30%) of the paid-in capital and actual surplus of the bank or trust company. When computing the total capital stock and surplus, the negative balance of a bank's undivided profits account shall be deducted.
- (2) A bank organized as a limited liability company shall not be covered by subsection (1) of this section, but shall comply with the legal lending limits applicable to national banks set forth in 12 U.S.C. sec. 84 and 12 C.F.R. sec. 32.4, as may be amended.
- (3) No bank or trust company shall permit any of its directors or executive officers to become indebted to it or become obligated as guarantor or surety to it in an amount which exceeds that which any other person is authorized by this section to become indebted or obligated.
- (4) In computing the indebtedness of any person:
  - (a) The liability of any partnership in which the person acts as a general partner, and any obligation entered into for the benefit of a person, partnership, or association, shall be included in the total liabilities of the person, partnership, or association; and
  - (b) Any credit exposure arising from a derivative transaction, repurchase agreement, reverse purchase agreement, securities lending transaction, or securities borrowing transaction shall be included. For the purposes of this paragraph, the term "derivative transaction" includes any transaction that is a contract, agreement, swap, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one (1) or more commodities, securities, currencies, interest or other rates, indices, or other assets.
- (5) Except as otherwise provided in this section, the same security, both in kind and amount, shall be required from stockholders as from nonstockholders.
- (6) The discount of bills of exchange drawn against actually existing value, and the purchase or discounting of commercial or business paper actually owned by the person negotiating the paper shall not be considered as borrowed money within the meaning of this section in fixing the limit of indebtedness or obligation of any person selling or negotiating the paper to a bank.

**Effective:** July 12, 2012

**History:** Amended 2012 Ky. Acts ch. 77, sec. 1, effective July 12, 2012. -- Amended 2010 Ky. Acts ch 28, sec. 15, effective July 15, 2010. -- Amended 2006 Ky. Acts ch. 183, sec. 9, effective July 12, 2006. -- Amended 1992 Ky. Acts ch. 77, sec. 3, effective July 14, 1992. -- Amended 1986 Ky. Acts ch. 444, sec. 9, effective July 15,

1986; and ch. 472, sec. 1, effective July 15, 1986. -- Recodified 1942 Ky. Acts ch. 208, sec. 1, effective October 1, 1942, from Ky. Stat. secs. 581, 583, 609, 610.

**Formerly codified as KRS 287.280.**

**Legislative Research Commission Note** (7/12/2006). This section was amended in 2006 Ky. Acts ch. 183. In that same session, 2006 Ky. Acts ch. 247, sec. 38 required that all sections of KRS Chapters 287, 288, 290, 291, 294, 366, 366A, and 368 be renumbered as sections of a single KRS chapter entitled the "Kentucky Financial Services Code." Therefore, the Statute Reviser, acting under KRS 7.136(1), has changed the number of this section and codified it as a section of KRS Chapter 286.

**Legislative Research Commission Note.** This section was amended by two 1986 Acts which do not appear to be in conflict and have been compiled together. However, in combining the amendments it was necessary to retain the words "in an amount" in subsection (2) of this section which had been deleted by Acts 1986, ch. 472, Â§ 1.