New York State Bar Association
Committee on Professional Ethics

Opinion 1139 (12/11/17)

Topic: Attorneys' Fees; Securing Fees and Expenses by Confessions of Judgment

Digest: Prior to conclusion of a pending matter, a lawyer may agree with a client to modify an engagement agreement with the client to provide, as security for legal fees and expenses already due and owing in a a fixed amount on which the parties agree, for the exception and filing of a confession of judgment, and the execution and recording of a collateral mortgage with a security interest, if the lawyer complies with rules governing business transactions with a client and thereafter abides by the general rules governing conflicts.

Rules: 1.0(f), 1.0(j), 1.5(a), 1.5(d)(5) & (f), 1.7, 1.8(a), 1.16(c)(5) & (d)

FACTS

1. The inquiring law firm represents two individuals and a company as defendants in a pending and hotly contested dissolution proceeding; the two individuals are principals of the client company, as to which the Court has appointed a Receiver. The law firm is owed a substantial amount in attorneys' fees and expenses incurred over more than a year in defense of the inquirer's clients. The Receiver holds funds consisting of, among other things, the proceeds from the sale of real property previously owned by one of the inquirer's clients. With the clients' joint consent, the firm has asked the Receiver and the Court to permit the Receiver to release funds to pay the inquirer's outstanding fees and expenses. The adverse party objects to the release of receivership funds for this purpose, and to date the firm remains unpaid.

2. The inquirer does not wish to abandon the clients, but is concerned that, in light of the likely expenses of the receivership, as well as creditors with potential claims with priority over any claim for defense fees and costs, there may be insufficient funds remaining to pay the inquirer's outstanding invoices. The firm recognizes that the clients are in a financially parlous condition, struggling to make ends meet, which is among the reasons why the inquirer does not want to impose the economic burden that the firm's withdrawal from the representation would impose on them. Having discussed the matter with the clients, the inquirer proposes to have each client execute, and to have the inquirer file or record as the case may be, client affidavits confessing judgment and a collateral mortgage with a security interest, in each instance limited to the fixed amount, on which the parties agree, currently due and owing to the law firm for services already performed.

3. The inquirer intends to notify the Receiver of these transactions, and anticipates that the Receiver will notify the Court and the adverse party. The law firm's engagement letter with the clients makes no provision for these security arrangements.

QUESTION

4. May a law firm agree with its clients to amend its existing engagement letter with the clients during the pendency of a matter to provide for the clients to execute, and for the law firm to file or record, affidavits confessing judgment and collateral mortgages as security for accrued but unpaid attorneys' fees and expenses in a fixed amount on which the parties agree?

OPINION

5. Our role is to interpret the New York Rules of Professional Conduct (the "Rules"), not to opine on issues of law, including laws addressing creditor rights. Accordingly, for our purposes, we

assume without deciding that the proposed security arrangements, as well as the contemplated notice of them, do not violate any statute or rule governing Court-supervised receiverships, including the rights of any third parties or arrangements between the inquiring firm and clients subject to the receivership. We note, too, that nothing in this opinion is intended to apply to fee arrangements in a domestic relations matter, in which special rules control. Rule 1.5(d)(5)(iii) (a lawyer may not enter into an arrangement for any fee in a domestic relations matter that "includes a security interest, confession of judgment or other lien without," among other things, "approval from a tribunal after notice to the adversary"); *see* N.Y. State 1134 (2017) (whether a lawyer in a domestic relations matter may use a credit card to secure legal fees is a question of law under 22 N.Y.C.R.R. Part 1400).

6. In N.Y. State 910 ¶ 19 (2012), this Committee said that "[r]etainer agreements, like all contracts, may be amended with the agreement of the lawyer and the client." We cautioned, however, that "such an amendment raises ethical concerns, because [the] lawyer is often in a position to take unfair advantage of the client." There, as here, the inquirer sought to amend an existing retainer agreement to provide for, among other things, arrangements (including a confession of judgment) to secure payment of the lawyer's fees and expenses. We noted there that, though certain amendments could be considered "normal fee negotiations" subject only to the regulations of Rule 1.5, which govern all fee agreements, "others are considered a 'business transaction with a client'" that are subject to the "higher scrutiny of Rule 1.8." We identified a number of factors that determine whether a particular amendment warranted this heightened level of review. *Id.* ¶¶ 20-24; *see* N.Y. State 1051 ¶ 16 (2015) (applying factors to conclude that Rule 1.8(a) applies to a change in a contingency fee agreement enabling the lawyer to be paid out of the proceeds of a third-party loan made as an advance against the client's later recovery in a structured settlement).

