


Don't Indemnify for Third Party Claims to Money in Settlement Agreements, Follow the Ethics Rules Instead

By Alessandra Morales and Ben Lebsack

Defendants and their insurers commonly propose language in settlement agreements in which the lawyer representing the plaintiff purports to indemnify and hold harmless the defendant and carrier for any future liability that may arise from any lienholder. These proposed indemnification terms violate several of the Colorado Rules of Professional Conduct by creating a conflict of interest between the lawyer and her client that interferes with a lawyer's independent professional judgment and a client's settlement authority.

Plaintiff's lawyers already must comply with the rules of professional conduct concerning the distribution of money to lienholders, including holding in trust money that may be subject to a third party's lien. Accordingly, there is no reason for a plaintiff's lawyer to agree to an indemnification provision regarding liens. An indemnification provision that requires more than what the rules require as to property of third parties held in trust is likely inconsistent with the rule governing such property.

Defense counsel and insurers request indemnification language because of fears that the lienholder will sue the defendant or her insurer and attorneys to recover unreimbursed expenses. Indeed, under the Medicare as Secondary Payor Act ("MSPA"),[1] the Centers for Medicare and Medicaid Services ("CMS") has a statutory right to recover such expenses from the primary payer (the insurance company ultimately liable) "even though it has already reimbursed the beneficiary or other party."[2] Under MSPA, CMS can recover unreimbursed expenses from "any entity, including a beneficiary, provider, supplier, physician, attorney, State agency or private insurer that has received a" payment from the insurer liable for payments for services also covered under Medicare.[3]

Colorado does not have an ethics opinion addressing whether a plaintiff's lawyer may agree to indemnify the defendant and its insurer for future claims based on a third party's lien. But at least fifteen other state and city ethics committees have addressed the issue and concluded that an attorney may not ethically propose or agree to such a term.[4] Some of these states' rules of professional conduct have minor differences with the Colorado rules, but the Colorado rules generally support the conclusions of these ethics committees. In Colorado, it would likely be professional misconduct to propose or agree to this type of term.

Colo. RPC 1.2(a) requires a lawyer to "abide by a client's decisions concerning the objectives of representation, and as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued" and in particular, "abide by a client's decision whether to settle a matter."

But an indemnification term "injects the attorney's own financial exposure into the process."[5] As the Montana Ethics Committee explains if "the client chooses to settle and chooses to agree to the proposed indemnification language, the indemnification demand could cause the lawyer to refuse the settlement offer or try to dissuade the client from settling in order to protect the lawyer's own personal, financial or business interests."[6]

Colo. RPC 1.7(a) provides that "a lawyer shall not represent a client if the representation involves a concurrent conflict of interest." Colo. RPC 1.7(a)(2) defines a "concurrent conflict of interest" to include "a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer."

A proposed indemnification term creates a conflict that violates Rule 1.7. An indemnification term would materially limit a lawyer "by virtue of the lawyer's own interest in having the client (rather than the lawyer) pay the liens in full."[7] As the Montana opinion explains, "the client wants to settle. Standing in the way is her attorney, who does not want to absorb the responsibility and liability of known and unknown potential liens."[8]

Colo. RPC 1.7(b) allows a lawyer to represent a client despite a concurrent conflict of interest under certain conditions, including the client consenting to the conflicted relationship. But the conflict an indemnification creates cannot be waived by the client.[9]

More than create a general conflict of interest between the lawyer and client, a settlement term requiring a lawyer to indemnify the defendant for medical liens violates a specific conflict of interest rule. Colo. RPC 1.8(e) prohibits several arrangements that create inherent conflicts of interest, including a lawyer providing "financial assistance to a client in connection with pending or contemplated litigation." The client and lawyer cannot waive this conflict.

The Arizona opinion concludes that because "an attorney cannot ethically provide financial assistance to a client by paying, or advancing, the client's medical expenses before or during litigation, an attorney cannot ethically agree, voluntarily or at the client's or Releasees' insistence, to guarantee, or accept ultimate liability for, the payment of those expenses."[10] The opinion elaborates that "[s]uch financial assistance in the guise of an agreement of indemnification could encourage prospective clients to seek legal counsel for improper reasons."[11]

And the New York opinion concludes the same under Rule 1.8, "Insofar as a lawyer may not agree to indemnify his or her own client's obligations to a third party as part of a settlement of the client's claim, it is also impermissible for another lawyer to enter into a settlement that requires such an indemnification."[12]

Despite the prohibition on loaning money to clients in connection with litigation, Colo. RPC 1.8(e) includes exceptions permitting a lawyer to "advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter" and "a lawyer representing an indigent client" to "pay court costs and expenses of litigation on behalf of the client."

