New York Law Journal

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# Analyzing the Fundamentals of Litigation Funding

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New York Law Journal

2013-08-19 00:00:00.0

The economics of litigation is changing. In view of the rising cost of heading to trial, the increasing length of time between complaint and final resolution, and the modernizing attitude of the bar, Third-Party Litigation Funding (TPLF) is gaining traction. TPLF companies advance funds using anticipated recoveries from commercial lawsuits as collateral. This funding takes the form of non-recourse investments. That is, the financing is repaid by a litigant borrower only in the event there is a favorable resolution upon completion of the litigation. As compensation, the TPLF companies receive specified fees, often calculated as a percentage of any settlement or judgment. When provided to plaintiffs, TPLF promotes access to justice by enabling plaintiffs with good cases but insufficient funds to bring lawsuits they otherwise may be unable to afford or would rather not self-fund, and to avoid premature settlements at a discount due to an exhaustion of their funds. When provided to defendants, TPLF allows corporations who can afford to litigate, but who may not want the expense, to hedge the costs. TPLF allows both parties to shift the risks of litigation.

**Background**

The rise of industrialization in the United States in the 1930s brought an increasing number of claims requiring legal representation, and with that, attorney contingency fee arrangements became more prevalent. TPLF differs from attorney funding because the TPLF companies are not providing a service for a fee, but rather are investing in an asset. The TPLF companies call this "monetizing commercial legal claims."

Large-scale commercial TPLF began in Australia in the early 1990s and soon spread to the United Kingdom, and other European countries, principally because the legal systems in those jurisdictions prohibit contingency fee litigation, and also because of the loser pays disincentives. Those jurisdictions permit contingent returns for funders.

In its original incarnation in the United States in the early 1990s, TPLF was directed to plaintiffs in personal injury cases. The loans were used to pay the costs of litigation, or to cover the plaintiff's living expenses during the pendency of the lawsuit. Typically, these loans were of a few thousand dollars in exchange for a share of recoveries that were only in the thousands of dollars. Now, the significant TPLF companies loan several millions of dollars in exchange for shares of recoveries that can be in the million to billion dollar range. The TPLF companies are doing well. According to an April 6, 2013 article in The Economist, their "[r]eturns are impressive enough to have drawn in both hedge funds and traditional finance companies."

**Numerous Issues at Play**

A specter of legal and ethical issues are raised by TPLF: (1) potential illegality of the arrangement, specifically, champerty, usury and fee sharing with non-lawyers; (2) loss of attorney-client privilege; (3) potential conflicts of interest; (4) issues with attorneys failing as advisors; and (5) loss of control of the proceeding.

The common law prohibition against champerty is defined by the U.S. Supreme Court as maintaining suit in return for a financial interest in the outcome.[1] New York has relaxed the medieval approach to champerty, but prohibits the purchase of debt, a thing in action or any claim or demand among other things, "with the intent and for the purpose of bringing an action or proceeding thereon."[2] In its Formal Opinion 2011-2 on Third-Party Litigation Financing, The Association of the Bar of the City of New York Committee on Professional Ethics states:

> While we are aware of no decision finding non-recourse funding arrangements champertous under New York law, lawyers should be mindful that courts in other jurisdictions have invalidated certain financing arrangements under applicable champerty laws.[3]

Subsequent New York case law has not changed this.

Usury is the taking of interest at a rate that exceeds the maximum rate provided by law. TPLF is non-recourse in nature, so usury is inapplicable since it contemplates a loan for which the borrower has an absolute obligation to repay the sum advanced.

TPLF companies generally avoid the prohibition against a lawyer sharing fees with a non-lawyer by contracting directly with the clients, not with their attorneys. That said, certain TPLF companies also take the position that what they do is no different than what a bank does—it is lawsuit financing, not fee splitting. The professional ethics bar has not publicly commented on that formulation.

Attorney-client privilege is an evidentiary doctrine basic to the relationship between an attorney and her client. It protects from discovery by the opposing party in litigation any communications from the client to her attorney, and in certain instances, communications from the attorney to her client. Disclosure of privileged communications to anyone other than another privileged person generally waives the privilege. The "common interest doctrine" is an exception to that rule. The exception applies if the parties' interests are identical, not just similar, and are legal, not just commercial.