7. The considerations germane to assessing the applicability of Rule 1.8(a) – among them, the timing and circumstances of the proposal, the sophistication of the client, the beneficiary of the amendment (lawyer or client), whether the client has deliberately disregarded an obligation to pay – are fact-intensive, but we need not resolve them, for the requirements of Rule 1.8(a) would apply to the inquirer's proposed security arrangements even if part of the original retainer agreement. Comment [16] on Rule 1.8 says as much: "When a lawyer acquires by contract a security interest in property other than that recovered through the lawyer's efforts in the litigation, such an acquisition is a business or financial transaction with a client and is governed by the requirements of paragraph (a)." *See* Cmt. [4C] (Rule 1.8(a) applies "when a lawyer accepts an interest in the client's business or other nonmonetary property as payment of all or part of the lawyer's fee"); N.Y. State 1104 (2016) (initial engagement letter securing legal fee with a promissory note is subject to Rule 1.8(a)); ABA 11-458 (2011) (amendment to fee arrangements that involve a lawyer acquiring an interest in client property is subject to Model Rule 1.8(a)). Thus, even if some of the factors outlined in N.Y. State 910 might justify an amendment here with reference only to Rule 1.5, the proposed security arrangements require adherence to Rule 1.8(a).

8. Rule 1.8(a) provides:

> A lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise professional judgment therein for the protection of the client, unless:
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> (1) the transaction is fair and reasonable to the client and the terms of the transaction are fully disclosed and transmitted in writing in a manner that can be reasonably understood by that client;
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> (2) the client is advised in writing of the desirability of seeking, and is given a reasonable

opportunity to seek the advice of independent legal counsel on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

9. Here, the interests of the inquirer and the clients are "differing" within the meaning of Rule 1.0(f), which defines "differing interests" as "every interest that will adversely affect either the judgment or the loyalty of a lawyer to the client, whether it be conflicting, inconsistent, diverse, or other interest." However much the parties may now view the arrangement as a means to maintain their attorney-client relationship, the entry of confessions of judgment and the recording of mortgages with a security interest places the lawyer in direct adversity to the clients. Similarly, while a client may not reasonably expect a lawyer to exercise professional judgment on the client's behalf in the negotiation of a routine retainer agreement, circumstances may exist in which such an expectation arises depending on the sophistication of the client, the complexity of the arrangement, whether the matter is ongoing, and whether the client has independent counsel to assess the transaction. *See* N.Y. State 1104 ¶ 5. That here the law firm is proposing a somewhat elaborate amendment to the parties' agreement amid an ongoing representation of otherwise unrepresented clients in a hotly contested litigation is likely to create a reasonable expectation that the law firm is exercising its professional judgment on the clients' behalf. *See* N.Y. State 1055 n. 1 (2015) (client expectation likely when, for example, client has no other counsel, and the lawyer is acting for the client in the matter); N.Y. State 913 ¶ 7 (2012) (client likely to rely on lawyer when lawyer is receiving equity in client's company as a fee).

10. Rule 1.8(a)(1) requires that the terms of the transaction be fair and reasonable to the clients. The fairness and reasonableness of the proposed arrangement depends primarily on "the circumstances reasonably ascertainable at the time of the transaction." N.Y. State 913 ¶ 12. This turns on facts and circumstances beyond our ability to evaluate based on the inquiry. For now, we note only that, as we said in N.Y. State 474 (1977), the amount of the confession of judgment (and by necessary implication, the amount of the mortgage) must be "commensurate with the value of the services rendered," which means that the fee may not be excessive in violation of Rule 1.5(a), and that the lawyer must "scrupulously observe the provisions" of ethical rules "bearing upon legal fees," including obtaining the clients' agreement to the amount. In addition, here, the inquirer intends to limit the amount of the security interest, whether by a confession of judgment or a collateral mortgage with a security interest, to the amount of fees and expenses currently due and owing for services already performed. We therefore need not address whether Rule 1.8(a) would permit the parties agree to agree on an amount higher than the accrued but unpaid invoices. *Compare* N.Y. State 910 ¶ 12 ("a confession of judgment to secure attorneys fees may be taken only as a form of security and not of payment, and that it may be taken only to secure payment for services previously rendered") *with* ABA 02-427 (2002) (not *per se* improper for a lawyer to take a security interest for the payment of fees "earned or to be earned").

11. Rule 1.8(a)(1) requires, too, that the law firm completely and lucidly explain the transaction in writing to the clients in language that the clients may reasonably grasp. This requirement is entwined with the requirements of Rule 1.8(a)(3), which says in part that the clients must give their "informed consent, in a writing signed by the client, to the essential terms of the transaction." Rule 1.0(j) defines "informed consent" as an "agreement by a person to a proposed course of conduct after the lawyer has communicated information adequate for the person to make an informed decision, and after the lawyer has adequately explained to the person the material risks of the proposed course of conduct and reasonably available alternatives." The "requirements for client consent to conflicts under [Rule] 1.8(a) are at least as stringent as those under Rule 1.7(b)," the rule on general conflicts. N.Y. State 1055 ¶ 8.

