

Third-Party Payers of Legal Fees: Proceed with Caution

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There are many instances in which a business entity, or even an individual, will undertake the obligation to pay legal fees on behalf of another person. Companies often agree to pay the legal fees of current or former employees. For example, a company may determine that the value of a new employee is worth paying the defense costs in a lawsuit brought by the employee's former employer for breach of a noncompete agreement. A parent company may agree to pay legal fees of a subsidiary involved in a dispute that may affect the interests of the parent, or a company that is the target of a governmental investigation may offer to provide defense costs to its employees who also may be targets. A similar dynamic also occurs when friends or relatives agree to pay legal fees of a loved one, usually in the context of criminal or divorce proceedings.

Parties who enter into these arrangements often overlook or fail to appreciate the ethical issues implicated, particularly the potential for a conflict of interest that arises among the three parties involved. Payers of legal fees undoubtedly have an interest in minimizing the expense of the representation, whereas it may be in the client's best interest to file motions and conduct extensive discovery, which inevitably increases litigation costs. Likewise, a third-party payer may desire to monitor the progress of litigation and feel the need to dictate the terms of the representation, since after all, he or she is footing the bill. But the payer must remember that he or she is not the client. An attorney's ethical duties—the duty of zealous representation, trust and confidentiality, the attorney-client privilege, and the duty to abide by the client's wishes—belong only to the client. Indeed, the Rules of Professional Conduct (RPC) expressly provide that a lawyer must maintain professional independence and shall not permit a third-party payer to interfere with the attorney's professional judgment or with the attorney-client

relationship. See RPC 1.8(f); RPC 5.4(c).

Recognizing that third-party payers may have interests that differ from those of the client—including an interest in minimizing the cost of the litigation—the New Jersey Supreme Court in *In re State Grand Jury Investigation*, 200 N.J. 481 (2009), clarified the obligations imposed upon third-party payers of a client’s legal fees.

In re Grand Jury stemmed from a criminal investigation into whether a corporate contractor submitted fraudulent invoices for services it allegedly rendered to the company. The company and several of its employees were the targets of the grand jury investigation. The company elected to provide and pay for an attorney to represent each employee. The state moved to disqualify the attorneys, arguing that the RPCs prohibited such retention because it created a conflict of interest.

The Supreme Court held that third-party payment of attorney fees is permissible provided the following six conditions are satisfied (*Id.* at 495-96):

- (1) The informed consent of the client is secured;
- (2) The third-party payer is prohibited from, in any way, directing, regulating or interfering with the lawyer’s professional judgment in representing his client;
- (3) There cannot be any current attorney-client relationship between the lawyer and third-party payer;
- (4) The lawyer is prohibited from communicating with the third-party payer concerning the substance of the representation;
- (5) The third-party payer shall process and pay all invoices within the regular course of its business, consistent with the manner, speed and frequency it pays its own counsel; and
- (6) Once a third-party payer commits to pay for the representation of another, the third-party payer shall not be relieved of its continuing obligation to pay without leave of court.

The court further held that if a third-party payer fails to pay the legal fees when due, the appropriate remedy is a summary action for an order to show cause why the third party should not be compelled to remit payment. The court stressed that a third-party payer’s obligation to pay fees continues until it can persuade the court why that obligation should terminate. Significantly, the court stated:

In such an application, the third-party payer shall bear the burden of proving that its obligation to continue to pay for the representation should cease [and] the fact that the lawyer and the client have elected to pursue a course of conduct deemed in the client’s best interests but disadvantageous to the third-party payer shall not be sufficient reason

to discontinue the third-party payer's continuing obligation of payment.

The court's ruling in *Grand Jury* was not limited to its specific factual scenario of employees providing testimony against employers before a grand jury. Rather, the court noted that its holding applies "regardless of the setting—whether administrative, criminal or civil, either as part of an investigation, during grand jury proceedings, or before, during and after trial."

