

## Are Unconscionable Fee Agreements Enforceable?

BY ROY SIMON

Is it possible for a client to ratify an attorney's unconscionable fee agreement? That question is so thorny that the Second Circuit could not answer it. Instead, in *v. Fox*, 418 F.3d 121 (2d Cir. Aug. 2, 2005), the court certified that question (and two related questions) to the New York Court of Appeals. A few weeks later, on August 25, 2005, the Court of Appeals agreed to answer the questions – see *King v. Fox*, 5 N.Y.3d 798, 801 N.Y.S.2d 561(2005) – but the court has not yet handed down its answer. This article attempts to provide some guidance to help the New York Court of Appeals answer the question

### Background: The Fee Agreement at Issue in *King v. Fox*

In 1972, guitarist Edward King joined the rock band Lynyrd Skynyrd. He co-wrote some of the band's biggest hits, including the song "Sweet Home Alabama." The band's 1973, 1974, and 1975 albums each went gold, and MCA signed Lynyrd Skynyrd to an exclusive recording agreement in 1974. Under the MCA agreement, King was entitled to both "writer's royalties" and "artist's royalties." But in 1975, King quit the band, and MCA stopped paying him artist's royalties. A few months later, King consulted noted New York entertainment lawyer Allen Grubman about his artist's royalties. Grubman contacted MCA and obtained an advance on King's writer's royalties, but informed King that he would need to retain a litigator in order to establish entitlement to the artist's royalties. Grubman charged King one-third of the advance he had secured on the writer's royalties and referred King to litigator Lawrence Fox for help in collecting the artist's royalties. Grubman did not request any payment from King regarding future royalties.

Fox was a personal injury litigator who knew "nothing" about the entertainment field. King told Fox that he suspected he was entitled to his artist's royalties but had no documentation to justify this hunch. Fox investigated by calling Lynyrd Skynyrd's attorney, who informed Fox that King was not entitled to any royalties because he had quit the band, and that King actually owed the band money. Fox met with King for a second time, told King it might be necessary to file a lawsuit, and offered to handle the matter for King (who was in "dire financial straits") on a contingency basis. This offer "thrilled" King, who signed a contingency fee agreement with Fox in November 1975 providing:

This is a retainer agreement authorizing us to proceed as your attorneys in the lawsuit against Lynyrd Skynyrd, Inc....Our fee for services in this matter will be a contingency fee, based upon any money recovered from the defendants.

*Our fee for representing you will be 1/3 of the recovery, whether by way of settlement, trial, judgment or other method. You will be responsible for any out of pocket expenses incurred for your benefit. [Emphasis added.]*

Fox says that he explained to King that the retainer agreement would give Fox "one-third of all of King's future royalties in addition to the recovery of any royalties past due." King, in contrast, understood the

agreement to cover “the accumulated royalties of whenever he was to settle the dispute,” but no future royalties. However, perhaps unaware that they disagreed over the interpretation, King and Fox did not discuss this issue at the time the fee agreement was made.

Fox soon secured a copy of the exclusive recording agreement between MCA and Lynyrd Skynyrd. The agreement stated that termination of a band member was not grounds for suspending his royalty payments. Fox therefore sued MCA on King’s behalf. MCA defended vigorously. During the litigation, MCA stopped paying King’s writer’s royalties, which had never been in question. Eventually, in fall 1978, the parties settled. MCA agreed to pay King everything he was owed, which totaled \$213,000.

In late fall 1978, when a tentative settlement agreement had been reached but before it had been signed, Fox mentioned to King that under the retainer agreement, Fox would be receiving one-third of King’s royalties in perpetuity. King was “shocked and surprised” by this information, but he “put it on the back burner” because getting the settlement funds was of the “utmost importance” to him. King asked Fox to send the settlement agreement and the retainer agreement to his wife’s attorney, John Groon, to review. Groon reviewed the agreement, and then asked Fox whether the retainer agreement entitled Fox to fees based on future royalty payments. Fox replied that the retainer agreement covered “all royalty money Ed is entitled to resulting from his involvement with Lynyrd Skynyrd” and urged King to call him (Fox) if he disagreed. Fox also emphasized to Groon that if King did not sign the settlement agreement with MCA by November 11, 1978, MCA would deposit King’s settlement money “into court as a stakeholder with the City of New York.” King would then be liable for MCA’s attorney’s fees, the settlement money would not earn interest, and it would “take a long time plus a fee on Ed’s behalf to receive the money back from the New York City Treasury.” All of this was untrue, but King “panicked.” His wife was about to have a baby, he needed the settlement money, and he did not want to risk liability for MCA’s attorney’s fees or having his settlement money tied up in the New York City Treasury for years. Therefore, King immediately signed and returned the settlement papers.