Client information manifestly is relevant to the TPLF companies' underwriting decisions, as their stock in trade depends upon their ability to evaluate a case astutely. For them, the more information, the better. Attorneys must use the utmost caution before releasing any information that may be privileged or confidential to a TPLF company. For example, in *Leader Technologies v. Facebook*,[4] the District of Delaware Court upheld a magistrate judge's decision finding the attorney-client privilege waived with respect to documents passed between the plaintiff and TPLF company. By comparison, in *Devon IT v. IBM*, the Eastern District of Pennsylvania Court found the common-interest doctrine did apply to confidential information shared with the TPLF company.[5]

In any event, under no circumstances may a lawyer disclose privileged information to a TPLF company unless the lawyer first obtains the client's informed consent, including by explaining to the client the potential for waiver of privilege and the consequences this could have in discovery or other aspects of the case. Attorneys should consider whether disclosure to potential investors should be limited to documents that otherwise must be produced in the litigation. Also, a nondisclosure agreement should be in place with a potential TPLF investor before any disclosure takes place. Many TPLF companies state that they do not seek access to information covered by the attorney-client privilege, but it has been reported that some agreements between TPLF companies and clients have provided for the company to have a right to inspect all documents, including those covered by the attorney-client privilege.

Conflicts of interest may arise if an attorney is receiving a fee from a TPLF company if that interest would impair the attorney's ability to advise a client solely in the client's best interest. Beyond that, it may be altogether impermissible for an attorney, or any company in which an attorney has a substantial interest, to extend financing to a client of that attorney. An attorney may also be at risk of a conflict if asked to opine on a TPLF agreement without which the client would be unable to afford to retain that attorney to prosecute the lawsuit.

The New York Rules of Professional Conduct (the Rules) demand attorneys render "candid advice"[6] to their clients. Thus, if retained to review a TPLF agreement for a client, a lawyer is responsible to explain to his client all aspects of the transaction. This evaluation includes a discussion of the reduction in damages the client will realize at the resolution of the case because of the lien of the TPLF company, whether the client could afford the costs of the litigation and her living expenses during its pendency absent the TPLF financing, whether the client eventually may be forced to settle for a lesser amount by a better financed defendant, and whether the client's own funds would be more productively used other than to fund the litigation, among other considerations. Also, if the attorney suggests the names of any TPLF companies, she should be clear that such assistance itself is not an endorsement of the TPLF companies so named.

The Rules prohibit a lawyer from allowing his independent professional judgment to be compromised in determining the course or strategy of a litigation, including decisions of whether to settle and the amount of the settlement; yet it stands to reason that a TPLF company would want to ensure a case that serves as its collateral is being managed in a way that protects its interests. While a client may agree to permit a TPLF company (or another third party) to direct the strategy or other aspects of a lawsuit, absent client consent, a lawyer may not permit the company to influence his independent professional judgment. If a client comes to an attorney with a preexisting, executed TPLF agreement transferring decision-making authority to the TPLF company, the attorney may find himself in an ethical quagmire. That said, many TPLF companies claim that the choice of law firm forms part of their funding decision, and after the funding commitment is made, they do not get involved in any decision making.

**TPLF Companies**

The most visible TPLF companies for lawsuits in United States courts are Burford Capital and Juridica Investments, both traded on the London Stock Exchange. In an article published on April 7, 2013, the Wall Street Journal reported that these companies "have investment pools of more than $300 million and $200 million, respectively." In 2012, Credit Suisse Group AG spun off its legal finance group, now called Parabellum Capital, which also funds U.S. litigations. In the same article, The Wall Street Journal reported that, since then, Parabellum has raised more than $200 million, and that a new entrant into U.S. third-party litigation funding, Gerchen Keller Capital, immediately raised $100 million. There also are many other TPLF companies, although they are not as prominently represented in the press.

The significant TPLF companies are interested exclusively in large-ticket commercial litigations involving sophisticated clients who are represented by major law firms. Most cases arise in the contexts of contract, trade secrets, international arbitration, antitrust and patents. The investments generally range from $2 to 3 million to $15 million, or more.

TPLF financing terms are bespoke; they are stylized to the needs of the funding recipients and the particularities of the lawsuit. In simplest form, TPLF companies provide capital to prosecute a lawsuit in exchange for a share of the proceeds. In doing so, the TPLF companies create the equivalent of a contingent fee arrangement: The TPLF company pays counsel's hourly rates and advances expenses, thus relieving the litigant of those costs, and if the case is successful, the litigant's share is reduced by the percentage that is paid to the TPLF company. The TPLF companies' fees normally range from 30 to 40 percent to sometimes as much as 60 percent of the amount recovered. If the case is lost, the TPLF companies receive nothing. In a compensation variable, the TPLF companies may propose a fee grid that ties their compensation to the duration of the case. Generally, the longer the case takes to resolve, the greater the recovery to the TPLF companies.

The stock in trade of TPLF companies is their ability to value the litigations, taking into consideration likelihood of success, amount of recovery, and expected length of time until final resolution. Some TPLF companies thus employ in-house lawyers from the best national law firms who evaluate the cases for which funding is requested, while others farm out this function to law firms.

