

1 THE STATE BAR OF CALIFORNIA
2 STANDING COMMITTEE ON
3 PROFESSIONAL RESPONSIBILITY AND CONDUCT
4 DRAFT FORMAL OPINION INTERIM NO. 20-0005
5 CONTINGENCY FEE AGREEMENTS AND EARNING AN HOURLY RATE WHEN TERMINATED
6 *[Rough Draft, seeking input and direction from Committee]*

7
8 **ISSUES:** Under what circumstances, if any, are “conversion clauses” in contingent fee
9 agreements ethically permissible?

10
11 **DIGEST:**

12
13 **AUTHORITIES**

14 **INTERPRETED:** Rules of Professional Conduct 1.2, 1.5, 1.16 of the Rules of Professional Conduct
15 of the State Bar of California. ¹

16 Business and Professions Code sections 6147 and 6148.
17

18 **INTRODUCTION AND SCOPE**

19 This opinion addresses the ethical permissibility of conversion clauses in contingent fee agreements. For
20 purposes of this opinion, a conversion clause is a contractual provision that, if triggered, converts the
21 fee due to a lawyer from an initial or primary contingent fee, to an alternate fee. Conversion clauses
22 may be triggered by many events, but are typically conditioned upon (1) the termination of the
23 attorney-client relationship, or (2) the client’s failure to follow the lawyer’s recommendation regarding
24 whether to accept a settlement proposal. Lawyer often maintain that conversions clauses are necessary
25 to “protect” contingent fee lawyers from bad-faith termination by wily clients. However, in appropriate
26 instances, California law already entitles discharged contingent fee lawyers to seek a *quantum meruit*
27 fee for their services.²

28 It is the view of the Committee [**to be discussed to see if we agree**] that conversions clauses are not
29 ethically prohibited *per se*, but must be carefully evaluated on a case-by-case basis. The circumstances
30 of each representation, as well as the precise terms of the fee arrangement and conversion clause,
31 should be carefully scrutinized to ensure that neither the client’s absolute right to discharge counsel nor
32 the client’s right to decide whether or not to settle (and on what terms) are violated or interfered with,
33 and also to ensure that the conversion clause would not result in an unconscionable fee.³ Conversion

¹ Unless otherwise indicated, all references to “Rules” in this opinion will be to the Rules of Professional Conduct of the State Bar of California.

² See *Russ Milibankd & Smith v. Conkle & Olesten* (2003) 113 Cal. App. 4th 656.

³ This opinion concerns only the issue of whether conversion clauses are ethically prohibited, not whether or to what extent they are legally enforceable. Accordingly, rather than focus upon the reasonableness of fees sought or collected, the relevant standard for assessing an ethical violation under Rule 1.5 is unconscionability. [**do we**

clauses are ethically permissible only where they do not interfere with the client's right to discharge the lawyer or the client's right to determine whether to settle, and where they would not result in an unconscionable fee.

DISCUSSION

Conversion clauses require careful scrutiny as to their ethical propriety because their use may improperly interfere with important client rights and may violate an attorney's ethical duties. These considerations, addressed herein, include a client's right to discharge counsel, a client's right to determine the objectives of a representation (especially with regard to settlement), and the attorney's duty not to seek or collect an unconscionable fee. Furthermore, not only must the lawyer comply with all relevant provisions of the Business and Professions Code, but because conversion clauses are of complex, the sophistication of the client is also an important consideration.

A. The Client's Right to Discharge Counsel.

Both the Rules and California decisional law confirm the client's absolute right to discharge his or her attorney. Rule 1.16(a)(4); *Fracasse v. Brent* (1972) 6 Cal. App. 3d 784; *Kroff v. Larson* (1985) 167 Cal. App. 3d 857, 860 (client has absolute right at any time to discharge an attorney, with or without cause). Conversion clauses must be scrutinized to ensure that they do directly or indirectly interfere with this right. For example, conversion clauses which purport to entitle a lawyer in a contingent fee representation, if terminated, to his or her hourly rate for hours worked (regardless of whether the contingency occurs, or what amount is recovered) pose a high risk of interfering with the client's right to discharge counsel. See, *Fracasse, supra* (improper to burden the client [in contingency cases] with an absolute obligation to pay the attorney regardless of outcome). Often a client in a contingent fee representation does not possess the means to pay an hourly fee, and has retained contingent fee counsel for this reason. A conversion clause that requires the client to pay the lawyer's hourly rate if the attorney is discharged is likely to impermissibly chill and burden the client's absolute right to discharge the lawyer, and must be carefully scrutinized for this possibility. See, *Colorado State Bar Ethics Opinion 100*; *Compton v. Killtelson* (2007, Alaska Supreme Court) 171 P.3d 172 (contingent fee agreement which retroactively converted to hourly fee upon discharge of attorney was unconscionable and violation of Model Rule 1.2); *U.S. Postal Service v. Haselrig Corp* (D. Md. 2004) 349 F. Supp. 2d 955 (agreement that attempted to unlawfully penalize client for discharge of attorney (by requiring payment of 40% contingency or flat \$35,000) was "unreasonable at inception").