A month or two after the settlement, King visited Fox in New York, intending to discuss the fee agreement. Fox showed King crates full of documents from the litigation and said he doubted if he and his staff could be adequately compensated for the hundreds of hours of work that they had put in on King’s case. King felt too embarrassed to bring up the fee arrangement, and never raised it again until eight years later, in 1986. In the meantime, Fox continued to collect one-third of all writer’s and artist’s royalties sent to King (even though the original dispute had concerned only artist’s royalties). Despite that, King hired Fox to represent him in two other lawsuits relating to Lynyrd Skynyrd. Fox and King both assumed that the fees for these suits were covered under the original retainer agreement.

### **King challenges Fox’s right to a percentage of future royalties**

In 1986, while the two new lawsuits were pending, King brought up the fee arrangement between himself and Fox in a telephone conversation. According to King, Fox said that he had “fought hard” to win back King’s rights to his royalties and King should be grateful. More significantly, Fox said that the fee arrangement “was somehow tied in, I don’t understand the exact language, but it was tied into the [1978] stipulation of settlement, and it was approved by the Judge or whatever, and he said he couldn’t change it even if he wanted to.” Although false, this gave King the impression that the MCA lawsuit had resulted in a court order obligating King to pay Fox the one-third contingency fee. Fox’s statement about

the court order “strongly intimidated” King from raising any further issues about Fox’s fees. However, Fox denies making the “court order” comment, and King never asked for a copy of the court order.

In 1987, after King’s fellow band members told him it was unusual to give anyone a percentage of his writer’s royalties, King asked Fox to stop taking one-third of his writer’s royalties, which had never been in jeopardy in the first place. Fox agreed to stop taking King’s writer’s royalties in the future, but he did not return any of the \$55,000 in writer’s royalties he had already collected up to that point. Fox also continued to collect one-third of King’s artist’s royalties.

Eventually, about ten years later (in 1995), King told the whole story to a new attorney, John Shackelford, who told King that Fox had been taking advantage of him for years by collecting an “illegal annuity.” Several months later, King sued Fox to get back more than \$400,000 that Fox had collected in “future royalties” since 1978. King alleged that his original fee agreement with Fox was unconscionable and that Fox had engaged in attorney misconduct. King demanded payment of the royalties improperly collected by Fox, plus interest, punitive damages, and rescission of the fee agreement. Fox counterclaimed, seeking a contingent fee on the writer’s royalties that King had withheld since 1987. The motions, trials, appeals, and remands lasted for years.

To cut to the chase, the District Court eventually issued summary judgment for Fox, holding that the fee agreement was not unconscionable, and that in any event King had “ratified” the agreement. King appealed to the Second Circuit, arguing that the original contingency agreement between King and Fox was substantively unconscionable and that the defense of ratification did not apply. King also claimed that any supposed ratification would be invalid because Fox had fraudulently convinced him that the agreement was mandated by a court order, leading King to drop the issue. The Second Circuit therefore had to decide whether King had ratified the fee agreement, either before or after the alleged fraud occurred.

### **The Second Circuit’s opinion in *King v. Fox***

The Second Circuit noted that the alleged “court order” conversation did not occur until 1986. By then, the fee agreement had been in effect for more than 10 years, and King had asked Fox to represent him in three different lawsuits. In a typical contract case, the Second Circuit noted, “King’s eight years of acquiescence in the agreement with full knowledge of its terms between 1978 and 1986 would be enough under New York law to show that he ratified the agreement.” But attorney fee agreements have been held to “higher standards” than ordinary contracts because courts have “traditional authority . . . to supervise the charging of fees for legal services under [their] inherent and statutory power to regulate the practice of law.” However, King had accepted the benefits of the fee agreement for approximately 10 years before the alleged fraud. By accepting the terms of the original fee agreement for so long, had King necessarily ratified those terms? And if King could prove that Fox defrauded him in 1986, would that misconduct preclude Fox’s ratification defense, either prior to or after the alleged fraud?

