LITIGATION FINANCE OVERVIEW

In a world where access to justice often depends on money, litigation finance makes justice accessible to claimants who would otherwise lack the resources to attain it on their own. Eighty-one percent of low-income Americans do not use legal assistance because they cannot afford the high fees associated with civil lawsuits, which some estimates place as high as $50,000 on average in the United States. As a result, many individuals or companies may choose to defer or even abandon legitimate claims if they are unlikely to be able to provide for their families or keep themselves solvent while the litigation plays out in court.

Faced with the prospect of forfeiting their chance to redress their grievances, individuals and companies need a “law banker” to help plaintiffs monetize the outcome of their claims so they can afford the high costs of litigation. Third-party litigation finance provides a more efficient and equitable means of redistributing risk and equalizing the bargaining power of litigants by providing funding to undercapitalized plaintiffs through the use of novel financial products.

What is Litigation Finance?
At its most basic level, “litigation finance” is the practice where a third-party unrelated to the subject matter of a lawsuit provides money to a party involved in litigation to help further that party’s objectives in the legal claim in return for a financial reward. The capital provided by lawsuit investors may help individual plaintiffs pay for living expenses or directly pay for some of the costs of litigation, including attorneys’ fees, expert witness fees, court costs, and other expenses associated with a lawsuit. Capital from a litigation finance provider may be used to fund operating expenses for companies involved in litigation. It can also be provided directly to law firms to finance their operations. The financial reward for investors can take different forms, including a flat fee, a multiple of the amount advanced, a percentage of the amount recovered, an interest rate when it is a loan to a law firm, or some other basis of compensation.

The History and Evolution of Litigation Finance

Direct forms of litigation finance, particularly the funding of lawsuit expenses by repeat players who are unrelated to the subject matter of a dispute, have emerged as an asset class only recently due to a degree of legal uncertainty that has historically discouraged investment in this area. The medieval English doctrines of “maintenance,” “champery,” and “barratry” – all of them involving an arrangement where a party supports another to enable him or her to further a claim – historically prohibited third-party financing of lawsuits in the United States and most other common law countries.

Over time, as other means of controlling abuses of the legal system became more
effective, the need for the prohibitions on
champerty, maintenance and barratry
receded. As parties in civil litigation are
responsible for their own legal costs, the
American civil justice system increasingly
recognized that access to justice depends
upon the broad availability of legal
representation for all socioeconomic levels.
The public policy for increasing access to
the legal system for those that could least
afford it overrode the concerns underlying
the prohibition policies in many states.
Today, widespread exceptions to these
historical doctrines recognize that financial
considerations often influenced access to
justice. These include contingent fee
arrangements, where an attorney is paid a
fixed percentage of a recovery only if there
is a favorable judgment or settlement, and
tort lawsuit advances, where outside
investors providing lawsuit funding in
exchange for a fee if the case is won or
settled. The success of lawsuit cash
advances for tort claims has led to several
companies trailblazing more generalized
lawsuit advance markets, including offering
contingency law firms various specially
debt products secured by the firms’ fees
from tort cases.

Litigation Finance Today
Currently, direct lawsuit financing is
permitted so long as the funding
organization does not control the litigation.
The litigation finance industry offers three
main product lines, with companies tending
to specialize in each specific product. The
first is the lawsuit advance for tort claims,
which provides funding to individual
plaintiffs for living expenses during
protracted litigation. Second is funding for
commercial matters in areas such as
contracts, intellectual property, antitrust,
and banking, among others. Third, a
number of companies provide loans to
underfinanced attorneys and law firms.

The slowdown of the global economy,
combined with tightening credit markets,
declining asset values, escalating legal
costs, increased backing by institutional
investors, and a growing receptivity in the
legal industry to innovative financial
products, has greatly expanded the both
the practice and viability of investing capital
in lawsuits. Over the course of a few
decades, the litigation finance industry has
evolved into an alternative asset class with
growing institutional participation, including
several public companies, and an overall
greater availability of financial products for
individuals, businesses and law firms.