A conversion clause may not penalize client who discharges the lawyer because the client feels the lawyer is doing a poor job. A contingent fee lawyer is already protected by the principles of *quantum meruit* to the extent the lawyer has earned and is entitled to a fee. See, *Fracasse, supra*. A conversion clause that operates as a penalty for a client discharging a lawyer improperly impedes the client's right to do so, and is ethically prohibited.

Timing of the payment of the alternate fee is also an important factor for analysis. If a conversion clause entitles a lawyer (upon discharge) to an *immediate* fee, prior to the occurrence of the contingency, such a clause is highly likely to interfere with a client's right to discharge counsel, and likely to be ethically prohibited. Thus, even an alternate fee that would not be improper or unconscionable in amount if

agree?] Additionally, this opinion does not address the propriety or enforceability of attorney's liens resulting from conversion clauses.

74 payment were due at the time of the contingent recovery, may be ethically prohibited if its timing is
75 such that it interferes with the client's right to discharge the lawyer.

76 Related to the issue of unconscionability (addressed in Section C. below) is whether the conversion
77 clause provides for alternate fee which would have the effect of rendering the case unreasonably
78 unappealing to potential successor contingent fee counsel. For example, a conversion clause which
79 would entitle the lawyer to a full contingent fee, or nearly a full contingent fee, no matter how much
80 work has been performed or remains to be performed, is highly likely to make it impossible for the client
81 to secured replacement counsel, and thus likely to impermissibly burden the client's right to discharge
82 counsel.⁴

83 **B. The Client's Right to Decide Whether or Not to Settle.**

84 A lawyer is ethically required to abide by a client's decision concerning the objectives of the
85 representation. The Rules expressly extend this precept to the decision to accept or reject a settlement
86 offer. "[A] lawyer shall abide by a client's decision whether to settlement a matter" Rule 1.2(a).
87 Nonetheless, conversion clauses are often designed to "protect" an attorney against a client's
88 unreasonable, or even bad-faith, decisions regarding whether to accept or reject settlement proposed
89 contrary to the lawyer's recommendation.

90 Such conversion clauses often purport to entitle the lawyer to payment of the lawyer's contingent fee
91 percentage of any settlement offer that the lawyer recommends the client to accept, which the client
92 rejects. Alternatively, some clauses entitle a lawyer to the lawyer's hourly rates if the client accepts a
93 settlement offer the lawyer believes is insufficient.

94 While ethics committees of other states have approached such settlement-related conversion clauses
95 from a variety of perspectives, all tend to agree that heightened scrutiny of such clauses is required.
96 *See, Wis State Bar Prof'l Ethics Comm. Formal Op. E-82-5 (1982)* (a contingent fee agreement that
97 permits charging hourly fees if attorney deems a settlement offer inadequate is overreaching and
98 unethical); *Philadelphia Bar Association Ethics Opinion 2001-1* (majority opinion would permit
99 conversion where there is clear advanced agreement on the goals of representation and agreement as
100 to alternate methods of compensation if the client's goals change; the minority opinion would permit
101 conversion clauses for sophisticated clients, not unsophisticated clients). **[There are many additional
102 out of state opinions, it is worth describing more?]** The Committee agrees that scrutiny is warranted.

103 Such clauses can also introduce a speculative element in favor of the lawyer: who can know whether the
104 opposing party would or could have actually performed under the rejected agreement against which the
105 lawyer now seeks to determine his or her fee? Such uncertainty is indicia of overreach by a lawyer
106 which further invades the client's right to determine whether or not to settle.