King also argued on appeal that the original fee agreement was unconscionable. The Second Circuit found an issue of material fact as to the conscionability of the agreement; but “if it is possible under New York law for a client to ratify an unconscionable fee agreement, the unconscionability determination is moot because it is undisputed that King knew of and accepted the terms of the agreement at least between the years 1978 and 1995.” The District Court had held that the fee agreement between King and

Fox was not unconscionable, but the District Court had not applied “the test traditionally employed by New York courts to gauge the conscionability of attorney’s fee agreements.” Under that test, contingent fees may be disallowed in spite of a retainer agreement “where the amount becomes large enough to be out of all proportion to the value of the professional services rendered.” Moreover, in attorney- client contracts, the burden is on the attorney to establish that the contract “was made by the client with full knowledge of all the material circumstances known to the attorney, and was in every respect free from fraud on his part, or misconception on the part of the client ....” Thus, even in the absence of fraud, “the agreement may be invalid if it appears that the attorney got the better of the bargain, unless he can show that the client was fully aware of the consequences and that there was no exploitation of the client’s confidence in the attorney.”

Another issue was timing. The District Court had held that unconscionability must be assessed at the time the contract is made, but the Second Circuit noted that courts have held to the contrary when attorney’s fee agreements are in dispute. “The vice in a contingency arrangement may be determined not only by whether the contract was fair in the first instance but also by whether it became unfair in its enforcement.” The court must make its unconscionability determination after a “full exploration of all the facts and circumstances” surrounding the agreement, including the intent of the parties and the value of the attorney’s services in proportion to the fees charged. No “magic number” makes a contingency fee agreement automatically unconscionable, but in King’s case “the sheer amount of the fee Fox collected – over \$500,000 for modest work on three lawsuits – could support a finding of unconscionability.” (The issue of unconscionability, the Second Circuit added in a footnote, is “a question of law,” not a jury question.)

### **May clients ratify unconscionable fee agreements?**

If the agreement were held to be unconscionable, the next question would be whether New York law allows a client to ratify an attorney’s unconscionable fee agreement. The Second Circuit made some exploratory efforts to answer that question but found the authorities “divided and scant.” Several old New York cases indicate that an unconscionable or otherwise voidable agreement may be ratified, and some recent decisions from the Southern District of New York share that view. However, as the Second Circuit itself observed, none of those cases concerned attorney-client agreements. Moreover, several courts had held that “unconscionability voids an agreement, making ratification impossible, especially in the attorney-client or fiduciary context.”

Concluding that New York courts “had not spoken definitively on the issue,” the Second Circuit certified the unconscionability/ratification question to the New York Court of Appeals.

### **How should the Court of Appeals rule?**

The New York Court of Appeals has agreed to consider whether it is possible for a client to ratify an attorney’s unconscionable fee agreement. How should the court rule? I will approach that question by examining some of the cases that the Second Circuit cited in *King v. Fox*.

Only one New York case cited by the Second Circuit, *Ballow Brasted O’Brien & Rusin, P.C. v. Logan*, 2004 WL 1784343 (W.D.N.Y. Aug. 10, 2004), revolves around an attorney fee agreement. The Second Circuit cited *Ballow Brasted* for the proposition that “an attorney’s fee agreement, even when induced by fraud, may be ratified when the client accepts benefits under that agreement.” But that is a poor description of

the case. Even if the case were about an unconscionable fee agreement rather than a fraudulent one, Ballow Brasted would not answer the certified question.