LITIGATION FINANCE IN THE
UNITED STATES
The U.S. legal industry is vast. The
combined value of all verdicts, settlements,
attorneys’ fees, and billings for non-lawyer
legal services would easily eclipse the GDP
of Switzerland. Within its courtrooms each
year are tens of millions of cases – a good
proportion of the civil docket comprised of
torts and commercial lawsuits – and
hundreds of billions of dollars change
hands. A market of this staggering size and
magnitude cannot help but offer a
compelling investment proposition.

Tort Law
Tort law is a body of law that is used to
apportion responsibility for damages that
occur as a result of negligence, accidents,
and personal injury. A person who suffers
an injury is entitled to receive damages,
usually monetary compensation, from the
person held responsible for those injuries.
Tort law defines what constitutes a legal
injury and whether a person may be held
liable for an injury they have caused. In
addition to physical injuries, legal injuries
may also include emotional, economic, or
reputational injuries, as well as violations of
privacy, property, or constitutional rights.
Damages that result from torts can include
wage losses, medical expenses, fire losses,
and property damage, among others.
Estimates place the number of tort cases
brought every year in the United States at
around 1.2 million for state courts and
approximately 100,000 in federal courts.
While the median award for all tort cases is
$24,000, the largest and often most
complicated cases can involve
stratospheric awards. For example, in 2011,
Exxon Mobil Corporation was hit with a $1.5
billion verdict for contaminating a
neighborhood’s water supply. The jury
awarded $500 million in compensatory
damages for emotional distress, loss of property value, and medical monitoring, including steep punitive damages.

Commercial Lawsuits
There are many causes for business litigation, but the most common is breach of contract. More than 12 million contract disputes are filed every year. In addition, there are thousands of lawsuits covering such broad areas as intellectual property, antitrust, real estate, banking, securities, insurance, and many others. While the confidential settlements that most business lawsuits result in make assessing the size of the market difficult, the total value of all judgments and settlements for commercial lawsuits is estimated at hundreds of billions of dollars per year. Contract disputes where the plaintiff is the buyer have the lowest awards with a median jury award of $17,000. In contrast, awards for employment discrimination and tortious interference are significantly higher. The largest lawsuits can result in awards approaching billions of dollars.

Lawyers and Law Firms
The emergence of third-party litigation finance has come about at a time when the legal industry is undergoing a titanic transformation. The insular and conservative disposition of lawyers has contributed to the stresses that are now affecting its ranks in the wake of the financial crisis, causing unprecedented changes and producing a painful restructuring in the way legal services are delivered. Recent developments like increased client control, legal self-help and outsourcing, as well as jurisdiction shopping force attorneys and law firms to become more proactive and flexible in competing in the marketplace. Despite these challenges, that marketplace is thriving: there are currently tens of thousands of plaintiffs’ lawyers who advertise for clients, find cases, and marshal their rights in court. Every year, approximately 180,000 law offices generate nearly $250 billion in revenue.

Arbitration
Arbitration is a market of substantial size that runs parallel with the traditional court system. Like courtroom litigation, arbitration is a process in which the plaintiff and defendant present their case to a third party, usually an arbitrator or panel of arbitrators. Arbitration has become increasingly common for resolving international business disputes, especially for parties that prefer not to use their own courts because they are expensive, function poorly, or may be susceptible to graft. International arbitration provides the parties with a neutral forum, leveling the playing field for litigants. Many international contracts specify that arbitration should be used to resolve any disputes that arise from that agreement. The types of cases brought before established arbitration organizations vary, but generally include complex commercial matters, often involving multiple jurisdictions. These matters are often large and the amounts in dispute often run into hundreds of millions or even billions of dollars.

Do Most Cases Settle?
A recent study by the U.S. Department of Justice found that as little as two percent of cases that reach a conclusion are decided by juries. The vast majority are either dismissed, fail to proceed, or are privately resolved among the parties through settlement.