107 It is the view of the Committee that the requirement imposed by Rule 1.2(a) that "a lawyer shall abide
108 by a client's decision whether to settlement a matter" is a clear an unwaivable duty, the elimination of
109 which is simply not permitted Rule 1.2(b). A conversion clause that impedes or burden's a client's right
110 to determine whether to settle is ethically prohibited. In addition, such conversion clauses can also
111 introduce a speculative element in favor of the lawyer: who can know whether the opposing party
112 would or could have actually performed under the rejected agreement against which the lawyer now

⁴ In addition to impermissibly interfering with a client's right to discharge the lawyer, such a conversion clause likely also seeks an unconscionable fee, and must be appropriately evaluated on that basis as well. *See, In re Van Sickle* (Cal. Bar. Ct. Aug. 24, 2006). *Accord, Colorado Ethics Opinion 100*, supra.

113 seeks to determine his or her fee? Such uncertainty is further indicia of overreach by a lawyer which
114 further invades the client's right to determine whether or not to settle.

115 Thus, conversion clauses keyed to the acceptance or rejection of settlement offers are ethically
116 prohibited, except in the narrow circumstances where (1) the goals of the representation are clearly
117 agreed-to in advance, (2) the lawyer and client also agree in advance to an alternate payment method
118 that complies with Rules 1.5 and 1.7, and (3) the client's informed written consent is obtained.⁵ [Is point
119 **#3 redundant, per Rule 1.5(b)(13)?**]

120 C. The Attorney's Duty Not to Seek or Collect an Unconscionable Fee.

121 Rule 1.5 prohibits a lawyer from making an arrangement for, charging, or collecting an unconscionable
122 fee, and sets forth 13 factors to be considered (without limitation) in determining the unconscionability
123 of a fee. Just as the primary contingent fee must comply with Rule 1.5, so too must any alternate fee.
124 Conversion clauses can impact an unconscionability analysis in numerous ways, and the determination
125 of whether a conversion clause would result in an unconscionable alternative fee must analyze the
126 effect of the clause both facially, and as-applied.

127 For example, if the alternate fee entitles the lawyer to lodestar fee computation (hours times rates)
128 which would exceed the primary contingent fee, the fee is likely to be unconscionable. This is especially
129 true where the fee agreement allows conversion to be subject to manipulation by the lawyer, for
130 example, by allowing the lawyer to claim the higher fee where it is the lawyer who causes the
131 termination of the attorney-client relationship. Obviously, some lawyers might continuously evaluate
132 the fee arrangement throughout the representation, looking to act at the moment it is to the lawyer's
133 advantage from a fee perspective to terminate a representation. Conversion clauses which would permit
134 and incentivize such overreach are not ethically permissible. Thus, depending on the circumstances, the
135 higher alternative fee may be unconscionable.

136 Accordingly, important factors in evaluating whether a conversion clause is unconscionable and
137 therefore ethically prohibited, include consideration of whether a conversion clause triggers an
138 alternate fee regardless of whether the relationship is terminated by the client or the attorney, and
139 regardless of the reason for the termination. Conversion clauses which are triggered by termination of
140 the representation *by the lawyer without cause*, are unconscionable. (Conversion clauses which are
141 triggered or by termination of the representation *by the client with cause* may impermissibly interfere
142 with a client's right to discharge counsel, addressed *supra*). Thus, it is the opinion of this Committee that
143 conversion clauses may only be permitted where conversion to the alternate fee is triggered by
144 termination of representation by the lawyer with cause, or by the client without cause – (and even then,
145 subject only to meeting all other criteria addressed herein). [**likely need further analysis of what “for-
146 cause” entails**]

147 A conversion clause which calls for payment of an alternate contingent fee *prior* to the occurrence, or
148 *regardless* of the occurrence of the contingency, is functionally not a contingent fee at all, and is unlikely

⁵ Cf, LACBA Formal Ethics Opinion No. 505 (2000) which approved of an engagement agreement by a public interest law firm which waived all attorney's fees so long as the client did not enter into any settlement agreement which required confidentiality. It is the opinion of this committee that such an arrangement permissibly falls within now exceptions articulated above, and therefor is not prohibited.

survive an unconscionability determination. See Rule 1.5 (b) (1), (2) (concerning over-reach, fraud, and failure to disclose material facts).

