

**LOS ANGELES COUNTY BAR ASSOCIATION
PROFESSIONAL RESPONSIBILITY AND ETHICS COMMITTEE**

OPINION NO. 526
February 9, 2015

CONTINGENCY LAWYER'S RIGHT TO NEGOTIATE A FEE AGREEMENT
THAT GIVES FIRST PROCEEDS TO THE LAWYER
AND SHIFTS TO THE CLIENT THE RISK OF NONPAYMENT

SUMMARY

A lawyer may enter into a binding and enforceable contingency fee agreement that provides to the lawyer some or all of the first proceeds of suit so as to impose on the client greater risk that the defendant's financial condition will limit the amount recovered from a settlement agreement or judgment. Any such risk-shifting agreement requires the client's informed consent based on the lawyer's full and fair disclosure of pertinent information known to the lawyer.

AUTHORITIES CITED

Rules of Professional Conduct:

Calif. Rules of Professional Conduct, Rules 3-300 and 4-200

Statutes:

Bus. & Prof. C. § 6147
Civ. C. § 1670.5
42 USC § 1983

Cases:

Brobeck, Phleger & Harrison v. Telex Corp., 602 F.2d 866 (9th Cir. 1979)
Yerkovich v. MCA, Inc., 11 F. Supp.2d 1167 (C.D. Cal. 1997)
Tarver v. State Bar, 37 Cal.3d 122 (1984)
Cetenko v. United California Bank, 30 Cal.3d 528 (1982)
Herrscher v. State Bar, 4 Cal.2d 399 (1934)
Goldstone v. State Bar, 214 Cal. 490 (1931)
Cotchett, Pitre & McCarthy v. Universal Paragon Corp., 187 Cal. App. 4th 1405 (2010)
Ramirez v. Sturdevant, 21 Cal. App.4th 904 (1994)
Alderman v. Hamilton, 205 Cal. App.3d 1033 (1988)
Sayble v. Feinman, 76 Cal. App.3d 509 (1978)
Setzer v. Robinson, 57 Cal.2d 213 (1962)
Matter of Phillips, 2011 Calif. Op. LEXIS 22 (Rev. Dept. 2011)

Matter of Goddard, 2011 Calif. Op. LEXIS 13 (Rev. Dept. 2011)
Matter of Wells, 2005 Calif. Op. LEXIS 9 (Rev. Dept. 2005)
Matter of Van Sickle, 2005 Calif. Op. LEXIS 3 (Rev. Dept. 2005)
Matter of Yagman, 3 Cal. State Bar Ct. Rptr. 788, 1997 Calif. Op. LEXIS 8 (Rev. Dept. 1997)
In re Stochel, 792 N.E.2d 874 (Ind. 2003)

Ethics Opinions:

Cal. State Bar Op. 1994-135
L.A. County Bar Ops. 496 (1998) and 518 (2006)

Other Authorities:

Restatement Third, The Law Governing Lawyers § 35(2)

STATEMENT OF FACTS

XYZ, Inc. wishes to pursue a contract breach claim against Potential Defendant. XYZ asks Lawyer to represent it on a contingent fee basis. XYZ explains to Lawyer that it has limited cash and credit, which it wishes to use to deal with the consequences of Potential Defendant's conduct, and that it therefor lacks the financial ability to pay Lawyer on an hourly basis or even on a mixed contingent-hourly basis. XYZ believes that the amount of its potential damages could be "devastating" to Potential Defendant. XYZ shares this view with Lawyer, and it further provides Lawyer with information it has regarding Potential Defendant's business activities, financial strength, and possible inability to satisfy XYZ's claim fully. Lawyer has no information that suggests that XYZ's beliefs are not well founded. Because of the nature of the claim, Lawyer expects that Potential Defendant will have no insurance to provide defense or indemnity, so that the entire financial burden of the proposed litigation will fall on Potential Defendant. Lawyer recognizes the resulting risk that her investment of time and other resources in pursuing Potential Defendant might result in a recovery limited by the Potential Defendant's financial condition. As a result, and at Lawyer's insistence, Lawyer and XYZ negotiate a contingency fee agreement that shifts to XYZ the entire risk of limited payment by Potential Defendant by giving Lawyer the right to the first proceeds of any settlement or judgment up to the full amount of the agreed contingent fee. The fee agreement is contained in an unambiguous writing that complies with Bus. & Prof. C. § 6147 and explains in clear language the risk that XYZ's recovery might be reduced or even eliminated by Lawyer's superior rights. Although the conduct of Potential Defendant has left XYZ in a perilous financial situation, and its management facing difficult operating problems, its management is experienced and capable.