LITIGATION FINANCE PRODUCTS
Lawsuit Advances for Tort Plaintiffs
Every year, millions of Americans are injured through the negligence of others. With their ability to work hindered, many find themselves unable to support their families. In cases of personal injury, victims may also need to pay for medical bills not covered by insurance. Even when lawsuits are eventually filed against the responsible parties, proceedings can drag on for years. Without a temporary lifeline, many victims risk financial ruin in their fight for justice.

Defendants who are repeat players in personal injury litigation are keenly aware
of the problems plaintiffs face. Those defendants have an incentive to prolong litigation, commonly using delay tactics like excessive motion and discovery requests. In fact, the higher the stakes, the more incentive a defendant has to wage a costly war of attrition that most plaintiffs are ill-prepared to bear. Predictably, financial pressure often leads to suboptimal outcomes for plaintiffs because it creates strong incentives to settle for far less than their cases are worth.

A cash advance from a litigation finance provider against the future proceeds of his lawsuit allows financially strapped plaintiffs to meet their daily or medical expenses before the resolution of their claims. Cash advances for tort claims are not actually loans; they are upfront cash payments to the plaintiff in return for a promise by the plaintiff to pay the investor a portion of any future proceeds from that claim.

The most important feature of lawsuit advances is their non-recourse nature. Recipients have no obligation to repay if their claims never proceed or are lost or dismissed. The amount of a plaintiff’s recovery is also a ceiling on any payments that must be made to the funding company. The attorney will repay the advance after receiving funds from the defendant or insurance company, either as a result of a negotiated settlement or court verdict. Unlike loans, there are no interim payments.

Litigation Finance for Intellectual Property

Intellectual property enforcement is the most developed segment of litigation finance and has been around for more than thirty years. Capital is widely available for valuable patents where the technology is being violated by affluent companies. Intellectual property investing is generally similar to investing in commercial cases, although certain nuances related to this area make it a special category. Unlike other forms of litigation finance, patent transfer and enforcement by third-parties – which accounts for the overwhelming majority of deals – is allowed by U.S. federal law. For this reason, an active market has developed, with more than $4 billion in annual deal volume. Many transactions in this field involve the outright purchase of patents from the owner rather than an agreement to divide the proceeds upon settlement.

Litigation Finance for Contingency Law Firms

Capital constraints can devastate lawsuits, leading to premature settlements or other undesired results for plaintiffs. Specialized financing, therefore, is necessary in abundance to bring important cases to conclusion. Outside of the legal field, companies usually have numerous options to finance their businesses, from offering securities – like stocks and bonds – to borrowing funds from banks and other institutional lenders. Law firms, however, do not have the same range of options.

Most contingency firms are self-financing, having only small bank lines of credit or no bank credit at all. They generally rely on either fee sharing with other law firms, partner’s contributions, or credit card debt. Law firms, therefore, are historically underserved by capital markets and as a result pay comparably higher rates to finance their operations than businesses in other industries.

Law firm funding deals can have many different features and are typically bespoke products that meet the specific needs of the law firm. With proper safeguards in place, this product can provide attractive returns to investors, while offering law firms the ability to significantly expand their business models.

THE INVESTMENT PROCESS

Funders seeking to avoid the pitfalls of lawsuit investment must understand the considerations involved in initiating, vetting, executing, and monitoring these types of investments. The more informed the participants, the less likely unpleasant surprises will be down the road – and the more likely that all parties will achieve the underlying goals that gave rise to the lawsuit investment in the first place.
Origination
The process of investing in lawsuits is complex. Case origination alone encompasses the use of multiple marketing channels to cultivate deals, attorney referrals, and brokers. After the initial vetting process, a more comprehensive review begins to determine eligibility, with relevant documents thoroughly reviewed by dedicated underwriters. Scrutiny of exhaustive breadth and detail is vital to ensure that lawsuit investments attain the returns they set out to achieve.

Underwriting
The underwriting process – the method of critically analyzing investments to select desirable opportunities – goes beyond evaluating the merits of underlying claims. It comprehensively assesses the investment opportunity by considering extrinsic factors affecting the prospects for a favorable recovery, while also mitigating significant counterparty risks that can arise from both clients and their attorneys. Many of the issues that determine the prospects of lawsuits are rooted in common sense, while others tend to be highly technical, requiring specialized knowledge and experience. The specific underwriting methodology largely depends on the funder’s specialization.

