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Follow The Money: Litigation Funders Back Your Foes

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I'll be talking tonight about third-party funding of litigation. This is a new trend in the United States, reaching significant volume only in the past few years, though it is already very well established in Australia and the UK.

There are two basic types of litigation funding: cash advances offered to individual plaintiffs and funding offered to plaintiffs' firms. Most litigation funders offer both types. I won't address the former type of funding, which is of less urgent importance to this audience, except to note a few salient features of it.

First, it is very expensive, with funders charging a minimum of 36 percent per year and with rates of 150 percent per year and higher being not uncommon. Second, the cash is advanced on a nonrecourse basis, meaning that the plaintiff doesn't have to repay it if there is no verdict or settlement in his or her favor. This is how the funders avoid state usury laws. Third, the funders often pitch their services to and through plaintiffs' firms, describing it as an additional service that the firms can offer to their clients. The clients can bring their case to the funder and walk away with cash in their pockets – something the firm would be barred from doing itself by ethics rules.

This presentation addresses the growing industry of companies that underwrite litigation by providing funding directly to plaintiffs' firms. I'd like to start with an example of litigation funding from the early days of the industry in this country.

In 1999, the South Carolina law firm Weaver, Bennett and Bland had a client who sued George Shinn, the owner of the Charlotte Hornets, for kidnapping and sexual assault. He countersued, and the client couldn't afford to pay the legal bills. The firm then received a cold call from a Las Vegas-based company called Speedy Bucks. Speedy Bucks offered to give $110,000 to the client, who would use it to pay for the litigation. The firm declined, saying that the arrangement would violate state law.

Speedy Bucks then approached the client directly and without notifying the firm. They gave her $200,000 in exchange for a deal that required her to repay a minimum of $600,000 plus half of

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any settlement. When Shinn offered to settle the case for $1 million, and the firm recommended accepting the offer, the client turned it down, correctly calculating that she would be better off going to trial and losing than agreeing to take any amount less than $1.2 million. And so the case went to trial in 2002, and the plaintiff lost. When she told Weaver, Bennett and Bland – a month after the trial – *why* she had refused the settlement offer, they sued Speedy Bucks for fraud and interference with contract. The firm eventually won over $500,000 in damages and costs. *Weaver, Bennett & Bland v. Speedy Bucks* (W.D.N.C. Aug. 14, 2007).

Apart from usury, the Speedy Bucks case shows one of the major problems of third-party litigation funding: perverse financial incentives are created that can make settlement impossible. In this case it caused a case to go to trial that would otherwise have settled. The ugliness of the trial is one reason that has been cited in the press for the Hornets' move to New Orleans following the 2001-2002 season.

Speedy Bucks was owned by a gentleman named Perry Walton. I'll be mentioning him again later. But first, let's turn to where the litigation funding industry is today. It consists of dozens of companies, ranging from low-rent storefront types of the Speedy Bucks variety to hedge funds and captives of insurance companies and banks. For example, Counsel Financial, which I will discuss in more detail momentarily, is backed by Citigroup. Credit Suisse Group owns a litigation funder, which it calls its "Litigation Risk Strategies" division. German insurance giant Allianz funds litigation through Allianz ProzessFinanz GmbH.

Most litigation funders are not captives of large corporations, but are standalone companies of varying size and importance. Juridica Investments Ltd. is probably the most well-known. It was incorporated in Guernsey in December 2007. Richard W. Fields – a former Dickstein Shapiro partner – is the principal. It is publicly traded in London, currently at 101.5 pence per share. Juridica will not invest in personal injury, class actions or mass torts – only business-versus-business litigation – but it seems to be unique in that respect. For example, Burford Capital Ltd., which is the company most commonly mentioned in the same breath as Juridica, is funding the Ecuadorian personal injury litigation against Chevron.

Let's look at how a typical litigation funder works, using Citigroup's Counsel Financial as an example. Most funders beyond the level of storefront payday-loan-type operations provide essentially the same services following the same model. Counsel Financial actively seeks to fund class actions, personal injury actions, and pharmaceutical litigation, among other things. It offers plaintiffs' firms a variety of options, ranging from a single cash advance to a case cost line of credit, to be drawn upon to pay for a particular case, all the way up to an attorney line of credit, which the firm can use for anything it likes, including paying firm overhead, advertising for new plaintiffs, or paying salaries. The money is secured by the firm's potential rights to recovery, and, again, there is a large continuum of possibilities, ranging from the right to recovery in a particular case to the rights in a firm's entire inventory of cases. A funding package consisting of an attorney line of credit secured by recovery rights in a firm's whole inventory is rather difficult to distinguish from owning stock in the firm.