ISSUE

Based on these facts, we are asked whether Lawyer acted improperly in entering into a contingent fee agreement that shifted to her client the risk of partial payment of any resulting settlement or judgment.

DISCUSSION

Introduction: As a general rule, a lawyer is entitled to collect a contingent fee only as and when the client receives payment on a resulting settlement or judgment. This is recognized by Restatement Third, The Law Governing Lawyers § 35(2):

Unless the contract construed in the circumstances indicates otherwise, when a lawyer has contracted for a contingent fee, the lawyer is entitled to receive the specified fee only when and to the extent the client receives payment.

See also In re Stochel, 792 N.E.2d 874 (Ind. 2003); *Sayble v. Feinman*, 76 Cal. App.3d 509 (1978); and Cal. State Bar Op. 1994-135 (1994). However, while the Restatement and other sources consider the lawyer's collection right in the absence of a fee agreement to the contrary, we are not aware of any civil or disciplinary opinion or advisory ethics opinion that directly addresses the question of whether a contingent fee lawyer may enter into a fee agreement that gives the lawyer the first proceeds of any recovery, up to the full amount of the lawyer's agreed fee, in order to shift to the client the risk that the defendant might be financially unable to satisfy any resulting settlement or judgment. We will address that issue in this opinion.

Fee Negotiations and Agreements: A lawyer's fee negotiation with a client generally is an arm's length transaction in which the lawyer is entitled to act to advance and protect his or her own interests. See, e.g., *Cotchett, Pitre & McCarthy v. Universal Paragon Corp.*, 187 Cal. App.4th 1405, 1421 (2010); *Ramirez v. Sturdevant*, 21 Cal. App.4th 904, 913 (1994); and *Setzer v. Robinson*, 57 Cal.2d 213, 217 (1962).¹

However, there are limitations on a lawyer's ability to negotiate a fee agreement. With respect to a contingent fee agreement, the first two restrictions are that the fee agreement will be enforceable only if it fully complies with the requirements of Bus. & Prof. C. § 6147 and is reasonably understandable to the client. The latter prerequisite follows from the rule that any lack of clarity will be read against the lawyer, at least if the lawyer drafted the agreement. See, e.g., *Alderman v. Hamilton*, 205 Cal. App.3d 1033, 1036-37 (1988), which states the rule that a fee agreement must be "fair, reasonable and fully explained to the client" ("explained" means that it must be fully stated and understandable, not that the lawyer has an obligation to provide

¹ A lawyer does not engage in a business transaction with a client when entering into an agreement for an hourly or flat fee or, as is the case here, a contingency fee agreement, and the business transaction rule, Rule 3-300 of California's Rules of Professional Conduct (hereafter *CRPC*) does not apply in any of those situations. See L.A. County Bar Op. 496 (1998).

legal advice to someone who is not yet a client²). The Statement of Facts shows that Lawyer has met both of these standards in her fee agreement with XYZ.

Illegal and Unconscionable Fees: The third and fourth limits on a lawyer's fee agreement are stated in CRPC 4-200: "(A) A member shall not enter into an agreement for, charge, or collect an *illegal or unconscionable* fee." (emphasis added) Examples of an "illegal" fee agreement under CRPC 4-200(A) include one that violates 28 USC § 2678 (making it a federal crime to enter into a contingent fee agreement for handling claims under the Federal Tort Claims Act for a fee in excess of statutory limits), one that attempts to prevent the federal district court from exercising its authority to determine the reasonableness of fees in an action under 42 USC § 1983 (*Matter of Yagman*, 3 Cal. State Bar Ct. Rptr. 788, 1997 Calif. Op. LEXIS 8 (Rev. Dept. 1997)), taking fees in a bankruptcy matter without permission of the federal bankruptcy court (*Matter of Phillips*, 2011 Calif. Op. LEXIS 22 (Rev. Dept. 2011)), and any fees when engaged in the unauthorized practice of law (*Matter of Wells*, 2005 Calif. Op. LEXIS 9 (Rev. Dept. 2005)). There is no statute, rule, or case law that would make illegal the contingent fee agreement that is the subject of this opinion.