Underwriters may use a number of tools to help them in their evaluation process. These include online databases, paid legal resources and computer-assisted legal research services. Underwriters will also rely on past experience with similar investments, as well as conversations with attorneys and legal experts, to form their investment decisions. Some companies have built proprietary models and applications to help automate the decision making process. Underwriting evaluates factors like the strength of a claim’s legal merits, procedural considerations, the plaintiff, the defendant, ability to pay and collection risk, insurance, the legal team, damages, liens, bankruptcy, and other encumbrances.

Structuring
Once underwriting is completed, the structuring of the transaction begins. That structure centers on the investment agreement, which sets forth the rights and obligations of investors, plaintiffs, and their attorneys, budgeting, payment arrangements, inter-claimant provisions, and other nuances that arise in the course of the investment process. The investment agreement is the primary mechanism for controlling after-the-fact risk in litigation finance transactions. It sets forth the rights and obligations of investors, plaintiffs, and their attorneys. It will restrict certain types of activities, which are detrimental to investors, while requiring timely disclosure and cooperation from all parties involved. The challenge posed in drafting effective investment agreements lies in striking a balance between the enforceability and flexibility of the document while keeping its terms attractive to clients and attorneys.

Compliance
The investment process continues even after the consummation of a funding transaction. Providers and their compliance teams must exercise vigilance in managing their investments for the entire life of the claim. Considerations must be made with regard to discount requests, the priority of liens, attorney substitutions, or, at worst, situations that can lead to the complete write-off of an investment. Those investments that avoid a total write-off situation will require payments monitoring, or, in cases of default, collection and dispute resolution. A successful investment process accordingly entails thorough preparation, an investment agreement that accounts for a myriad of contingencies while remaining attractive and easy to understand, as well as continuing oversight of all aspects of the lawsuit and related obligations.

Working with Attorneys
One of the most important factors running through all phases of the investment process is a funder’s relationships with the attorneys and law firms driving the legal claims. Respecting the attorney’s role, the
obligations of the attorney-client relationship, and the attorneys themselves – through courtesy, clear communication, and understanding – helps to solidify the working partnership among funder, attorney, and client that lies at the very heart of the investment process.

**ADDRESSING CRITICISMS OF LITIGATION FINANCE**

Litigation finance is not without controversy, having been praised and criticized by legal scholars, practitioners, the media, and special interests on the basis of public policy issues and from a legal ethics perspective. This emerging industry is celebrated by those who welcome it as an equalizer that provides access to the legal system, yet others deride it as a threat to public interest. Lawsuit investors also must contend with a visceral element of suspicion and skepticism; many are opposed to the industry, although they are unsure exactly why.

**Litigation Finance Does Not Promote Frivolous Litigation**

A leading criticism of litigation finance is the suggestion that it leads to increased litigation in society, especially an explosion of frivolous claims and “trafficking” in cases that would otherwise not be filed. However, the anticipated cascade of frivolous litigation has yet to materialize, despite the wide availability of tort advances for more than a decade. If we believe that greater equality of access to the justice system is a desirable outcome, then an increase in the overall use of courts should be welcomed if it helps finance access to justice for those who cannot afford it unaided. Litigation finance, therefore, promotes equilibrium within the justice system by allowing those with legitimate and serious causes of action to enforce their rights. This has the effect of correcting previous distortions in the system that resulted from the scarcity of capital.

**Tort Advances Are Not Predatory Lending**

From a public policy perspective, several commentators have written about the high costs of tort advances and have drawn parallels with predatory lending. While these claims have inspired a great deal of vitriol against tort advance companies, they do not survive closer scrutiny.