While a Medicare lien may be related to pending or contemplated litigation, medical "liens are clearly not court costs and are far broader than litigation expenses."[13] Court costs and litigation expenses "include filing fees, expenses of investigation, medical diagnostic work connected with the matter under litigation and treatment necessary for the diagnosis, and the costs of obtaining and presenting evidence."[14] Court costs and litigation expenses are necessary for preparing and trying the case, but an "indemnification agreement is ancillary to the settlement and separate from the preparation and trial of the case."[15]

Comment 10 to Colo. RPC 1.8 similarly defines costs and expenses. It notes that the rule permits a lawyer to advance court costs and expenses, "including the expenses of medical examination and the costs of obtaining and presenting evidence, because these advances are virtually indistinguishable from contingent fees and help ensure access to the courts."[16] And the comment bolsters the conclusions of these ethics opinions that Rule 1.8 prohibits a lawyer from agreeing to a provision indemnifying the defendant from claims by lienholders. It notes that lawyers "may not subsidize lawsuits or administrative proceedings brought on behalf of their clients, including making or guaranteeing loans to their clients for living expenses, 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."[17]

Colo. RPC 2.1 requires a lawyer to "exercise independent professional judgment and render candid advice" when representing a client. The prospect of being personally liable for hundreds of thousands of dollars due to an indemnification provision interferes with that judgment. The Indiana opinion explains that "[f]orcing the attorney to weigh the settlement's benefits to the client with his own personal risk places an inappropriate burden on the essential element of independence."[18]

The Rules of Professional Conduct describe a lawyer's obligations as to the funds of clients and third parties.

Rule 1.15 can be broken down to three instances where a lawyer must, may and does not have to reimburse a third party's financial interest.

Overall, Rule 1.15A mandates that upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly or otherwise as permitted by law or by agreement with the client, deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, render a full accounting regarding such property.

With respect to the client's property in a lawyer's possession, a lawyer's duty is generally to the client and not to third parties.[19] This general rule may be altered by statute, contract, or by court order.

First, a lawyer must reimburse a third party's interest when it is mandated by statute. Colorado statutes recognize undisputed financial interests for three entities including Hospitals via C.R.S. §38-27-10, Medicaid via CRS §6-4-403 and Medicare via §1862 of the Social Security Act, codified at 42 U.S.C. §1395. These statutes not only make the entities' interest undisputable, but it also obliges lawyers to honor said liens otherwise one can be held

personally liable for a distribution which is contrary to a statute.

Second, where the third party holds an undisputed interest because they entered into a contract with the client, the third party is entitled to receive funds which are expected to come under the control of the lawyer on behalf of the client as a result of that agreement; including an assignment by the client, an agreement between a health care provider and the client for health care services, agreements between the client and an employer, a landlord or an insurer. This is true whether the contract was executed orally or in writing. If the client does not dispute the contract, then the third party's reimbursement is required.

Where there is a statutory lien or court order and the client demands that the lawyer not disclose the fact that the lawyer is holding the property, Rule 1.15(b) requires the lawyer to distribute the funds in accordance with the statutory lien or court order, notwithstanding the client's wishes.

Third, where the third party holds an undisputed interest as a court order, the lawyer has an ethical obligation to act in compliance with any court orders that have been issued regarding any settlement proceeds.

Next, there are two instances in which a lawyer may be obligated to reimburse a third party based on the lawyer's own actions.

For example, when a third party has been induced by the conduct of the lawyer to believe they will be paid from the property held by the lawyer, but the client disputes the third party's entitlement. In this instance, the lawyer should advise the client and the third party to attempt to resolve the dispute. The lawyer should distribute the undisputed portions of the property. If the client and the third party are unable to resolve their dispute, the lawyer should file an interpleader action about the portion in dispute.

Also, when an attorney personally executes a "lien" the attorney subjects themselves to personal liability and possibly violates the rules of professional conduct.

Now, moving on to when a lawyer may honor a third party's claimed financial interest. This comes up when your client consents to the payment of a third party's financial interest, despite it being a perfected lien or not. If there is no dispute over the lien, you may pay the lien with your client's consent.

