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Law Firms Must Beware Risks In Nontraditional Financing

By **Katherine Toomey** (June 5, 2020, 5:32 PM EDT)


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The COVID-19 pandemic and the related economic crisis are causing financial uncertainty and liquidity problems at law firms of all sizes. Law firms are responding by taking aggressive steps to slash expenses by shortening or eliminating summer programs, deferring start dates for new hires, reducing pay, moving employees to part-time schedules, and laying off personnel.

Although it gets less press, law firms are almost certainly also looking to maximize income and bolster their cash positions through shifting personnel to countercyclical practices, aggressive collection strategies, drawing down letters of credit, and capital calls on partners. Firms are looking for loans from the U.S. government as well as conventional banks. But law firms tend to have few hard assets for security, and, given the economic circumstances, banks may look skeptically at their balance sheets. Firms may therefore look to less traditional forms of funding.

Pierce Bainbridge's Financial Model

According to recent press reports (and at least five lawsuits filed against the firm in the last three months), long before the recent crisis started to wreak havoc on the economy and on law firms, the now-troubled Pierce Bainbridge used both portfolio litigation funding and old-fashioned factoring to finance the regular operations of the firm.[1]

Pierce Bainbridge's agreement with the law firm's initial funder, Pravati Capital, gave the funder a share of the firm's earnings on a group of contingency litigation matters in exchange for financing that could be used not only for costs and fees related to cases being litigated, but also for the ordinary operational costs of the law firm.[2] Pravati Capital was replaced as the firm's primary funder by Virage Capital Management in April 2019.[3] Reporting has estimated Pierce Bainbridge's debt to Virage in the range of $65 million.[4]

But that jaw-dropping amount was clearly insufficient. Starting in late 2019, firm founder John Pierce, purportedly on behalf of the firm, reportedly turned to a much more unusual form of financing for top-tier law firms — factoring — to make ends meet.

And since February this year, the firm and its founder John Pierce have been sued by at least four funders — Slate Advance LLC, West Coast Business Capital, Creative Capital Funding LLC and Karrish Kapital LLC — in each case for breach of a factoring contract. All in all, it appears that Pierce Bainbridge obtained around $4.5 million in financing through factoring contracts.[5]

What Is Portfolio Funding?

Litigation funding agreements come in all shapes and sizes. But, generally speaking, portfolio funding differs from ordinary litigation funding, which is usually a contract that is executed on a single-case basis between a client and a funder, in which the client pledges a share of its recovery in exchange for the funding of its case.

While all deals are bespoke and vary depending on the needs of the firm and the risk appetite of the funder, in a portfolio funding arrangement with a law firm, the funder provides financing to the firm, secured by a portion of the law firm's own right to contingency fees obtained in a specified portfolio of cases agreed upon by the law firm and the funder.

As with single-case funding, the capital advanced in a portfolio funding deal is typically nonrecourse, meaning that there is no obligation for repayment if the cases prove to be unsuccessful and the firm does not ultimately obtain its contingency fee.

What Is Factoring?

Factoring is a form of financing in which a business sells a certain amount of its receivables for an immediate payment at a discount. In its purest form, a factoring contract provides for a factor to purchase specified receivables based on a particular set of invoices, a new bank account is set up, the debtors are told that their invoices have been factored and provided with the new account payment details, and the factor collects his share of the receivables from the account on a specific percentage-per-week basis until he has received all of the payments to which he is entitled.

Factoring is an outright purchase of receivables in exchange for its discounted payment, and the factor takes all risk of nonpayment by the invoice debtors. Because the factor takes on the risk of nonpayment, the discount rate tends to be steep. That is, this form of financing is considerably more expensive than a commercial loan secured by the receivables.

Intersection With New and Developing Areas of Law

Firms in today's financial crisis may be looking at similar types of financing to provide liquidity and cash support in stressful times. In deciding whether to engage in these types of transactions, firms may wish to consider recent developments in two areas of law: (1) recent developments in what interest a law firm has in "unfinished business," i.e., cases that are taken to new firms by departing lawyers; and (2) whether portfolio funding and factoring are consistent with attorneys' ethical obligations.

Funders' Interest in Future Case Recoveries

The press has reported that exiting Pierce Bainbridge attorneys have been contacted by Virage, which is claiming an entitlement to future recoveries in cases that they have taken with them to their new firms.[6] Departing Pierce Bainbridge attorneys have been quick to dismiss Virage's position,[7] and to the extent that the attorneys work exclusively on an hourly fee basis, it appears that the attorneys have a right to do so.

But attorneys trying to take contingency cases to new firms might indeed have obligations to Pierce Bainbridge and/or Virage for future recoveries, which in turn may make it difficult for these attorneys to find a new firm to agree to continue the case with them.