12. In Opinion 910, we approved a lawyer obtaining a confession of judgment provided that, among other things, "the client clearly understands the character, effect and purpose of the confession of judgment. This includes the potential effect of a confession of judgment on the client's credit standing and employment opportunities." Publicly-docketed confessions of judgment, and a UCC-recorded mortgage with security interest, are potent creditor tools that may have a substantial harmful impact on the client-debtors, among them an injurious effect on banking accounts, the ability to obtain or maintain credit lines, and to sustain business operations. Without attempting an exhaustive list of information that may be "adequate" in these circumstances, components of the information to be relayed may include: (a) whether the firm intends to seek entry of a judgment based on the client affidavits confessing judgment; (b) whether and to what extent the entry of a judgment starts the accrual of statutory post-judgment interest; (c) whether the clients' affidavits effect a waiver of their right, if any, to arbitration of fee disputes as set forth in Rule 1.5(f) and 22 N.Y.C.R.R. Part 137 *et seq.*, a question of law on which we do not opine; and (d) whether a reasonable alternative exists to address the law firm's unpaid invoices – for instance, holding but not filing the security documents. Our concern is that the clients be fully advised of all the material consequences of the proposed course of conduct and any reasonably viable alternative to enable the client to make an informed choice.

13. We are mindful of the opposing interests at stake. Inhering in the concept of informed consent is freedom of choice, that is, circumstances that are not so coercive as to negate any meaningful election. Here, the clients' difficult financial position may leave them no option but to accede to the law firm's request if the only alternative is the law firm's withdrawal from representing them in the pending matter. Yet a law firm has a right to be paid for services rendered in accordance with the parties' agreement. Rule 1.16(c)(5) permits a law firm to withdraw from a representation when a client "deliberately disregards an agreement or obligation to the lawyer as to expenses or fees," albeit here, under Rule 1.16(d), only with permission of the Court if the rules of the Court so mandate. In our view, if a law firm has a right to withdraw from a representation consistent with Rule 1.16(c)(5) – the inquirer so assumes and we proceed on that assumption – then a proposed amendment to a retainer agreement securing the clients' existing obligations to the law firm does not create circumstances in which informed consent is beyond the contemplation of Rule 1.8(a).

14. The balance of Rule 1.8(a) reinforces the import of the provision for informed consent. Rule 1.8(a)(3) prescribes that, in the same writing setting forth the essential terms of the transaction, the lawyer must also describe the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction. *See* N.Y. State 958 ¶ 12 (2013) (lawyer's charging of a finder's fee must be fully set forth in writing to the client compliant with Rule 1.8(a)). Here, the lawyer's role is the preparation of the security documents, and the law firm appears poised to act for the client in effecting those transactions. The transactions are for the benefit of the law firm, no matter that the clients may wish the law firm to refrain from withdrawal. This fact enhances the significance of Rule 1.8(a)(2), which obligates the law firm to advise the clients, in writing, of the desirability of seeking, and giving the clients a reasonable chance to obtain, independent counsel to advise them on the proposed security arrangements. Although Rule 1.8(a)(2) does not require the clients actually to retain separate disinterested counsel, case law exists to suggest that the absence of one may facilitate challenges to business transactions with clients. *See, e.g., McMahon* v. *Eke-Nweke*, 503 F. Supp. 2d 598, 604 (E.D.N.Y. 2007) (analysis under predecessor of Rule 1.8(a)).

15. The focus of the inquiry, and hence this opinion, is on the inquirer's ethical duties in obtaining the proposed amendment to the parties' existing engagement agreement. Nevertheless, one further consideration merits mention. If the parties agree to the proposed amendment consistent with Rule 1.8(a), the inquirer, in continuing to represent the clients, is still bound by Rule 1.7 governing general conflicts of interest. Rule 1.7(a)(2) provides that a lawyer shall not represent a

client, except as permitted by Rule 1.7(b), if "there is a significant risk that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other personal interests." Thus, the inquirer should consider whether the firm's security interests affect the firm's ongoing representation of the clients in the dissolution proceeding. It is possible, for instance, that in some circumstances either delay or expedition of the proceedings could enhance the value of the inquirer's security interests. *See* N.Y. City 2000-3 (2000) ("An attorney's inquiry into her potential ethical obligations arising out of a transaction in which the attorney accepts securities for fees does not end with [the rule on business transactions with clients]). Unique issues of potential conflicts of interest also may arise as a result of such arrangements."); *see also* Rule 1.8 Cmt. [4D] ("An exchange of securities for legal services will also trigger the requirements of Rule 1.7 if the lawyer's ownership interest in the client would, or reasonably may, affect the lawyer's exercise of professional judgment on behalf of the client").

CONCLUSION

16. A law firm may seek its clients' agreement to modify its retainer agreement with the clients during the pendency of a current matter to secure payment, by confessions of judgment and collateral mortgages, of fully earned but unpaid legal fees and expenses in an amount on which the parties agree, if the law firm complies with the rules governing business transactions with clients and is mindful of ongoing obligations to avoid general conflicts of interest.

(26-17)