ETHICS AND ALTERNATIVE FINANCING
FOR PATENT LITIGATION

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CHAPTER 17
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ETHICS AND ALTERNATIVE FINANCING FOR PATENT LITIGATION

1. INTRODUCTION

This paper identifies ethical issues relating to fee arrangements for patent infringement litigation that appear in cases, ethics opinions, and ethics rules, including some general issues concerning fee arrangements for patent litigation, and some more specific ethics issues concerning alternative financing. A nuts-and-bolts view of ethics rules (with special emphasis on Texas rules) in the context of alternative financing for patent litigation is presented. For the most part, the examples herein represent common situations that raise potential ethics issues in alternative financing arrangements.

Financing for litigation can take many different forms. This paper focuses on alternative litigation financing (“ALF”) in the form of funding by entities other than the parties, counsel, or other entities with a preexisting contractual relationship with one of the parties, such as an indemnitor or a liability insurer.

Financing of litigation is on the rise, and ALF is now a large industry with its own trade association. The American Bar Association Commission on Ethics 20/20 formed a Working Group on Alternative Litigation Finance to study the impact of third party financing on the client-lawyer relationship and the professional responsibilities of lawyers. While occasional litigation funding contracts appeared throughout the last century, some trace the beginning of the current ALF industry to Las Vegas entrepreneur, Perry Walton, the “self-proclaimed father of the modern litigation finance industry.” After pleading guilty in 1997 to criminal charges, the “former rock musician and mobile-home park developer” formed Future Settlement Funding Corporation and began conducting two-day $12,400 seminars on how others could develop their own litigation financing companies. Many companies have followed Walton’s guidance to fund personal injury suits.

The ALF industry is segmented, although any one funding entity may span more than one segment. One portion of the industry generally funds personal tort litigation. This group might also fund an individual inventor in a patent infringement matter. Another group provides loans to lawyers and law firms. A third group funds commercial litigation, usually to large companies who hire large law firms. This group includes public companies such as Juridica and Burford. Other ALFs in this group are private funds and less is known about the nature and scope of their investments.

For Texas attorneys, the ethical rules apply in the Texas Disciplinary Rules of Professional Conduct and the Texas Lawyer’s Creed. The Texas Disciplinary Rules of Professional Conduct are based substantially on the ABA Model Rules of Professional Conduct. While there are unique ethics rules existing across state and federal courts, this discussion will focus primarily on the Texas Disciplinary Rules of Professional Conduct (the “Rules”) and the Texas Lawyer’s Creed (the “Creed”). The Rules can be the basis of a misconduct charge against a Texas attorney (Rule 8.04). However, the Rules do not specify any penalty. By contrast, the Creed is expressly “aspirational,” aspiring to conduct above and beyond the Rules.

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1 The industry is sometimes called the “settlement advance” business.
2 In the examples we will use the name ALF for the funder.
8 As there is not a formal comprehensive set of rules in federal courts, the appropriate venue for patent litigation, the rules of Texas were chosen as both authors of this paper reside there. However, when appropriate, comparisons are made to the ABA Model Rules, which necessarily also inform the attorney as to ethical considerations.
9 The Creed provides in separate parts:
   “I am a lawyer; I am entrusted by the People of Texas to preserve and improve our legal system. I am licensed by the Supreme Court of Texas. I must therefore abide by the Texas Disciplinary Rules of Professional Conduct, but I know that Professionalism requires more than merely avoiding the violation of laws and rules. I am committed to this Creed for no other reason than it is right.”
   and
   “The desire for respect and confidence by lawyers from the public should provide the members of our profession with the necessary incentive to attain the highest degree of ethical and professional conduct. These rules are primarily aspirational. Compliance with the rules depends primarily upon understanding and voluntary compliance, secondarily upon reinforcement by peer pressure and public opinion, and finally when necessary by enforcement by the courts through their inherent powers and rules already in existence.”
2. THE COMPETENT LAWYER VERSUS THE REASONABLE MAN

Texas attorneys have given themselves a surprisingly easy standard to meet for setting up attorneys’ financing arrangements. In many areas of law, the “reasonable man” is the test. This is also the test under the ABA Model Rule 1.5. But this is not the test under the Rules. Texas Disciplinary Rules of Professional Conduct, Rule 1.04(a) provides:

A lawyer shall not enter into an arrangement for, charge, or collect an illegal fee or unconscionable fee. A fee is unconscionable if a competent lawyer could not form a reasonable belief that the fee is reasonable.

By contrast, ABA Model Rule 1.5(a) provides:

A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses.

Thus in Texas, for ethics purposes, any financing arrangement will not be tested by the “reasonable man” standard. Rather, the arrangement is tested by whether (1) a competent lawyer, (2) could not form a reasonable belief, (3) that the fee is reasonable.

The differences between a “reasonable man” and a “competent lawyer” have not been explored in the cases or opinions and are perhaps more appropriate material for the late-night comics. Adding even more humor to the situation, the Texas comments explain that the change from the ABA’s “unreasonable fee” to the Texas standard (“if a competent lawyer could not form a reasonable belief that the fee is reasonable”) was done because “reasonableness” is “too vague and uncertain.” Texas Comment – Rule 1.04(1).10 Contradicting this express reason, Comment 7 explains that determining unconscionability is “difficult” and “subjective,” that only an approximate range of fees might be “unconscionable,” that there is a “degree of uncertainty” about unconscionability, and that the lawyer, not the client, should be given the benefit of the doubt.