In any unconscionability analysis, the sophistication of the client is relevant. Rule. 1.5 (b)(4). Conversion clauses can be complex in construction and effect, and difficult to parse and understand. Thus, the client's level of sophistication as a consumer of legal services remains an important consideration.⁶

Similarly, a conversion clause which requires payment to a discharged lawyer of a pre-determined contingent fee, regardless of the work performed or work remaining in the matter, may not survive an unconscionability analysis. See Rule 1.5 (b)(3), (7), (12); *Matter of Scapa & Brown* (Rev. Dept. 1993) (attorney's fee contract requiring payment of a "minimum" fee if client discharged attorney regardless of work performed constitutes an attempt to charge an unconscionable fee). Established law already provides for payment to discharged contingent fee counsel on a *quantum meruit* basis. A conversion clause which converts a contingent fee to the attorney's hourly rate upon termination of the attorney-client relationship must be evaluated for unconscionability especially where, because a representation began primarily as a contingent fee representation, the lawyer may or may not have incurred excessive or unreasonable hours on the matter.⁷

FACTUAL SCENARIOS AND ANALYSIS OF EACH

Scenario No. 1: Fee agreement for a litigation matter provides that Lawyer will be paid a contingent fee of 35% of the recovery, but if Lawyer is discharged by the client prior to recovery, Client agrees to immediately pay Lawyer at Lawyer's hourly rate for all time expended. Client is an unsophisticated consumer of legal services; this is the first time client has ever engaged a lawyer.

Analysis of Scenario No. 1: California law permits a discharged attorney to seek a *quantum meruit* fee. Thus, the effect of this fee agreement is to replace Lawyer's pre-existing right to seek quantum meruit, with a contractual entitlement to immediate payment of Lawyer's hourly rates, regardless of outcome, results obtained, or the reasonableness of Lawyer's rate or hours expended. Coupled with the unsophistication of the client, the conversion to hourly fees without regard to the occurrence of the contingency and the immediate obligation to pay same, impermissibly interferes with Client's right to discharge Lawyer. Further, replacement of Lawyer's *quantum meruit* rights with a contractual entitlement to hourly fees regardless of rate or hours could lead to an unconscionable fee being sought or obtained – (although from the facts presented it cannot be determined that the fee set forth in the agreement is *per se* unconscionable). Because it interferes with Client's right to discharge Lawyer, this conversion clause is ethically prohibited.

⁶ Of course, depending on the specifics of the conversion clause, the fee agreement must comply with Business & Professions Code section 6147 (contingent) and/or section 6148 (hourly). The failure comply with the applicable section(s) renders the fee agreement voidable at the election of the client, and entitles the lawyer to *quantum meruit* compensation. [do we want to go further –failure to comply with B&P as independent ethical violation?]

⁷ While Rule 1.5 evaluates unconscionability for purposes of an attorney's ethical duties, California law requires that attorney fee agreements and billings "must be fair, reasonable and fully explained to the client". *Bird, Marella, Boxer & Wolpert v. Superior Court* (2003) 106.Cal.App. 4th 419, 430-31 (quoting *Altschul v. Syble* (1978) 83 Cal. App. 3d 153, 162).

Scenario No. 2: Fee Agreement for a litigation matter provides that Lawyer will be paid a contingent fee of 35% of the recovery, but if the attorney-client relationship ends (for any reason) before the recovery is obtained (whether the Lawyer withdraws or is terminated by the Client), Client agrees to pay Lawyer – if and when the contingency occurs -- per Lawyer hourly rate for all time expended. Client is unsophisticated as a consumer of legal services.

Analysis of Scenario No. 2. This arrangement is subject to much of the same analysis as Scenario No. 1. It is ethically prohibited for the additional reason that it provides Lawyer with unfettered ability to unilaterally convert the contingent fee to a guaranteed hourly fee at Lawyer’s sole discretion, providing Lawyer with the ability to potentially gain a greater fee than the contingent fee. Not only would this arrangement burden Client’s right to discharge attorney as described in the analysis of Scenario No. 1, but it would also provide for Lawyer to obtain unconscionable fee by terminating the representation when it appears profitable.