The TPLF companies do not always enter a case at the beginning. For example, as a trial appears inevitable, a plaintiff who has paid hourly rates to his lawyers through the course of a lawsuit may decide he doesn't want to absorb the onerous costs of trial, or can't afford it. The plaintiff may also have an outstanding balance due to his law firm, and the firm will not proceed before their fee is paid. Enter the TPLF company, which pays the balance due to the law firm, finances the remainder of the case, and takes a percentage of the recovery if the case is successful, or takes nothing if the case fails.

TPLF companies view corporate claims as an asset class. Consequently, there is no requirement that there be a relationship between the use of the funds and the claim that serves as collateral. For example, if a manufacturer wants to build a new plant, and independent of that, simultaneously is prosecuting or could prosecute a lawsuit with likely substantial recovery, the manufacturer could use TPLF capital to construct the plant. In return for a diminished recovery in the lawsuit, the manufacturer carries no risk from a possible bad judgment. But the manufacturer cannot just walk away from the case. The manufacturer remains responsible for practical involvement and strategic decision-making, as guided by counsel.

Although far less common, and much more difficult to arrange, several TPLF companies also offer funding to defendants. When funding defendants, TPLF companies attempt to create the economics of a reverse contingent fee. In order to do so, the TPLF company and the litigant agree on a successful result in advance. This does not mean that the defendant will have to pay nothing, but rather they examine realistically the probable outcome of the action. For example, a defendant may admit that it is liable for $25 million. The TPLF company advances the costs of the litigation, and if the case is resolved for less than $25 million, the defendant pays the TPLF company a percentage, or all, of the difference between $25 million and the actual amount of the damages awarded. However, the defendant client is assured its liability will not exceed $25 million.

The availability of TPLF in foreign countries is of particular interest to institutional investors in the United States, as a result of the U.S. Supreme Court case, *Morrison v. National Australia Bank*,[7] which held that investors no longer have the protection of U.S. securities laws if the securities were purchased on a foreign exchange. Given the prevalence of global investing by multi-billion dollar stock portfolios, if a domestic U.S. investor on a foreign exchange wants to recover assets based on securities fraud in that foreign jurisdiction, the availability of TPLF makes such an action feasible, as it creates a fee dynamic similar to the contingent fee arrangement normally provided to plaintiffs in domestic securities litigations. In 2010, NERA Economic Consulting published a study on Trends in Australian Securities Class Actions. The study identified the emergence of litigation funding as the most significant development behind the increase in securities class action litigation in that country.

**Conclusion**

Commentators are not unanimous that TPLF is a good thing. The U.S. Chamber of Commerce's Institute for Legal Reform (ILR) opined:

> By increasing the funds available to pursue litigation, third-party litigation financing inevitably increases the volume of litigation. Moreover, because third-party financing vitiates traditional safeguards against frivolous claims, much of this increased litigation volume consists of claims of questionable merit. For this reason, lawmakers and regulators should consider prohibiting third-party funding in the United States.

The ILR should take heart, however. If its assessment is correct, it will not be long before the TPLF companies are out of business due to their poor business judgments in funding frivolous litigations on a non-recourse basis.

Proponents of TPLF contend that it has an equalizing effect on litigants' bargaining power, promotes increased access to justice and allows litigants to leverage the value of a good claim or to hedge the costs of litigation. According to Steven Gillers, a recognized authority in legal ethics, "the question is whether allowing companies to make non-recourse advances is a good thing, and surely it is."[8] Good or bad, attorneys must be fully cognizant of their professional obligations when considering TPLF.

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**Endnotes:**

1. *In re Primus,* 436 U.S. 412, 424 n.15 (1978).

2. N.Y. Judiciary Law, §489.

3. The Association of the Bar of the City of New York Committee on Professional Ethics, Formal Opinion 2011-2: Third-Party Litigation Financing, http://www.nycbar.org/ethics/ethics-opinions-local/2011-opinions/1159-formal-opinion-2011-02.

4. *Leader Technologies v. Facebook*, 719 F. Supp. 2d 373 (D. Del. 2010).

5. *Devon IT v. IBM*, C.A. No. 10-2899, 2012 U.S. Dist. LEXIS 166749 (E.D. Pa. Sept. 27, 2012)

6. New York Rules of Professional Conduct, Rule 2.1.

7. *Morrison v. Nat'l Austl. Bank*, 130 S. Ct. 2869 (2010).

8. Steven Gillers, "Waiting for Good Dough: Litigation Funding Comes to Law," 43 Akron L. Rev. 677, 689 (2010).