Whether a hypothetical person is a “competent lawyer” likely has very little to do with whether that hypothetical person is reasonable. Given the creativity, ingenuity, and advocacy skills of the pool of competent lawyers, this standard should not prove a high bar to establish that almost any fee complies with the Rules.

3. THE TIMING OF THE DETERMINATION OF REASONABleness

The ethics rule concerning fees is subject to conflicting interpretations as to whether the test of reasonableness is applied only at the time that the fee arrangement is made or also applied when the attorney seeks to collect the fee.

Comment 7 to Texas Rule 1.04 recognizes the time issue and provides that “except in unusual circumstances,” the determination of unconscionability should focus on the time the arrangement was made:

Secondly, fee arrangements normally are made at the outset of representation, a time when many uncertainties and contingencies exist, while claims of unconscionability are made in hindsight when the contingencies have been resolved. The "unconscionability" standard adopts that difference in perspective and requires that a lawyer be given the benefit of any such uncertainties for disciplinary purposes only. Except in very unusual situations, therefore, the circumstances at the time a fee arrangement is made should control in determining a question of unconscionability.

Certainly, the arrangement must meet the reasonableness test at the time the arrangement is made. For example, ABA Formal Opinion 11-458 states that “reasonableness” is determined at the time the fee agreement is reached.11 Less certain is whether the arrangement must also be tested at other times during the engagement, such as at the time of collection.12

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10 To be fair, the Texas rules added “illegal” and “unconscionable” also for more clarity, but one cannot help but doubt whether “unconscionable” is truly less vague than “reasonable.” See Comment 7 to Texas Rule 1.04.
12 See, e.g., Matter of Powell, 2011 WL 4498991 (Ind. Sept. 29, 2011) (“Even if a fee agreement is reasonable under the circumstances at the time entered into, subsequent developments may render collection of the fee unreasonable.”) (Client agreed to pay Attorney one-third of all money in a trust if the attorney successfully removed the trustee. After just one phone call, the trustee agreed to step down.).
Example 1 – Easy Money:
Client and Firm agree to a classic contingency fee for litigation. By all measures, the arrangement is reasonable on the date of the agreement. Before the case is over, the Client and the Firm terminate the arrangement. The case settles the day after the engagement begins without the Firm doing anything.

Issue: Can the attorney ethically collect the fee?

Answer: The assumption that the arrangement is reasonable when made means that the ethical issues arise, if at all, only because subsequent events might make the arrangement unreasonable. Under the ABA rule, there is no ethical issue. The attorney can collect the fee. Under the Indiana rule, there may be doubt whether the attorney can collect the fee.

Perhaps one way around this issue for the client is to argue that it was not reasonable, at the time that the arrangement was made, for the arrangement not to include provisions concerning collection of the fee at different times during the engagement.

Example 2 – You’re Fired:
Client and Firm agree to a classic contingency fee for litigation. By all measures, the arrangement is reasonable on the date of the agreement. Before the case is over, the Client fires the Firm. The Client engages new counsel and recovers a sizeable sum. Can the Firm ethically collect the contingency fee?

Issue: Can the attorney ethically collect the fee?

Answer: The assumption that the arrangement is reasonable when made means that the ethical issues arise, if at all, only because subsequent events might make the arrangement unreasonable. In Texas, the attorney can collect seek recovery of either the agreed contingency fee when the case ends or quantum meruit.13 Similarly, under the ABA rule, there is no ethical issue. The attorney can collect the fee.

At least one commentator and some jurisdictions disagree. Allowing an attorney to collect a full contingency fee when discharged before the case ends can impair a client’s ability to select counsel.14

Some jurisdictions are particularly wary of fees that are fully “earned” upon entering the engagement. In general, however, “[a] lawyer may designate a fee arrangement as a non-refundable retainer and upon receipt deposit such funds in the lawyer's operating account. The amount of a non-refundable retainer fee must be reasonable in amount and comply with Rule 1.5.”15

The “fixed fee” situation is complicated when someone other than the client is setting the fee. For example, in 1994 the Kentucky bar took the position that fixed or flat fee arrangements between a liability insurer and counsel are per se unethical.16

The pressures exerted by the insurer through the set fee interfere with the exercise of the attorney’s independent professional judgment, in contravention of Rule 1.8(f)(2). The set fee arrangement also clashes with Rule 1.7(b) in that it creates a situation whereby the attorney has an interest in the outcome of the action which conflicts with the duties owed to the client; quite simply, in easy cases, counsel will take a financial windfall; in difficult cases, counsel will take a financial loss.