Scenario No. 3: Hourly fee agreement for a litigation matter provides that Lawyer will be paid per Lawyer’s hourly rates – to be paid at the conclusion of the representation. However Lawyer will cap the total hourly fees at 35% of recovery if Client does not discharge Lawyer prior to recovery. Client is a wealthy, but unsophisticated, consumer of legal services.

Analysis of Scenario No. 3. At first blush, Scenario No. 3 is the near functional obverse of Scenario No. 1: if Client does not discharge Lawyer, the 35% contingent fee applies, but if Client fires Lawyer, Lawyer is entitled to hourly rates. However, the fee agreement in Scenario No. 3 is presented to Client as an hourly fee agreement, and would likely be understood as such even by an unsophisticated client. Thus, the relevant question is whether the proposed fee cap and conditions (35% if Lawyer not terminated) impermissibly interferes with Client’s right to discharge Lawyer. Because an hourly fee attorney is typically entitled (at least per the fee agreement) to all hourly fees up to time of discharge, and because the proposed alternate fee “cap” would only operate to benefit (not burden) Client, this particular conversion clause does not impermissibly interfere with Client’s right to discharge Lawyer, and is ethically permissible.

[Do we agree with this result/analysis?]

Scenario No. 4: Contingent fee agreement provides that if (1) a settlement offer is made to client, (2) Lawyer recommends Client accept the offer, (3) Client rejects that settlement offer, and (4) Client ultimately recovers less than that settlement offer, Lawyer shall be entitled to Lawyer’s contingent fee computed as against the amount of the rejected settlement. Client is a relatively sophisticated consumer of legal services.

Analysis of Scenario No. 4. The effect of the fee agreement in Scenario No. 4 is to provide significant pressure upon Client to follow Lawyer’s advice to accept a settlement, and to do so by potentially penalizing Client for failing to do so. This arrangement would deliberately increase Client’s risk if Client does not do as Lawyer sees fit in order to shift decisional authority from the Client to the Lawyer. This arrangement plainly impermissibly interferes with Client’s right to decide whether to settle, and is therefore ethically prohibited.

Scenario No. 5: Fee agreement provides that Lawyer will represent client (a business entity) in the prosecution and defense of claims in litigation on primarily a contingent fee of (1) 35% of affirmative recovery and (2) 35% of the amount of any reduction in the amount sought by client’s litigation adversaries (the “defensive contingency”). The fee agreement further provides that in the event that Client chooses to settle the litigation for a walk-away, Lawyer shall be entitled to the greater of (1) the 35% defensive contingent fee, or (2) a *quantum meruit* fee determined by lodestar method per Lawyer’s

reasonable hours incurred and Lawyer's reasonable hourly rates (set forth in the agreement). Client is a sophisticated consumer of legal services and was represented in the negotiation of the fee agreement by in-house counsel. During the negotiation of the fee agreement, Lawyer and Client discussed Client's strong preference for contingent fee representation for cash-flow reasons, as well as the possibility that, depending on Client's ever-changing business needs, Client might ultimately choose not to pursue its valuable affirmative claims if it can secure resolution. The fee agreement terms were the agreed-upon result of such discussion.

Analysis of Scenario No. 5. This arrangement appears, at least facially, to improperly interfere with Client's right to decide whether to settle, however, closer analysis reveals otherwise. The significant sophistication of the client (indeed, represented in negotiation of the fee agreement by in-house counsel) is a material factor, significant to the analysis. It is also material that the fee agreement negotiations explored the impetus and effect of the alternate fee and that the alternate fee was designed to encourage Lawyer to provide a contingent fee representation (Client's preference) despite the real and disclosed risk that Client may chose not to pursue its valuable affirmative claims to conclusion. Thus, under the circumstances presented, the alternate fee neither interferes with Client's decision whether to settle, nor constitutes an unconscionable fee, as described. Therefore, this conversion clause is ethically permissible. **[Do we agree?]**

CONCLUSION

Conversion clauses are not ethically prohibited *per se*, but must be carefully scrutinized on a case-by-case basis, including application of the factors identified above. Conversion clauses tied to termination of the attorney-client relationship are only ethically permissible where triggered by termination by the client *without cause*, or termination by the attorney *with cause*. Conversion clauses that impede a client's right to decide whether to settle are prohibited, as are conversion clauses that would result in an unconscionable fee, either facially or as-applied.