A series of cases arising out of law firm insolvencies, including Heller Ehrman, Coudert Brothers and Thelen, have examined the question of what interest a dissolving firm has in ongoing cases. In each case, the courts have determined that the insolvent firm has an interest in hourly receivables earned and billed by the dissolving firm. However, no continuing interest in hourly work exists after the case transfers to another firm. That is, an existing receivable is an asset of a dissolving firm, but a case or a client relationship is not.

The most recent case to explore this question involved the dissolution of the D.C.-based firm Howrey and was decided in February of this year.[8] Its receiver, Allan Diamond, brought suit against other firms that former Howrey attorneys had joined, bringing ongoing cases with them.

Diamond's argument was that, under the "unfinished business rule,"[9] the cases that Howrey attorneys were working on at the time of the dissolution were themselves assets of the bankruptcy estate and that other firms that took them over owed the Howrey estate (at least) some portion of their profits earned in working on the cases.[10] The fundamental question — the interest of the Howrey bankruptcy estate in ongoing and future hourly work for former clients of the firm — was certified to the District of Columbia Court of Appeals.

Similar to prior decisions relating to the dissolution of Thelen, Coudert Brothers and Heller Ehrman, the D.C. Court of Appeals determined that hourly billed client matters are not "property" of the firm, and recognizing that clients can leave a firm at any time, the firm had at best "a unilateral expectation," rather than a "legitimate claim of entitlement, to future fees."[11]

The D.C. Court of Appeals was, however, careful to distinguish its holding in the Diamond matter from its previous rulings in Beckman v. Farmer[12] and Young v. Delaney.[13] These cases held that a law firm does have a continuing property interest in a contingency matter that one partner took with him when he left the firm (or when the firm dissolved) and that there was a duty to account to the former firm or its partners for any receipts that arose from contingency matters.

Based on this analysis (and of course depending on the terms of the funding contract), it is likely that a funder with a lien either on a dissolving firm's assets, or its recoveries in a particular case or portfolio, would have a continuing interest in a contingency matter that ended up with another firm.

Ethical Considerations[14]

In 2018, the New York City Bar Association, or NYCBA, issued Formal Opinion 2018-5 in which it held that portfolio funding violates Rule 5.4 of the New York Rules of Professional Conduct.[15] Rule 5.4 bars attorneys from sharing fees with nonattorneys and is designed to protect an attorney's independent judgment.

In reaching this decision, the NYCBA noted first that this was not an ordinary litigation financing transaction in which the client was assigning part of his interest in a recovery to the funder. Such agreements do not implicate the fee-splitting prohibition of Rule 5.4.[16] Rather, the portfolio financing arrangement under review was between the law firm and a funder and was an allocation of the law firm's contingent interest in the case recoveries.

Relying on a long line of other ethics opinions, the NYCBA determined that:

> Rule 5.4(a) forbids a funding arrangement in which the lawyer's future payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters. That is true whether the arrangement is a non-recourse loan secured by legal fees or it involves financing in which the amount of the lawyer's payments varies with the amount of legal fees in one or more matters.[17]

The NYCBA opinion may not, however, be the last word on portfolio funding and Rule 5.4. Indeed, a number of court cases have expressed the view that Rule 5.4 should not unnaturally restrict law firms from obtaining financing that is available to other businesses.[18]

In addition, these issues were recently discussed at length in a report by the New York City Bar Association's Litigation Finance Working Group issued in February.[19] That report recognizes that portfolio funding can be beneficial to both law firms and clients in certain circumstances and seeks to harmonize those benefits with the concerns raised in ethics decisions prohibiting such funding. The working group proposed two potential amendments to Rule 5.4 that would permit attorneys, under certain circumstances, to take advantage of this type of funding arrangement.

As the NYCBA noted in its 2018 ethics opinion, other ethical rules may also be relevant to portfolio funding. For example, Rule 1.6 requires lawyers to maintain in confidence not merely conventionally privileged communications, but also client secrets and confidences, which go beyond matters strictly covered by privilege. It is difficult to imagine that reports can be generated for funders, budgets prepared, or odds of winning summarized without some discussion of case strategy and other confidential matters.

In addition, Rule 1.8(f) prohibits an attorney, in the absence of a client's informed consent, from accepting funding that may interfere with an attorney's professional judgment, and Rule 2.1 requires a lawyer to exercise independent judgment in the provision of legal services.

Factoring raises similar ethical questions. Any sale of unearned future receivables would almost certainly run afoul of the same fee-splitting concerns as portfolio funding.