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13 Mandell & Wright v. Thomas, 441 S.W.2d 841, 847 (Tex. 1969).
15 Kentucky Supreme Court Commentary to Ky. R. 1.5, Comm. 11 (2009); Accord Prof'l Ethics Committee for the State Bar of Texas Op. No. 611 at 3 (September 2011) (“A legal fee relating to future services is a non-refundable retainer at the time received only if the fee in its entirety is a reasonable fee to secure the availability of the lawyer's future services and compensate the lawyer for the preclusion of other employment that results from the acceptance of employment by the client.”) (emphasis in original).
16 See Kentucky Bar Ass’n KAB E-368 (1994).
4. AN ORAL CONTINGENCY ARRANGEMENT

Example 3 – Oral Contingency:
Client and Firm agree to an oral classic contingency fee for litigation. By all measures, the arrangement is reasonable.

Issue: Can the Firm ethically collect the fee?

Answer: No. In addition to statute of frauds issues, Texas and the ABA require that a contingency fee be in writing.17

5. CONTINGENCY ARRANGEMENTS AND SETTLEMENT, TRIAL, AND APPEAL

Example 4 – Distinguishing Settlement, Trial and Appeal:
Client and Firm agree to a written contingency fee for litigation, but the agreement does not distinguish different recoveries depending whether the case settles, goes to full trial or goes to appeal. By all other measures, the arrangement is reasonable. The case settles after just a few days of work by the Firm.

Issue: Can the Firm ethically collect the fee despite the lack of distinction between the events of settlement, trial and appeal?

Answer: In Texas, the Firm likely can ethically recover. Texas Ethics Rule 1.04(d) does not require that a contingency agreement distinguish between settlement, trial and appeal. By contrast, ABA Model Rule 1.5(c) requires these distinctions. The ABA Rule does not state that the recovery amounts must differ, but the ABA rule does require that the agreement identify these different events. Note that the assumption in this example is that the agreement is otherwise reasonable. There could still be an ethical issue concerning whether an agreement that fails to distinguish, or at least identify, settlement, trial and appeal meets the overall reasonableness test.

6. CONTINGENCY ARRANGEMENTS AND EXPENSES

Example 5 – Contingency Arrangements and Deduction of Expenses:
Client and Firm agree to a written contingency fee for litigation, but the agreement does not state whether any expenses are paid and deducted before calculating the contingency payment. The case goes through full trial. Firm sends Client a bill for its expenses and for a contingency fee calculated by applying the agreed percentage to the remainder after deducting the expenses.

Issue: Can the Firm ethically collect the expenses and the fee?

Answer: No. The Firm cannot ethically collect the expenses and the fee as presented to the client.

Texas ethics Rule 1.04(c) requires that the engagement agreement must “state the method by which the fee is to be determined. ... The agreement shall state the litigation and other expenses to be deducted from the recovery, and whether such expenses are to be deducted before or after the contingent fee is calculated.”

7. CONTINGENCY ARRANGEMENTS – ILLEGAL OR UNCONSCIONABLE

Example 6 – Immediate payment:
Client and Firm agree to a written contingency fee for litigation. The agreement provides that if Client terminates Firm before the matter concludes, Client must pay the “then present value” of the contingent fee. Client terminates Firm before the matter terminates.

Issue: Can the Firm ethically collect the expenses and the fee?

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17 ABA Model Rule 1.5(c); Texas Rule 1.04(c).
**Answer:** No. The Texas Supreme Court has held such an immediate payment provision to be unconscionable. The provision is therefore not only unethical, it is also unenforceable. The Supreme Court identified the following reasons for its determination:

1. The present value determination placed an undue burden on the client’s ability to change counsel;
2. Because the fee became due without knowing whether the Client would actually win the case, the provision violated the rule that a lawyer is entitled to a contingent fee only when and to the extent that the client receives payment.
3. The arrangement violated Rule 1.04(d) by giving the Firm a property interest in the claim rather than a contingency fee.
4. The fee unfairly shifts risks away from the attorney and to the client.
5. The fee provides an incentive to the attorney to be terminated.
6. The fee violates the attorney’s duty to provide notice to the client as to how the fee is calculated.

**Example 7 – High percentages:**

Client and Firm agree to a series of two contingency fee agreements for litigation. The effect of the two agreements, together, is that Client pays 60% if the case settles prior to jury selection, 80% if jury selection commences, and 100% if the case is appealed. Additionally, Client must pay $200 per hour for the attorney’s time.

**Issue:** Can the Firm ethically collect the expenses and the fee?

**Answer:** No. The fees are unconscionably high.

**8. ALTERNATIVE LITIGATION FINANCING – ILLEGAL MAINTENANCE, CHAMPERTY OR BARRATRY?**

**Example 8 – Assignment of a portion of a claim for financing:**

Client wishes to pursue a patent infringement action against an infringer. However, Client does not have the financial resources to pursue such a claim. Client goes to ALF, a business that focuses on funding litigation. ALF and Client sign an agreement that provides:

1. ALF will pay the fees for Client’s patent litigation
2. If Client receives any recovery (in settlement or by judgment), then, Client will at that time pay ALF all moneys advanced by ALF plus x% interest.