One striking feature of litigation funding – prominently advertised by the funders – is that it is "free" to the plaintiffs' firms, because their clients will be responsible for the interest payments. This has generally been found permissible by courts and legislatures, with the proviso that the clients must be made aware of this responsibility and must consent to it. I suggest to you that it is extremely unlikely that individual personal injury clients will normally understand and be in a position to consent to such a clause in a retention agreement, a problem that is enormously compounded in the context of a class action. Also, no amount of cautionary boilerplate in the contract can change the fact that a plaintiff's firm trying to shift its obligation to pay interest on its cash advances to its clients has a very serious conflict of interest.

As I suggested, most legislative or case law commentary on the subject just blandly notes the need for consent, but not everyone has been so acquiescent. The firms that brought the personal injury litigation on behalf of the Ground Zero workers funded the litigation through Counsel Financial. They owed Counsel Financial $11 million in interest payments when the litigation settled, and tried to charge $6.1 million of it to the plaintiffs. Judge Alvin Hellerstein acknowledged that passing on the interest to the plaintiffs was legally permissible, but held that it wasn't clear that the plaintiffs had understood or approved the charges. He ordered the plaintiffs' lawyers to absorb them out of their profits. *In Re Ground Zero Litig*., No. 1:21-mc-00100-AKH (S.D.N.Y. Aug. 27, 2010).

Notwithstanding setbacks like the Ground Zero litigation (which was a setback only for the plaintiffs' firms, not for the funders), the litigation funding model is thriving. Industry members have estimated that the total amount of direct funding to plaintiffs' firms now exceeds $1 billion. And the industry has a trade association to lobby for it. The American Legal Finance Association was founded in 2004, and is located in New York City at 228 Park Avenue South.

What the American Legal Finance Association exists for is to make litigation funding legal in as many states as possible. Their model is to approach legislatures and to get them to endorse their "voluntary" code of standards by codifying them. Thus, in the guise of regulating the industry and bringing it up to the high standards that ALFA claims that it stands for, they achieve legislative ratification of the industry.

The reason that the industry needs ratification is that, in many places, it is *illegal* under the longstanding legal doctrines of maintenance and champerty. Maintenance is the giving of assistance to a litigant in pursuing a lawsuit, and champerty is a form of maintenance in which the party giving assistance does so in exchange for an interest in the outcome of the lawsuit. In an illustrative case, *Rancman v. Interim Settlement Funding Corp*., the Ohio Supreme Court struck down a litigation funding contract that advanced cash to a car crash plaintiff at a 280 percent annual interest rate. A consortium of litigation funders filed amicus briefs. The court upheld maintenance and champerty, holding that "[a]n intermeddler is not permitted to gorge upon the fruits of litigation." *Rancman*, 789 N.E.2d 217 (Ohio 2003).

Remember Perry Walton and the Speedy Bucks case? Walton started out as the owner of Wild West Funding, a personal loan business run out of his house in Las Vegas. He then went into the litigation funding business. In addition to Speedy Bucks, Walton founded the com-

pany that made the 280 percent per year loan to Roberta Rancman and caused the Ohio Supreme Court to declare litigation funding illegal in 2003.

ALFA was founded – not quite literally – to persuade the world that they're not like Perry Walton. And they're good at it. *Rancman* was overturned by statute, following lobbying by ALFA. *See* OH Stat. Ann. § 1349.55. Texas, Florida, New Jersey, Mississippi, Massachusetts, North Carolina, South Carolina and New Hampshire courts have either nullified champerty entirely or have upheld particular litigation funding contracts. Maine and Connecticut allow litigation funding by statute, and similar legislation is currently pending in Kentucky. The situation in New York is confused. In 2005, ALFA negotiated an agreement with Eliot Spitzer for the Attorney General's office to tolerate litigation funding under certain standards of conduct. But § 489(1) of the NY Code forbids champerty, and *Trust v. Love Funding*, 918 N.E.2d 889 (NY Ct. App. 2009) strongly suggests that the bar is still valid in New York. Obviously, the *Re Ground Zero Litig*. order suggests the contrary.