One critical element of predatory financing that tort advances lack is deception of the consumer. Although plaintiffs will pay more for this type of financing than for traditional loan products, funding companies do not engage in deception during the funding process. Even though this industry, like many others, has had its share of bad operators, most funding companies provide a great deal of disclosure to their clients, in their communications and funding agreements. Most funding providers will agree that litigation finance may be an expensive way to raise capital, but that heavy price tag is directly related to the significant costs of doing business in this industry, which arise from high operating expenses, losses and reductions that accompany such investments, and the overall riskiness of investing in lawsuits.

**Confidentiality and the Attorney-Client Privilege**

Perhaps the most common criticism of litigation finance from a legal ethics perspective is regarding its potential to negatively impact the legal profession’s duty of confidentiality. Some are concerned that litigation finance may undermine the fiduciary and professional obligations of attorneys toward their clients. They argue that confidentiality, the cornerstone of the attorney-client relationship, may be forfeited as a result of disclosures made by attorneys to funding companies while evaluating claims for investment.

Although detrimental breaches of confidentiality are possible, a closer examination of how funding companies actually make their investments will reveal that these concerns are overstated. The client is free to tell a prospective funder anything other than what the client said to the attorney, without waiving the privilege. As a result, the client could tell the funder a great deal, including how the incident came about, so long as the client was not asked what he told his attorney. A funder can examine documents as well, provided they
are not communications between the client and the attorney. A prospective investor can expect to receive substantial information from the plaintiff about the claim without ever creating waiver problems.

Conflicts of Interest
Critics also suggest that litigation finance providers will seek to protect their investments and to maximize the expected value of claims by demanding control over the litigation, perhaps hiring the lawyers directly, devising the litigation strategy to be employed, and deciding whether to accept a settlement offer. However, most companies do not attempt to control litigation, and so in most cases there should be no confusion about who the client is. Most transactions in litigation finance do not involve the transfer of a cause of action to a new party. They are transfers of only a portion of a claim’s proceeds. Moreover, funding companies themselves do not participate in the case in any way and their contracts confer no right of interference.

REGULATION OF LITIGATION FINANCE
A fair amount of uncertainty lingers around how courts would interpret litigation finance deals in a sizable minority of jurisdictions. Despite significant progress in the past decade, the United States still lacks a transparent and comprehensive regulatory regime for litigation finance. There is currently no federal law regulating this industry. Rather, the industry is regulated on a state level by a diverse patchwork of case precedent, common law doctrines, state bar ethics opinions, state statutes, and agreements with regulatory bodies. Each state correspondingly has its own unique view of how investment in lawsuits should be treated. The degree of regulation — or whether lawsuit investments are permitted in a state at all — varies greatly among jurisdictions. A majority of states have allowed litigation finance to proceed. However, seven states — Ohio, Michigan, Minnesota, New York, Massachusetts, North Carolina, and South Carolina — have relied upon common law or state usury law to invalidate litigation finance arrangements.

Prudent investors must know where state laws permit investing in lawsuits, whether the assignment of lawsuit proceeds is permitted in various states, how state usury laws and courts treat investment models where the payment of proceeds is contingent on the outcome of the claim, whether state bar ethics rules allow attorneys to enable and participate in such deals, licensing requirements, and current legislative and regulatory efforts.

LITIGATION FINANCE IN OTHER COUNTRIES
While the assent of litigation finance is a truly international phenomenon, the majority of the financing activity has been concentrated in common law countries, which also have to contend with many of the same problems as the United States, namely the high costs of litigation that impede access to justice. Of all common law countries, litigation finance has been most enthusiastically embraced in Australia and United Kingdom. The great strides made in Australia and the United Kingdom toward acceptance of and mounting participation in litigation financing speak both to the international market potential of the industry and the increasing likelihood that such progressive viewpoints may, over time, overtake more restrictive attitudes, including those found in many U.S. jurisdictions. The leadership Australia has demonstrated in the global litigation finance market stands as a venerable example for the development of the industry in other countries. Likewise, the United Kingdom’s position as a global financial and legal center has spurred the development of its own litigation finance sector, and that growth, in turn, has given rise organically to efforts at voluntary self-regulation. The development of litigation finance in Australia and the United Kingdom alike demonstrate natural courses of evolution for the industry of which other countries — the United States among them — should take notice.