**Issue:** Is the assignment legal and enforceable?

**Answer:** The first and most obvious ethics issue concerning a litigation financing agreement is whether the agreement is an illegal transaction. Historically, such agreements raise issues of maintenance, champerty and barratry. “[P]ut simply, maintenance is helping another prosecute a suit; champerty is maintaining a suit in return for a financial interest in the outcome; and barratry is a continuing practice of maintenance or champerty.” Additional issues raised can include usury, gambling, and consumer protection statutes.
Whether the ALF agreement is illegal is not, per se, an issue for trial counsel for a party unless the trial counsel is engaged in connection with the ALF agreement or interested in some way in the ALF agreement. It is an issue for counsel for the Client (the counsel who represents Client, if any, in negotiation of the ALF agreement) and for the ALF.

In Texas, litigation financing agreements are generally legal. In fact, in general in Texas, champerty is not absolutely prohibited and no cause of action for champerty exists. In Texas, litigation financing agreements are generally legal.25 In fact, in general in Texas, champerty is not absolutely prohibited and no cause of action for champerty exists.26 Barratry remains a crime in Texas, but is seldom enforced. However, by statute, Texas law has allowed assignment of an “interest in a cause of action on which suit has been filed” since 1889.28 Case law, however, citing public policy, prohibits assignment of claims for legal malpractice, certain assignment of interests in an estate, collusive assignments of insurance claims, Mary Carter agreements, settlement agreements enabling one joint tortfeasor to sue another on the injured plaintiff’s claim, and assignments of claims under the Deceptive Trade Practices Act.29 Patent infringement actions are not within the exceptions, i.e., assignment of patent infringement actions is permitted.

Because the practice of many Texas patent litigators is not limited to Texas courts, Texas parties, or Texas facts, knowing only Texas law on this issue is not a safe practice. Even outside Texas, the modern cases that recognize maintenance, champerty, or barratry have tended not to find third-party financing agreements – at least the kind of the modern industry – to violate any of these doctrines. According to one survey, 29 out of 51 jurisdictions, including the District of Columbia, permit some form of champerty as long as the ALF is not:

1. Clearly promoting “frivolous” litigation (e.g. a lawsuit that the party that does vindicate a genuine legal interest of the party bringing the lawsuit);
2. Engaging in “malice champerty”, which is the support of meritorious litigation motivated by an improper motive. (e.g. prima facie tort in NY);
3. “Intermeddling” with the conduct of the litigation (e.g. determining trial strategy or controlling settlement).

27 Penal Code §38.12 includes the following possibly applicable provisions:

Sec. 38.12. BARRATRY AND SOLICITATION OF PROFESSIONAL EMPLOYMENT.
(a) A person commits an offense if, with intent to obtain an economic benefit the person:

... (3) pays, gives, or advances or offers to pay, give, or advance to a prospective client money or anything of value to obtain employment as a professional from the prospective client;

(b) A person commits an offense if the person:

(1) knowingly finances the commission of an offense under Subsection (a);
(2) invests funds the person knows or believes are intended to further the commission of an offense under Subsection (a); or
(3) is a professional who knowingly accepts employment within the scope of the person's license, registration, or certification that results from the solicitation of employment in violation of Subsection (a).

28 Tex. Prop. Code §12.014. See Act approved March 26, 1889, 21st Leg., R.S., ch 89, 1889 Tex. Gen. Laws 103, 103, reprinted in 9 H.P.N. Gammel, The Laws of Texas 1822-1897, at 1131, 1131 (Austin, Gammel Book Co. 1898) (Vernon 1989). While the current language of the statute focuses on a “suit that has been filed,” at least one Texas court has held that a person may assign an interest in a future cause of action.

Modern decisions in Minnesota, Ohio, Pennsylvania, and Arizona have concluded that certain litigation financing agreements as champertous. However, in 2008, the Ohio legislature enacted a statute permitting ALF agreements. Other than these few decisions, modern third-party financing agreements seem to have survived attacks based on maintenance and champerty.

In 2008, a North Carolina Court of Appeals held a litigation funding agreement not to be an illegal gaming contract and not to be champertous. However, the court found that the agreement met the elements of usury and was also a violation of the state consumer protection statute. The North Carolina court likely would not find the agreement in the example above to be illegal champerty (but would find the agreement to be usurious if the interest were too high). While the agreement could affect Client’s decision about a reasonable settlement, the North Carolina court requires that the affect (or control) must be “for the purpose of stirring up strife and continuing litigation.” That is a difficult standard to meet.

In Florida, a financing agreement by Client’s sister (drafted by and solicited by Client) was held not to be champertous. When considering a litigation funding agreement, the Massachusetts Supreme Judicial Court simply did away with the doctrine of champerty. The South Carolina Supreme Court did likewise.

New York recognizes champerty, but New York’s champerty law requires that the funding agreement be “with the intent and for the purpose of bringing an action or proceeding thereon.” New York case law upholds litigation funding agreements and assignments as long as the primary purpose and intent of the assignment is for some reason other than bringing suit on that assignment. In New York, an ALF agreement may survive a champerty challenge by assigning a portion of the proceeds rather than assigning the claim itself. Thus, by crafting the agreement to focus on the investment or settlement proceeds, a litigation funding agreement can pass muster in New York.

In the end, the issue of champerty may be avoided by choosing the right form for the funding agreement. A patent owner can always avoid the assignment of a cause of action by assigning or exclusively licensing the underlying patent (and the right to sue for past infringement). The issue of champerty should not apply to such an assignment.