The dispute in *Ballow Brasted* was not a fee dispute between a law firm and its client but rather a fee dispute between two law firms. One firm had been original counsel and the other successor counsel in a personal injury suit. Years earlier, in the underlying personal injury suit, the parties had entered into a Stipulation Regarding Substitution of Counsel of Record that had been “So Ordered” by the court. That “Substitution Order” – which is not an ordinary contract but rather a court order – entitled plaintiff’s original law firm (Ballow Brasted O’Brien & Rusin, P.C., or BBOR), to “20% of the gross legal fees” paid to successor counsel (Logan). But after Logan settled the case and collected a fee of \$840,000, he refused to pay BBOR its 20% share of the fees. BBOR eventually sued Logan, who defended by arguing that BBOR had fraudulently induced him to enter into the Substitution Order. (The opinion does not suggest the nature of the fraud, but we can speculate that BBOR painted a much rosier picture of the underlying personal injury case than Logan actually found, so Logan had expected a much larger fee than he actually received, and he felt entitled to keep the entire fee that he collected.)

The court rejected Logan’s fraud argument and entered summary judgment for BBOR on two grounds. First, Logan had waited too long (almost five years) to raise fraud as a basis for reconsideration of the Substitution Order; Rule 60(b)(3) of the Federal Rules of Civil Procedure required him to do so no later than one year after the Substitution Order was entered in 1998. Consequently, the court did not actually adjudicate the fraud question. Second, the Ballow Brasted court said:

[E]ven if the parties’ contract was induced by BBOR’s alleged fraud, (1) the contract would be voidable, not void, (2) Logan would have to affirm or disavow the contract, (3) Logan affirmed or ratified the Substitution Order because he has accepted the benefits there under and (4) Logan cannot accept the benefits of the Substitution Order while avoiding the corresponding obligations there under....[Emphasis added.]

From this language, the Second Circuit extracted the proposition that “an attorney’s fee agreement, even when induced by fraud, may be ratified when the client accepts benefits under that agreement.” (Emphasis added.) But the Ballow Brasted case cannot stand for that proposition because the client was not a party to the suit between Logan and BBOR and had no financial interest in its outcome. If the proposition is valid, its validity must rest on the two cases that the Ballow Brasted court cited to support it.

The first case cited by the *Ballow Brasted* court to support its ratification theory is *Ferguson v. Lion Holding, Inc.*, 312 F.Supp.2d 484, 498-500 (S.D.N.Y. 2004), a case also cited by the Second Circuit. *Ballow Brasted* accurately described *Ferguson* as holding that “a contract induced by fraud is voidable” and “the aggrieved party may not both retain benefit of contract while ignoring its obligations there under.” If these principles apply to King’s case, the unconscionable fee agreement between King and Fox might well be enforced because King had obtained the benefit of Fox’s legal work in three lawsuits. But the *Ferguson* case is of minimal relevance here because *Ferguson* is not about attorney-client contracts. Rather, *Ferguson* is a breach of contract case by former executives against an insurance company. Similarly, the second case cited by the *Ballow Brasted* court to support its ratification theory, *Turkish v. Kasnetz*, 27 F.3d 23, 28 (2d Cir.1994), has nothing to do with attorney fee agreements. Nor do any other

New York cases directly address whether a client may ratify an unconscionable agreement for attorney fees.

## **Beyond the Hudson River**

Since New York state and federal courts have not provided any authority that speaks directly to the questions the Second Circuit certified to the New York Court of Appeals, we will have to venture out into the vast uncivilized realms beyond the Hudson River. I will briefly look at the two cases on ratification of attorney fee agreements that the Second Circuit cited from outside New York.

One case cited by the Second Circuit is *Walton v. Hoover, Bax & Slovacek, LLP*, 149 S.W.2d 834, 846-47 (Tex. App. 2004). There, a Texas rancher believed that various oil and gas companies with leases on his ranch were damaging his land and underpaying his royalties. The rancher hired an experienced oil and gas lawyer named Steven Parrott, a partner at the law firm of Hoover, Bax & Slovacek ("HBS"). Parrott agreed to take on the matter for a 30% contingent fee. His retainer agreement contained the following termination clause: "You may terminate the Firm's legal representation at any time .... Upon termination by You, You agree to immediately pay the Firm the then present value of the Contingent Fee...." (Emphasis by the court.) Parrott negotiated relatively small settlements with four companies and received his fee without a problem. A larger company (Bass) then offered to settle for \$6,000,000, but the offer was contingent on conditions that were unacceptable to the client, who soon discharged Parrott. Bass eventually settled for only \$900,000, but Parrott sought his full 30% contingent fee under the termination clause (more than \$1.7 million).