What does the *Grand Jury* decision mean in practical terms for third-party payers? It means that the third party pays the legal bills but does not get to review unredacted invoices or otherwise be privy to strategy discussions between the lawyer and client. As the Supreme Court explained, an attorney's decision-making process should be free from third-party interference and should not in any way be influenced by monetary incentives. In other words, the court sought to protect the client against a third party who may use its purse strings and the threat of nonpayment to pressure the client or the attorney into pursuing a course of litigation that may not be in the client's best interest. The decision also means something along the lines of "in for a penny, in for a pound."

As the court made clear, once a third-party payer undertakes payment of legal fees on behalf of a client, the payer cannot unilaterally terminate the representation, but must seek leave of court to be relieved of its obligation to pay. But not just any reason will suffice. The third party will have to demonstrate good cause to be relieved of its payment obligation, and, according to *In re Grand Jury*, an attorney's pursuit of a course of action with which a third-party payer disagrees is not sufficient to establish good cause.

The significance of the *In re Grand Jury* decision cannot be overstated. Requiring third-party payers to seek leave of court before terminating representation is, much like the doctrine of advancement in the corporate context, a transformative lever that protects litigants and provides their attorneys with a powerful tool to ensure that payers comply with their obligation and ensures that the litigation being funded is not inappropriately influenced or disrupted. Yet, surprisingly, in the six years since the seminal decision was handed down, there are no published opinions applying or interpreting the *In re Grand Jury* restrictions, suggesting that few lawyers have sought to utilize the protections that *In re Grand Jury* affords.

Although the requirements set forth in *In re Grand Jury* are strict, there are ways that third-party payers can minimize the exposure to the unending payment obligations that could attach to an initial agreement to fund a litigation. First, because under *In re Grand Jury*, the payer must show good cause to cease paying fees, one way to demonstrate such good cause may be to show that litigation costs exceeded the payer's reasonable expectations. To that end, it would be prudent for the payer to discuss expenses with the attorney up front, and obtain an estimated cost and a litigation budget prior to signing a retainer. Indeed, it is advisable that the estimated litigation cost be included in the retainer, along with the scope and goals of the representation, all of which may help establish good cause to terminate representation should it turn out that those goals are not being met or the budget is being exceeded. In a similar vein,

perhaps including certain reservation of rights provisions into the retainer whereby the payer reserves the right to withdraw or cease paying legal fees under certain specified circumstances can help establish good cause if necessary.

Second, the court in *In re Grand Jury* reaffirmed the prohibition against third-party payers interfering with litigation strategy and mandated that payers wishing to be relieved from funding a litigation demonstrate a good-faith basis to discontinue payment, independent of their disagreement with strategic decisions of counsel. In other words, a court will frown upon, and likely will not permit a payer to terminate the retainer, if there is evidence that the payer is attempting to influence legal strategy or otherwise interfere with the client or the attorney's strategic decisions. As such, payers should be scrupulous in ensuring that they are not seeking to dictate the terms of the representation or in any way trying to improperly influence the client or the lawyer. If at all possible, payers should counsel the attorneys to submit redacted invoices, and avoid strategy discussions with the attorney and the client so the court does not perceive that the payer is seeking to influence the representation.

The court's holding in *In re Grand Jury*, although rarely invoked, has broad implications for lawyers, clients and third parties paying for a client's legal fees. It is a powerful tool and it is important that each of the persons involved in the relationship understand their respective rights and obligations.

One issue that was left unaddressed by the *In re Grand Jury* decision is how the six conditions set by the court apply in the context of insurance contracts, such as liability insurance, Director and Officers' insurance, or when a defense-and-indemnity clause, which appears in many commercial contracts, is triggered. In those instances, a carrier typically designates and pays an attorney to defend claims against the insured policyholder, oversees the litigation and reviews unredacted bills. In many instances, an insurance carrier initially pays for a defense under a reservation of rights, but where a potentially covered claim is dismissed, discontinues paying for the remainder of the defense. These practices, which are commonplace in the insurance industry, do not comply with *In re Grand Jury*. The application of the *In re Grand Jury* factors to the insurance industry is an issue that will be left for the Supreme Court to resolve in the future.

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