9. ALTERNATIVE LITIGATION FINANCING – ILLEGAL USURY?

Example 9 – Assignment of a portion of a claim for financing:

Client wishes to pursue a patent infringement action against an infringer. However, Client does not have the financial resources to pursue such a claim. Client goes to ALF, a business that focuses on funding litigation. ALF and Client sign an agreement that provides:

1. ALF will pay the fees and expenses for Client’s patent litigation.
2. If Client receives any recovery (in settlement or by judgment), then, if there is sufficient money, Client will at that time pay ALF:
   A. Twice the amount actually paid by ALF plus
   B. An extra return of 3% of the remaining recovery.

31 Johnson v. Wright, 682 N.W.2d 671 (Minn.App. 2004).
35 Ohio Revised Code Section 1349.55.
37 If Client receives any recovery, Client owes the amount advanced plus interest. However, it is possible that a reasonable settlement might be less than the amounts advanced. Thus, ALF might influence Client not to accept the settlement, or the agreement itself might influence Client not to accept the settlement, because Client would owe a balance to ALF if Client accepts the settlement.
38 Kraft v. Mason, 668 So.2d 679 (Fla.App. 4 Dist. 1996).
41 NY Jud. Law § 478, 479.
3. If Client’s recovery is insufficient to pay the amount above, then a formula will determine a percentage of
the recovery (less than 80%), that Client will pay ALF.
4. If Client recovers nothing, then Client owes ALF nothing.

**Issue:** Is the agreement usurious?

**Answer:** In Texas, the elements of a usurious transaction are “(1) a loan of money, (2) an absolute obligation to
repay the principal, and (3) the exaction of a greater compensation than allowed by law for the use of the money by
the borrower.” *First Bank v. Tony's Tortilla Factory, Inc.*, 877 S.W.2d 285, 287 (Tex. 1994). At least two Texas
courts have concluded that the ALF agreement above is not usurious because the repayment obligation is not
absolute. Neither agreement was found to be usurious – again, because the repayment obligation was not absolute.
Of course, all usury discussions require a greater compensation than allowed by law, but that is rarely hard to prove
in connection with ALF agreements.

In anticipation of the usury issue, many ALF agreements stress repeatedly that the agreement is not a loan but is
an investment. Likely, no court would be swayed by such self-serving language. ALFA, the industry
organization for ALFs, explains on its website that its members do not provide “loans” because the payments are
“non-recourse,” by which ALFA means that the repayment occurs only if the Client recovers in the lawsuit. This
actually merges two of the three elements of usury (whether the arrangement is a loan and whether the repayment
obligation is absolute).

The determinative issue in most cases is whether the repayment obligation is absolute. A repayment obligation
that is absolute, if the return exceeds the usury rate, is usually found to be illegal usury.

10. ALTERNATIVE LITIGATION FINANCING – MAY AN ATTORNEY REFER A CLIENT TO AN
ALF?

**Example 10 – Referral to ALF:**

Client wishes to pursue a patent infringement action against an infringer. Client does not have the financial
resources to pursue such a claim. Firm refers Client to ALF. Firm has no interest in or relationship with ALF.

**Issue:** May Firm make this referral?

**Answer:** Probably “Yes.” No Texas Rule or Model Rule prohibits this referral. No Texas ethics opinion has
addressed the issue. Because it is generally legal for Client to enter into the ALF agreement, we can see no reason
that would prohibit Firm from making this referral. Several state bar ethics opinions have considered the issue and
concluded that such referrals are permitted.

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45 See, e.g., Comments of Augusta Capital, LLC to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. (Feb. 7, 2011)
(“funding”); Comments of Oasis Legal Finance, LLC to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. (Jan. 18,
2011) (“This product does not fall into a traditional ‘loan product’ category as it is non-recourse.”).
46 Many courts have expressed distaste for the obvious attempt to call these loans something different. See, e.g., *Echeverria v.
11. ALTERNATIVE LITIGATION FINANCING – MAY AN ATTORNEY RECEIVE A FEE FOR REFERRING A CLIENT TO AN ALF?

Example 11 – Referral to ALF:

Client wishes to pursue a patent infringement action against an infringer. Client does not have the financial resources to pursue such a claim. Attorney refers Client to ALF. Attorney has no interest in or relationship with ALF, but Attorney receives a fee from ALF for the referral.

Issue: May Attorney make this referral?

Answer: Texas has no authority yet on this issue. Many state ethics opinions prohibit Attorney from receiving a referral fee. A referral fee seems to create a conflict of interest between Attorney’s profit and Client’s best interest. However, the ABA White Paper suggests that under certain conditions, Attorney may receive a referral fee. Texas Rule 7.03(b) and Model Rule 7.2(b) prohibit Attorney from paying others for referrals of clients. However, neither the Texas Rules nor the Model Rules contain an express prohibition against Attorney receiving referral fees. If acceptance of referral fees from ALF are not absolutely prohibited (it may be), at the very least, Attorney must disclose the referral fee to Client and obtain Client’s written consent.