The court found Parrott's termination clause to be unconscionable and said that "a court will not enforce an unconscionable fee arrangement." HBS argued that the client had ratified the engagement letter by accepting the benefits of HBS's representation on his claims against companies other than Bass and by paying HBS's fees from the settlements he received on those claims. The court said HBS had waived this argument by not asserting it below, so the ratification argument was not properly before the court, but the court nevertheless said that "a contractual provision that violates public policy cannot be ratified."

The other case about ratification cited by the Second Circuit in *King v. Fox is Blattman v. Gadd*, 296 P. 681, 689 (1st App. Dist. 1931). There, the trustees of a local land reclamation board agreed to pay an attorney named Metteer a hefty contingent fee (ultimately amounting to \$68,000) to appeal a contract claim worth only \$160,000. The necessary appeal papers had been virtually completed before Metteer was hired and he did very little work on the case. (The trial court fixed the value of Metteer's legal services at a paltry \$1,500.) The appellate court, suspecting that Metteer had been paid for his influence rather than for his legal work, minced no words: "Phrasing it bluntly," the court said, "the unconscionableness of the entire transaction was manifest, and the proceeding in its inception indicated a scheme rather than a contract. ... A holding in support of a contract such as this would go far toward a destruction of all public service and would bring about suspicion and distrust of public agencies and hasten an era of anarchy and chaos." Because the contract called for payment of fees that were "grossly unreasonable," the contract was "beyond the power of the trustees to enter into, and therefore beyond their power to ratify." The case is therefore squarely on point and – unlike any other case cited by the Second Circuit – actually adjudicated the question whether a client can ratify an unconscionable legal fee agreement. But should the New York Court of Appeals follow a 75-year-old case from an intermediate California appellate court that confronted a shocking misuse of public funds during depths of the Great Depression?

## **Conclusion: Many factors are relevant**

Because no case other than *Blattman v. Gadd* has fully considered and adjudicated whether a client may ratify an unconscionable agreement for legal fees, we should step back and resort to first principles. Certainly attorneys have solemn fiduciary duties to each client and should not be permitted to profit from an unconscionable fee agreement, especially where the attorney has deceived or misled a client regarding the terms or factual context of the fee agreement. Therefore, a holding that a client may *always* ratify an unconscionable attorney's fee agreement would be unwise. On the other hand, a client who suspects or knows that a fee agreement is unconscionable should not be permitted to exploit the attorney by reaping all of the benefits of the attorney's work before asserting unconscionability. Therefore, a holding that a client may *never* ratify an unconscionable fee agreement would also be unwise. Rather, the holding ought to come out somewhere in the middle, depending on all of the facts and circumstances.

What facts and circumstances should a court consider? Here are some that come to mind: (1) Was the fee agreement obviously unconscionable on its face, or was it just on the borderline of unconscionability? (2) How sophisticated and experienced was the client in dealing with lawyers and fee agreements? (3) How clearly written was the fee agreement? (4) At what point did the client know or suspect enough to question the legitimacy of the fee agreement? (5) Did the client question the attorney about the fee agreement, or challenge the attorney's right to collect the fees the attorney claimed under the agreement? If so, what was the attorney's response? (6) Did the attorney discourage or intimidate the client so that the client was afraid to challenge the fee agreement? and (7) Did the attorney mislead the client about the fee agreement, or conceal facts that otherwise would have enabled the client to perceive problems with the fee agreement?

In the end, I hope the New York Court of Appeals holds that it is possible for a client to ratify an unconscionable fee agreement in certain circumstances. But I also hope the Court of Appeals will make it impossible for an attorney to collect an excessive fee based on such an agreement. Even if a client has ratified an unconscionable fee agreement, the attorney should not be permitted to collect the full amount of the unconscionable fee, and (absent misconduct by the client) should not even be permitted to collect the full amount of a reasonable fee. Rather, the attorney should suffer some penalty for devising an unconscionable fee agreement in the first place. Tools such as quantum meruit, disgorgement, monetary sanctions, and forfeiture can inflict penalties that will remove the incentive for attorneys to charge unconscionable fees without opening the door for clever and sophisticated clients to obtain all of the benefits of the attorney's services without paying for them. It is a delicate balancing act, but one that the New York Court of Appeals is well suited to perform.

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