An advisory opinion of the Ohio Supreme Court's Board of Commissioners on Grievance and Discipline goes further, stating that a lawyer is precluded from selling his or her fees at any stage.[20] And any factoring of specific invoices would risk violating Rule 1.6 because it would almost certainly constitute the disclosure of confidential or secret information of the client without the client's consent.

Indeed, the State Bar of Texas has specifically held that, unless the client is informed and consents, "a lawyer may not sell or transfer ... accounts receivable owing by the lawyer's clients or former clients except with the clients' consent, after consultation with the lawyer, to the disclosure of confidential information incident to such sale or transfer."[21]

Considerations for Firms Thinking About Nontraditional Financing

As illustrated by the discussion above, legal developments in recent months may be relevant to a firm's choice to seek funding, as Pierce Bainbridge did, through portfolio funding or factoring. Before considering such strategies, a law firm would be well-advised to research carefully the state ethics rules and opinions in each state that it operates in.

In particular, firms should look at confidentiality obligations, independent judgment obligations and fee-splitting prohibitions to make sure that their factoring or funding agreements does not violate ethical standards. If a firm wishes to engage in factoring, the affected clients should be informed and consent should be obtained pursuant to the relevant ethics rules. Finally, it would be advisable for firms to consult independent ethics experts before engaging in such financing transactions.

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[1] Law Offices of Bruce J. Chasan, LLC v. Pierce Bainbridge Beck Price & Hecht LLP, et al., CA No. 2020-CV-1338 (E.D. Pa., Mar. 9, 2020) ("Chasan"); Slate Advance LLC v. Pierce Bainbridge Beck Price & Hecht LLP, et al., Index No. 604227/2020 (Nassau Co. Supr. Ct., Mar. 17, 2020; West Coast Business Capital v. Pierce Bainbridge Beck Price & Hecht LLP, et al., Index No. 803696/2020 (Erie Co. Sup. Ct., Mar. 12, 2020); Creative Capital Funding LLC v. Pierce Bainbridge Beck Price & Hecht LLP, et al., No. 2020-25857 (Harris Co. District Court (TX), Apr. 24, 2020); Karrish Capital v. Pierce Bainbridge Beck Price & Hecht LLP, et al., Index No. [unassigned] (New York Co. Sup. Ct., May 27, 2020).

[2] Chasan Complaint, Ex. G at 5-6, para 4.

[3] "Intervenor Virage SPV 2 LLC's Plea in Intervention," filed in Creative Capital Funding LLC v. Pierce Bainbridge Beck Price & Hecht, et al., No. 2020-25857 (Harris Co. Dist. Court (TX), May 29, 2020).

[4] Id.

[5] See cases cited in n. [1], supra.

[6] https://www.law360.com/articles/1266520/pierce-bainbridge-funder-targets-ex-partners-in-debt-chase.

[7] Id.

[8] Diamond v. Hogan Lovells US LLP, 950 F.3d 1200, 1205 n.3, 1208 (9th Cir. 2020).

[9] Jewel v. Boxer, 156 Cal. App. 3d 171 (1984).

[10] Diamond v. Jones Day LLP (In re: Howrey LLP), 515 B.R. 624, 626 (Bankr. N.D. Cal. 2014).

[11] Diamond v. Hogan Lovells US LLP, 950 F.3d 1200, 1202 (9th Cir. 2020).

[12] 579 A.2d 618 (DC 1992).

[13] 647 A.2d 784 (DC 1994).

[14] For consistency, I refer herein to the American Bar Association's Rules of Professional Conduct.

Most states and the District of Columbia have adopted them in some form. Each state, however, has its own ethics rules and some differ substantially from the ABA Model Rules and those of other states.

[15] Formal Op. 2018-5: Litigation Funders' Contingent Interest in Legal Fees (NYCBA 2018).

[16] Id. at 2.

[17] Id. at 4.

[18] E.g., Hamilton Capital VII, LLC, I v. Khorrami, LLP, 2015 WL 4920281, at *5 (N.Y. Sup. Ct. Aug. 17, 2015); Lawsuit Funding v. Lessoff, 2013 WL 6409971, at *5 (N.Y. Sup. Ct. Dec. 4, 2013); PNC Bank, Delaware v. Berg, 1997 WL 527978, at *10 n. 5 (Del. Super. Ct. 1997).

[19] Report to the President by the New York City Bar Association Working Group on Litigation Funding, Feb. 28, 2020.

[20] Sup. Ct. of Ohio, Bd. of Comm'rs on Grievances and Discipline, Informal Op. 2004-2 (2004).

[21] Opinion No. 655, May 2016, 79 Tex. B.J. 470 (2016).