12. ALTERNATIVE LITIGATION FINANCING – MAY AN ATTORNEY OWN THE ALF?

Example 12 – Attorney interest in ALF:

Client wishes to pursue a patent infringement action against an infringer. Client is not indigent. However, Client does not have the financial resources to pursue such a claim. Firm refers Client to ALF. ALF is 100% owned by Attorney in Firm.

Issue: May Firm make this referral or this arrangement?

Answer: In most states, the answer is “No.” In Texas, the answer is “Yes,” but it is a very, very qualified yes. Any one of the following facts could make the arrangement and the referral unethical:

1. If the Firm-Client engagement does not meet the ethical requirements for a contingent fee in Rule 1.04;
2. If ALF does not make loans to the general public but only makes loans to clients of Attorney or Firm;
3. If the referral or agreement creates a conflict of interest prohibited by Rule 1.06 (for example, if the loyalty of Attorney to Client is jeopardized);
4. If the referral or the ALF agreement or the relationship between ALF and Firm and Attorney is used to influence Client to secure or continue the employment of Firm or Attorney;
5. If the referral or the ALF agreement or the relationship between ALF and Firm and Attorney is in any manner which violates Rules 7.02 or 7.03 (primarily concerned with communications, solicitation, and advertising);
6. If any communication or advertising of Attorney or Firm’s services violates Rule 7.01;
7. If any transaction involving Client and Attorney or Firm violates Rule 1.08;
8. If Attorney or Firm violate Rule 8.04, particularly Subsections (a) (3) and (8)(misconduct, dishonesty, fraud, deceit, misrepresentation);
9. If the interest charges are not fair, reasonable, customary and at a lawful rate.

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50 ABA White Paper, p. 16.
The Texas rule is interesting in light of the fact that Attorney and Firm are prohibited from making the loan to Client. Under the Model Rule 1.8(e) and under the Texas Rule 1.8(d), Firm may not advance litigation funds to Client except in two situations: (1) Firm may advance court costs and expenses of litigation contingent on the outcome of the matter and (2) if Client is indigent, Firm may pay court costs and expenses of the litigation. It is interesting that Texas did not include the relevant Comment (Comment 10) in the Model Rules that explains that the two reasons for the prohibition are “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.”

Further, under Model Rule 1.8(i) and Texas Rule 1.8(h), Firm may not acquire a proprietary interest in litigation (other than a permitted contingent fee and any statutory lien). Again, the Texas Rules do not include the Model Rule Comment that explains that “the general rule has its basis in common law champerty and maintenance and is designed to avoid giving the lawyer too great an interest in the representation. In addition, when the lawyer acquires an ownership interest in the subject of the representation, it will be more difficult for a client to discharge the lawyer if the client so desires.”

In other jurisdictions, this example is answered with an absolute “No.” The reasoning includes fear that Client might reasonably believe that the ALF services are part of the attorney-client relationship, fear that Attorney’s interest in ALF might affect the exercise of Partner’s independent professional judgment on behalf of Client, fear that Attorney will tout the ability to refer clients to ALF as a means of attracting clients, and fear of compromising the confidential communications between Attorney and Client.54

13. ALTERNATIVE LITIGATION FINANCING – MAY FIRM EVALUATE THE ALF AGREEMENT FOR CLIENT?

Example 13 – Referral to ALF:

Client is considering an ALF agreement for patent litigation that Attorney is handling. Client asks Attorney to review the ALF agreement before Client signs.

**Issue:** May Attorney review the ALF agreement for Client? May Attorney receive a fee separate from the fee for the litigation for this work?

**Answer:** In likely all jurisdictions, Attorney may evaluate the ALF agreement for Client and may receive a reasonable fee. This general answer is subject to the following conditions.

1. Attorney must have competence to evaluate the ALF agreement.55 At a minimum, Attorney should become familiar with the terms of the ALF agreement and explain the risks and benefits to Client in terms Client can understand. Attorney likely should compare the proposed ALF agreement with other available means of funding, and possibly to recommend alternatives. If Attorney is not competent to evaluate the risks and benefits, Attorney should refer Client to a competent advisor.56
2. Attorney should advise Client that the ALF agreement may require Client and Attorney to disclose confidential information, but Attorney must never disclose such information without Client’s consent.57
3. Attorney should advise Client about the risk of waiver of the attorney-client privilege.58
4. In some jurisdictions, but not all, Attorney must be satisfied that the ALF agreement is in Client’s best interests.59
5. Attorney must insure that Attorney’s involvement in the ALF agreement does not interfere with Attorney’s professional judgment.60

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54 N.Y. State Bar Ass’n Comm. on Prof’l Ethics, Advisory Op. 769 (2003); Florida Opinion 00-3 (2002).
55 Texas Rule 1.01; Model Rule 1.1.
6. At least one opinion (from South Carolina) requires Attorney to inform ALF in writing that Client, not ALF, retains the right to control all aspects of the litigation.61

The issue of Attorney evaluating the ALF agreement becomes more complicated if the agreement affects Attorney’s financial interests – which it almost always will do by definition. For example:

1. Attorney may have a long-term relationship with ALF.
2. The ALF agreement may, and likely does, address whether, when and how the attorneys fees and expenses are paid.
3. Attorney may be getting a referral fee from ALF.