This sort of confusion over the legal status of litigation funding is in fact the norm. The industry has been operating *sub rosa* for some time. The contract in dispute in the *Speedy Bucks* case was secured in 1999 in South Carolina. The funding contract in *Rancman* was also from 1999, in Ohio. In checking up on the other trial obligations of an opponent, I just stumbled across another funding agreement from 2003 in California. The industry has been accepting the occasional judicial reversal as part of the cost of doing business, while at the same time – since at least its amicus briefs in *Rancman* in 2003 – lobbying for legislative and judicial recognition.

Whenever the merits of the litigation funding industry are being debated, one of the bones of contention is whether litigation funding increases litigation. Its proponents always say that litigation funding won't increase litigation, because no rational lender would fund an unmeritorious lawsuit. This argument is very naïve, as it ignores the pricing of risk. Any financial risk is worth taking if the price is right, and it is not hard to make the price right by the terms of a funding contract.

The real issue is how litigation funding *spreads* risk. For anyone who stands to make money from litigation, as much litigation as possible with a positive expected value should happen. For example, imagine a litigation with a 10 percent chance of a $100 million payoff. The expected value is $10 million. If you can buy that for $2 million, it's a good investment – unless you don't like a 90 percent chance of losing your money and going bankrupt. But if the risk of loss can be distributed by making lots of uncorrelated investments with a positive expected value, then the wins will outweigh the losses. Litigation funding enables plaintiffs' firms that are reluctant to take on risky litigation to shift the risks of failure to investors, who are able to bear the risk because they can spread it around. Obviously that will cause more litigation to occur.

As we all learned from the collapse of the mortgage market – if we didn't learn it before – when there is an activity that can generate money, smart people will find ways to make that activity happen more so that they can make more money from it. If it is profitable for them to do so, they will make it happen a lot more than it would happen "naturally." I believe that we are at the point in this process where a large part of the camel's nose is in the tent, and a bad smell is coming as the funding industry nudges its way into our economy and court system.

In addition to the increase in litigation overall, there are other ways that litigation funding disrupts the normal operation of litigation. The most obvious is that – with another interested party that has to be paid off – settlements will become more expensive, and sometimes will not happen. The *Speedy Bucks* case is an excellent illustration of that.

The involvement of litigation funders with plaintiffs' firms is likely to cause multiple problems created by the fundamental conflict of interest between the objectives of the funders and of the individual plaintiffs. Although such relationships are supposed to be arms length, and funders are supposed to have no influence on litigation, it is difficult to believe that plaintiffs' firms that receive a large portion of their funds from a third party will not come under the influence of that third party to at least some extent. Funders may want to hasten settlement to recoup their investment, delay settlement to increase their interest charges, and steer cases toward monetary and away from injunctive relief, among other things.

As discussed previously, plaintiffs' firms may be sorely tempted to shift risks to third-party funders in exchange for a stream of certain cash (which does not have to be repaid in the event of a loss). But in the current legal climate of alternative payment schemes for *defense* firms, the same sorts of pressures may apply to some of them as well. If a defense firm takes on a sizable amount of contingent-fee cases, that can impair short-term cash flow and create uncertainty about future income, causing the firm to falter and partners to consider jumping ship. Litigation funding – in this case funding to support a case brought on behalf of one corporation against another – may be a tempting way to convert future uncertainties into a secure present cash flow.

Finally, the involvement of third-party funders risks the disclosure of confidential information. Funders obviously want as much information about their potential investment as they can get, including frank and honest evaluations of strengths and weaknesses. The case law right now suggests strongly that there is *no* privilege for communications with a third-party funder. *See, e.g., Leader Tech. v. Facebook* (D. Del. June 24, 2010); *Bray & Gillespie Mgmt. v. Lexington Ins.* (M.D. Fla. Nov. 17, 2008). So if you are defending a case in which the plaintiffs' firm has litigation funding, go after the communications with the funder.

The litigation funding industry is a powerful force that will distort and, most importantly, increase U.S. litigation. It needs to be resisted. I encourage you to get involved in efforts to push back against the industry. Organizations like the U.S. Chamber of Commerce, the American Tort Reform Association, the Product Liability Advisory Counsel, and the American Insurance Association have been involved, the Chamber probably the most prominently. Pay attention to opportunities to express your views, such as the ABA's Commission on Ethics 20/20, which recently finished collecting comments on proposals for ethics rules on legal financing. And keep an eye on your state legislature or the legislatures where you or your clients get sued, so that you can do what you can to head off the industry's lobbying efforts.