The concept of "unconscionable" under CRPC 4-200(A) is more complex. A fee can be unconscionable without respect to its size when the fee is arrived at by some form of dishonesty or overreaching by the lawyer. This was described as follows in *Herrscher v. State Bar*, 4 Cal.2d 399, 402 (1934): "In the few cases where discipline has been enforced against an attorney for charging excessive fees, there has usually been present some element of fraud or overreaching on the attorney's part, or failure on the attorney's part to disclose the true facts, so that the fee charged, under the circumstances, constituted a practical appropriation of the client's funds under the guise of retaining them as fees. (citations omitted)" An example of the *Herrscher* kind of unconscionability is found in *Matter of Van Sickle*, 2005 Calif. Op. LEXIS 3 (Rev. Dept. 2005). There, a lawyer agreed to represent a client on a contingent fee basis as the replacement for the client's prior contingency fee lawyer in the same matter. The second lawyer's fee was to be an unremarkable 35%, but the fee agreement was held to be unconscionable because he failed to disclose to this client that this fee would be in addition to any fee payable by the client to her prior lawyer. There is nothing in the Statement of Facts that suggests such a violation because the surrounding facts were known fully to XYZ, and Lawyer did not hide or misrepresent any fact or any aspect of the fee agreement.

More commonly, a fee can be unconscionable from its size alone: "[I]f a fee is charged so exorbitant and wholly disproportionate to the services performed as to shock the conscience of those to whose attention it is called, such a case warrants disciplinary action by this court." *Goldstone v. State Bar*, 214 Cal. 490, 498-99 (1931) (followed, e.g., in *Tarver v. State Bar*, 37 Cal.3d 122 (1984) (lawyer disbarred based, among other things, on charging an unconscionable fee). The shock the conscience standard is measured by the non-exclusive list of factors set out in CRPC 4-200(B).

² It is only to a current client that a lawyer is obligated to provide representation, but a fee is unconscionable under CRPC 4-200(A) if charged without the client's informed consent. **Error! Main Document Only.** See *Matter of Goddard*, 2011 Calif. Op. LEXIS 13 (Rev. Dept. 2011).

There is no known authority that would make unconscionable under the “shock the conscience” standard a fee agreement that shifts to the client the risk of limited collectability and thereby results in the lawyer receiving compensation that is disproportionate as measured by usual contingency fee rates or when compared to any net amount received by the client. As stated in the first sentence of CRPC 4-200(A), the propriety of a fee normally is measured at the time the fee agreement is made. See, e.g., L.A. County Bar Op. 518 (2006). The rule is the same in the civil context. See, e.g., in *Brobeck, Phleger & Harrison v. Telex Corp.*, 602 F.2d 866, 875 (9th Cir. 1979) (applying California law), *cert. denied*, 444 U.S. 981 (1979) and *Cetenko v. United California Bank*, 30 Cal.3d 528, 532 (1982). The requirement that the measurement be at the time the fee agreement is made is consistent with general principles of contractual unconscionability. *Yerkovich v. MCA, Inc.*, 11 F. Supp.2d 1167, 1173 (C.D. Cal. 1997) and Civ. C. § 1670.5. Because of this rule, the eventuality that Lawyer receives most or even all of the recovery does not factor into the unconscionability analysis. Rather, the inquiry must be whether the facts known when the fee agreement was made require the conclusion that the risk-shifting device was unconscionable.

In other circumstances, such as hourly fee arrangements in which the amount of an attorney’s fee turns out to match or even exceed the amount of the client’s recovery, and even where the client recovers nothing, the fee agreement does not become unconscionable simply because the client receives a small recovery or none at all. The same is true when a lawyer represents a losing defendant in litigation or when a transactional lawyer represents a client in an unconsummated deal that therefore has no financial reward for the client. Likewise, in the contingent fee context the amount of contractual attorney fees might result in little or no net recovery to the client.

Conclusion:

To the extent a lawyer’s fee is contingent on the outcome of a representation, the lawyer invests time and other resources with knowledge that he or she might earn little or no fee for a host of possible reasons. These include, among others, the client having misrepresented or misunderstood the facts on which the lawyer decided to accept the representation, changes in the law governing the matter, and the unavailability of witnesses or other evidence. Where a lawyer and client recognize the additional risk that there might be a successful outcome, but only a limited recovery because of the potential defendant’s financial condition, they can shift that risk in whole or part to the client with informed consent that is based on a full sharing by the lawyer of pertinent information known to the lawyer. Where a lawyer’s fee agreement would not have been unconscionable had the matter resolved in a financial favorable manner for the client, it does not become unconscionable by reason that the defendant later defaults in satisfying a judgment or contractual settlement obligation, or negotiates a settlement limited by its financial weakness, so that the amount actually obtained by the lawyer’s client is reduced or nonexistent.

This Opinion is advisory only. The Committee acts on specific questions submitted *ex parte*, and its opinion is based on the facts set forth in the inquiry submitted.