Any of the above facts could lead a disciplinary review board to view the ALF agreement as either a transaction between Client and Attorney or otherwise as a conflict of interest.62 Any transaction that involves Client and Attorney must meet the requirements of Texas Rule 1.08(a) (and its counterpart in other jurisdictions, which provides:

Rule 1.08 Conflict of Interest: Prohibited Transactions

(a) A lawyer shall not enter into a business transaction with a client unless:

(1) The transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed in a manner which can be reasonably understood by the client;
(2) The client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
(3) The client consents in writing thereto.63

14. ALTERNATIVE LITIGATION FINANCING – “YOUR ONE STOP FOR PATENT LITIGATION”

Example 14 – Advertising:
Attorney, a patent litigator, also owns an interest in an ALF. Attorney’s business cards and advertising include reference to Attorney’s ability to arrange financing for the litigation.

Issue: Does Attorney’s advertising violate any ethical rules?

Answer: Yes, this advertising is a violation of Texas ethical rule 7.03(c) which provides:

(c) A lawyer, in order to solicit professional employment, shall not pay, give, advance, or offer to pay, give, or advance anything of value, other than actual litigation expenses and other financial assistance as permitted by Rule 1.08(d), to a prospective client or any other person; provided however, this provision does not prohibit the payment of legitimate referral fees as permitted by paragraph (b) of this Rule.

This prohibition is noted in several Texas ethics opinions concerning ALF agreements.64 Note that Texas Rule 7.03(c) has no corollary in the Model Rules, but the Model Rules do contain similar prohibitions on Attorney providing a loan to Client.

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62 Even a well meaning attorney trying to help out a client can run into ethical problems by helping a client get a loan. See Passante v. McWilliam, 62 Cal. Rptr. 2d 298 (Cal. Ct. App. 1997).
63 The Model Rule requires informed consent. Texas requires only consent.
15. ALTERNATIVE LITIGATION FINANCING – ALF VETO POWER OVER CLIENT’S TERMINATION OF ATTORNEY

Example 15 – Referral to ALF:
ALF agrees to provide funding for Client’s patent infringement litigation. The agreement provides that Client may not terminate Attorney without ALF’s consent. Client and ALF do not disclose this provision to Attorney.

Issue: Is there an ethical violation?

Answer: Likely the Attorney has not committed any ethical violation. It would be an ethical violation for Attorney to enter into any agreement with Client that restricts Client’s right or freedom to terminate Attorney. Texas Rule 1.15(a) and Model Rule 1.16(a). It would be an ethical violation for Attorney to negotiate an agreement between Client and ALF that restricts Client’s right or freedom to terminate Attorney. However, if Attorney is not involved in the negotiations, does not see the ALF agreement, and never learns of the restriction, Attorney has not committed an ethics violation.

However, the agreement is likely champertous and unenforceable. ALF’s ability to veto termination of counsel likely would be deemed “officious meddling.”

16. ALTERNATIVE LITIGATION FINANCING – PARTNER HAS WORKED WITH ALF FOR A LONG TIME

Example 16 – Long relationship:
Partner has worked on many patent infringement cases for many years where ALF provided the funding for the clients. New Client comes to Partner with a patent infringement case. Partner refers New Client to ALF for funding.

Issue: Is Partner at any ethical risk because of the referral?

Answer: As always, the answer is “It depends.” However, a long time relationship between Partner and ALF could be the basis for a claim that Partner has a conflict of interest in violation of Texas Rule 1.06(b)(2). A lawyer with a long-term history of working with a particular ALF may have an interest in keeping the ALF happy.

17. ALTERNATIVE LITIGATION FINANCING – FIRM PREVIOUSLY REPRESENTED ALF

Example 17 – Long relationship:
ALF engaged Firm to write its contracts and governing documents. Partner in Firm now represents Client in a patent infringement case. Client obtains funding from ALF.

Issue: Is Partner at any ethical risk because of the prior engagement of the Firm?

Answer: In Texas, the answer is unclear. In New York, the prior engagement leads to an inference that Partner and Firm intend to represent both ALF and Client.

18. ALTERNATIVE LITIGATION FINANCING – RECEIPT OF REFERRAL FEE FROM ALF

Example 18 – Long relationship:
Attorney receives referral fees from ALF whenever Attorney sends clients to ALF.

Issue: Has Attorney committed an ethical violation?

Answer: Yes. The acceptance of referral fees very likely constitutes a material limitation on the representation of the client, resulting from a personal interest of the lawyer. Attorney must obtain the consent from Client concerning the referral-fee arrangement.

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65 ABA White Paper, p. 18.
66 Id.
67 Leon v. Martinez, 638 N.E.2d 511 (N.Y. 1994)
19. ALTERNATIVE LITIGATION FINANCING – ATTORNEY SHARES OF STOCK IN LIEU OF FEES

**Example 19**—
Attorney agrees to represent Client in a patent infringement case and accepts shares of stock in Client in lieu of fees.