Or this can also be triggered, when the third party has been induced by the lawyer to believe that the contract will be honored, (explicitly or implicitly) the lawyer should attempt to have the client consent to disclosure and should further advise the client to attempt to resolve the dispute. If the client agrees, you **may** honor the third party's interest. If the client doesn't agree—you **must** interplead.

Lastly, when you are not obligated to honor a third party's claimed financial interest. Most obviously, when the third party does not hold an interest because of a statutory lien, or a court order. The lawyer shall promptly distribute the property to the client.

On the other hand, where the third party holds an interest pursuant to a contract with the client, but the client disputes the validity of the contract or the amount of the contract and further demands that the lawyer not disclose that the lawyer is holding the property: The lawyer should maintain the confidentiality of the information, pursuant to Rule 1.6(a) and distribute the property to the client pursuant to Rules 1.2(a) and 1.15(b).

In conclusion, the distribution of property should be addressed with the client when the lawyer first learns of the claimed financial interest, statutory lien, contract, or court order to prevent disputes from arising upon receipt of the funds by the lawyer. Early detection can avoid many of the complications discussed above. A lawyer should always operate in the client's best interest and handle a client's money with extreme caution in every regard but especially when dealing with a competing third party's financial interest.

Rule 1.15A makes it professional misconduct for a lawyer to ignore a Medicare lien and not pay it. The rule "requires lawyers to protect funds of clients **and third persons**."[20] The rule should be enough to address the concerns of defendants and their insurers

as to whether plaintiff's counsel will pay a lien.

And to the extent a defendant or insurer wants an indemnification provision broader than what Rule 1.15 requires, the provision may violate the rule by interfering with the lawyer's obligation to disburse funds to the client consistent with the fee agreement. As the Maryland opinion explains "If lawyers follow this rule, which includes obligations to third parties under federal and state laws, they are ethically bound to disburse the remaining funds to their clients consistent with their retainer agreements and the governing substantive law."[21]

Plaintiff's lawyers should not agree to settlement terms that require the lawyer to indemnify the defendant, defense counsel, or insurer from claims by lienholders. They violate several rules. Plaintiff's lawyers already have clear obligations regarding third party claims to client money under the rules, so indemnification provisions are not necessary to compel a lawyer to handle payment of liens out of settlement proceeds. ▲▲▲

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Endnotes:

[1] 42 U.S.C. § 1395y (b) (3) (A)

[2] 42 CFR § 411.24(i)(1).

[3] 42 CFR § 411.24(g).

[4] Wis. Formal Ethics Op. E-87-11 (1987); N. Car. Ethics Op. 2000-4 (2001); Ariz. Ethics Op. 2003-05 (2003); Indiana Ethics Op. 1 of 2005; Illinois Ethics Op. 06-01 (2006); Mo. Formal Ethics Op. 125 (2008); S.C. Ethics Op. 08-07 (2008); N.Y. City Ethics Op. 2010-3 (2010); Tenn. Formal Ethics Op. 2010-F-154 (2010); Ohio Supreme Court Ethics Op. 2011-1 (2011); Kan. Ethics Op. 11-02 (2011); N.Y. State Ethics Op. 852 (2011); Md. Ethics Op. 2012-03 (2012); Mont. Ethics Op. 13-1224 (2013).

[5] Ariz. Ethics Opinion 03-05.

[6] Mont. Ethics Op. 13-1224, at 4.

[7] Ariz. Ethics Opinion 03-05.

[8] Mont. Ethics Op. 13-1224, at 5.

[9] *Id*.

[10] Ariz. Ethics Opinion 03-05.

[11] *Id*.

[12] N.Y. State Ethics Op. 852.

[13] Mont. Ethics Op. 13-1224, at 5.

[14] N.Y. State Ethics Op. 852.

[15] Md. Ethics Op. 2012-03.

[16] Colo. RPC 1.8 [cmt. 10].

[17] Colo. RPC 1.8 [cmt. 10].

[18] Ind. Ethics Op. 1 of 2005.

[19] *See, e.g., Klancke v. Smith*, 829 P.2d 464 (Colo. App. 1991) (lawyer's duty is to act in the best interest of the client; in the absence of fraud or malice, a lawyer is not liable to third parties for distribution of funds to the client).

[20] Md. Ethics Op. 2012-03

[21] *Id.*, citing S.C. Ethics Op. 08-07.