Australia
In the past decade, Australian courts have emerged as thought leaders of litigation
finance. Their progressive views have outpaced the development of the industry in other countries by a large margin. Litigation finance, or litigation funding as it is known in Australia, has thrived for nearly two decades despite numerous challenges to its legality. The Australian litigation finance industry pioneered many methodologies now being applied by companies targeting markets in the United States and United Kingdom. It also provided very important metrics for evaluating risk in commercial deals. Perhaps most importantly, the development of the legal framework that enables litigation finance in Australia serves as an important precedent for other jurisdictions, as the debate there shares many of the same features with those that are occurring in other countries. As the global industry matures, many continue to view Australia as the vanguard of the litigation finance industry.

United Kingdom

The development of the litigation finance market in the United Kingdom is interesting from a number of perspectives. Foremost, English law is often persuasive for courts and cited by jurists in other jurisdictions because it serves a foundation for all common-law countries, including the United States. Recent court cases in the United Kingdom, as well as reports by legal scholars, government agencies and professional organizations, have all confirmed the legality of litigation finance transactions.

The acceptance of litigation funding in the United Kingdom, however, comes with a caveat. English courts have consistently held that champerty and maintenance prohibitions against third-party funding do not apply so long as investors do not control the plaintiffs or the underlying claims. Issues of control also trouble English courts because of the perceived interference with the attorney-client relationship that arises when a third party, rather than the claimant, is directing litigation. As a result, U.K. funding companies have sought to assure regulators that their investment practices are in line with public policy. In a typical funding transaction, the plaintiff decides which lawyers to hire. Furthermore, plaintiffs and their attorneys, not the investors, agree on case strategy and direct the prosecution of their claims. Moreover, the plaintiff will ultimately decide whether to settle the claim for a given amount.

A voluntary code of conduct, the Code of Conduct of Litigation Funders, became law in November 2011. The Code requires lawsuit investors to give certain assurances to claimants regarding their participation in their claims. These assurances include, among other things, that the funder: (a) will not try to take over or control the litigation; (b) is adequately capitalized to fund the litigation; and (c) will not withdraw from funding a claim unless there is a material adverse development.

THE FUTURE OF LITIGATION FINANCE

The years ahead dawn cautiously bright for the litigation finance industry. Despite some regulatory resistance and lingering stigma, litigation finance is poised to continue its ascent in the United States and internationally. What started out as a cottage industry in the mid-nineties has acquired considerable momentum over the past several years, particularly in emerging niches like commercial funding and lending to law firms. As third-party funding matures and business models are tested across different markets, many expect litigation finance to become a permanent feature of the global legal sector.

Information about new products now spreads at unprecedented rates, creating a deeper understanding of litigation finance among a much broader range of participants. The laws, regulations and legal precedent relating to third-party funding are becoming more developed in the United States as an increasing number of states examine third-party funding transactions. Systemic economic changes spurred on by the 2008 financial crisis continue to contribute to the expansion of third-party funding. At the same time, litigation finance offers investors an opportunity for portfolio diversification, long-term wealth appreciation, as well as an attractive value proposition: scalability and substantial
absolute returns uncorrelated to traditional assets like equities, fixed income, foreign exchange, and commodities.

As the industry continues to expand, new products will emerge to address a broader range of geographic and legal markets. Providers have begun to expand their business models to civil law jurisdictions like Hong Kong, Singapore, and several European countries. New products for defendants that offer to help fund the defense of a claim in exchange for a portion of the damaged saved will help to protect against litigation costs and also mitigate the downside arising from adverse decisions. As competition among funders grows, the companies themselves will become more integrated. The growth and globalization of the litigation finance industry will also likely spur on a convergence of regulatory efforts, with burgeoning jurisdictions looking to import laws and regulations from more established markets like the United States and Australia. Through it all, litigation finance will be poised to continue to make justice attainable for all those who deserve it, regardless of their economic resources.

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