**Issue:** Has Attorney committed an ethical violation?

**Answer:** It depends. The ABA Standing Committee on Ethics and Professional Responsibility has concluded that Attorney may acquire an ownership interest in the stock of corporate Client rather than fees, but Client must give “informed consent” to the investment and the transaction must satisfy the requirements of Model Rule 1.8(a). The ethical concern here is that Attorney might manipulate the investment transaction in a way that is not fair to Client. To avoid an ethics violation, the lawyer must obtain the client’s consent to the conflict created by the lawyer’s role in funding the contract and the client’s consent must be confirmed in writing.

In Texas, consent written consent alone is required. In most other states, “informed consent” is required. Informed consent means that Client agrees “after the lawyer has communicated adequate information and explanation about the material risks and reasonably available alternatives to the proposed course of conduct.” Attorney should also suggest reasonably available alternatives to Client providing shares of stock if alternatives may be in the client’s best interest.

20. ALTERNATIVE LITIGATION FINANCING – EFFECT ON SETTLEMENT

**Example 20**—
Client agrees that ALF has the right to approve or reject any proposed settlement of the patent infringement cause of action. Attorney represents Client in the patent infringement action, and referred Client to ALF. Attorney knows that ALF requires these consent clauses, but Attorney did not represent Client in the negotiation with ALF.

**Issue:** Has Attorney committed an ethical violation?

**Answer:** Likely not, but there are ethical issues to consider.

The consent/rejection provision of the ALF-Client agreement may be unenforceable. Certainly, if the Client-Attorney engagement agreement limited Client’s authority to make settlement decisions, many courts would find the provision unenforceable and unethical. Whether the ALF-Client agreement having such a settlement limitation would require Attorney to withdraw remains unanswered. The question to be answered is whether Client’s delegation of settlement decision making is a significant limitation on Attorney’s independent professional judgment with respect to representing Client. Attorneys must evaluate any settlement offer from the standpoint of the client’s best interests, taking into account the terms of the offer and the risks of proceeding to litigation.

21. ALTERNATIVE LITIGATION FINANCING – ATTORNEY OBTAINS FUNDING FROM ALF

**Example 21**—
Client engages Attorney for its patent infringement action. Attorney contracts with ALF to have ALF provide the expected fee, at a discount, in exchange for a security interest in the payments to be made by Client.

**Issue:** Has Attorney committed an ethical violation?

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68 Texas Rule 1.06.
70 Model Rule 1.0(e).
72 See Restatement of the Law Governing Lawyers § 22 and Reporter’s Note; see also ABA White Paper p 28-29.
73 See Model Rule 1.2(c) (only reasonable limitations on scope of representation are permissible); Model Rule 1.16(a)(1) (withdrawal required where representation would result in violation of the rules of professional conduct); See also ABA White Paper p 28-29.
74 Model Rule 1.2(a)
**Answer:** Likely yes. In most states, including Texas, lawyers generally are prohibited from sharing a fee with a non-lawyer.\(^75\) The purpose of this prohibition is to protect the independence of a lawyer’s professional judgment.\(^76\)

Ethics opinions in Ohio and Utah have concluded that such agreements are in violation of the prohibitions against sharing fees with non-lawyers and allowing a person other than the client to influence the representation.\(^77\) However, an Ohio court found that it is permissible for a lender to take a security interest in a lawyer’s accounts receivable as long as it was within the boundaries permitted by commercial law.\(^78\)

### 22. ALTERNATIVE LITIGATION FINANCING – LITIGATION REPORTS AND EVALUATIONS TO ALF

**Example 22 –**

Client obtains ALF supplied funding for its patent infringement litigation. Both before and during the litigation, ALF requires that Attorney provide reports and evaluations of the litigation and settlement possibilities.

**Issue:** What ethical issues must Attorney consider?

**Answer:** The required reports and evaluations impact attorney-client confidentiality, the attorney-client privilege, and the work product exemption.

The ethical rules require that Attorney use reasonable care to protect the confidentiality of attorney-client communications.\(^79\) A client may not reveal client confidential information except to a limited number of persons identified in the ethics rules, and an ALF is not among the identified persons. Therefore, unless the client approves, the attorney may not disclose any information to ALF. The attorney would be well advised to obtain express written approval for any disclosure to ALF.

In addition, a report or evaluation provided to ALF could become discoverable.\(^80\) If the report or evaluation includes information that would, but for the disclosure, be protectable under the attorney-client privilege or the work product exemption, then the attorney should explain the risks to the client and then obtain approval for the disclosure.

**CONCLUSION**

The potential ethical issues in an ALF supplier situation are almost limitless. In general, if an ALF is supplying funding for patent infringement litigation, the attorney must keep in mind the ethical rules concerning reasonableness of the fees, the client’s best interest, the client’s right to control the litigation, and the need to inform the client about risk of loss of confidentiality and privilege.

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\(^{75}\) Texas Rule 5.04(a); MODEL RULE 5.4(a); See also ABA Whitepaper p 31.

\(^{76}\) Model Rule 5.4, cmt. [1]; See also ABA White Paper p 31.


\(^{78}\) Core Funding Group v. McDonald, No. L-05-1291, 2006 WL 832833 (Ohio Ct. App. Mar. 31, 2006); See also ABA Whitepaper p 31.

\(^{79}\) Texas Rule 1.5; Model Rule 1.6, cmts. [16]–[17].