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Litigation Risk Mitigation Through the Use of Third-Party Litigation Funding

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Third-party litigation funding is a relatively new, but rapidly expanding litigation financing vehicle. General counsel and commercial litigators would be well served to understand the changing landscape regarding the scope and potential uses of such funding.

The basic concept involves an investor (a "*third-party litigation funder*") paying some portion of the attorney fees and expenses related to a specific dispute, rather than the client doing so. In return, that third-party litigation funder receives a portion of any judgment or settlement.

Third-Party Litigation Funding v. 'Legal Funding'

Third-party litigation funding is sometimes confused with "*legal funding*." In practice, however, there are two distinct markets.

Legal funding typically refers to non-recourse financing intended for a plaintiff's personal use during the pendency of the litigation, such as for medical expenses, rent or other personal expenses, until the expected settlement or judgment can be monetized. This arrangement is most commonly used in the personal injury and medical malpractice contexts. In a typical legal funding agreement, the plaintiff's attorney receives no portion of the money advanced by the third party â€" the funds are not intended to be used to pay for legal costs. Plaintiffs in these transactions are commonly *individuals*.

Third-party litigation funding, on the other hand, refers to financing (usually obtained at the outset of litigation) wherein the third-party litigation funder pays for direct litigation fees and costs in exchange for a portion of the recovery of the case. The business model essentially involves making a calculated bet that plaintiff's eventual recovery will be large enough to return the funder's investment with a substantial return. Plaintiffs in these transactions are commonly companies, though one recent and well-known example involved billionaire Peter Thiel acting as the third-party litigation funder of Hulk Hogan's lawsuit against Gawker.

Origins

The model for third-party litigation funding originated in Australia before being exported to Europe and then, more recently, to the United States. Since reaching our shores, more than $1 billion has reportedly been committed (largely by institutional investors) to third-party litigation funders.

Investors' Perspective

A key benefit for investors, aside from the outsized returns that can be earned, is the level of diversification this sort of investment can bring to a portfolio. Succinctly stated, there is no correlation between such "litigation assets" and the overall financial markets. In addition, the cases in a litigation funder's portfolio are largely idiosyncratic, so they also have little or no correlation to each other.

Plaintiffs' Perspective

Sharing of risk, of course, is a key benefit for the plaintiff. While third-party litigation funding may have "loan" characteristics, the transactions typically (actually, we believe, universally) do not impose any recourse on the plaintiff absent extraordinary situations, like fraud. Additionally, third-party litigation financing provides the advantage of keeping capital available for alternative (*i.e.*, core) uses, rather than tied up in expensive, drawn-out legal disputes.

Another significant benefit is that the process serves as an additional reality check on the merits of the litigation in question. If the third-party litigation funder decides not to fund as a result of its underwriting process, for example, that may be telling. A related benefit is that third-party litigation funders typically continue to provide a level of assistance during the course of the litigation (a rare situation in which "back-seat driving" does not have a negative connotation).

Using litigation financing will, of course, reduce a claim's potential upside. And it will typically require the plaintiff to disclose sensitive and confidential information to the third-party litigation funder.

It also should be noted that while third-party litigation financing is much more common for plaintiffs, *defendants* may be funded as well, though the market for defendant-side financing is far less evolved. Defendant-side transactions tend to be structured in a manner resembling reverse contingency fees. That is, the third-party litigation funder in a defendant-side financing agreement commonly receives an interest in the differential between a defendant's exposure and the ultimate amount of the claim paid.

Mechanics

While each third-party litigation funding transaction is unique and structured individually, there are common elements generally included in each contract.

Repayment of the third-party litigation funder's investment is secured by, and contingent upon, a successful outcome of the claim. The financing may be a fixed amount or may be tied to benchmarks. Capital may be offered in a lump sum or the plaintiff may be able to draw funds over time.

Control

In a typical deal, the plaintiff retains both ownership of the cause of action and control of the litigation, including all decision-making authority to settle the litigation; the third-party litigation funder does not have the right to direct, control or settle the litigation.

Tax Issues

Third-party litigation funders typically seek to structure their deals as prepaid forward contracts rather than loans. One reason is to avoid usury and other regulatory issues. Another reason is that prepaid forward contracts should provide capital gain tax treatment for the funder. Like a loan, the prepaid forward contract structure does not require the plaintiff to take the upfront payment into income immediately. Rather, the tax treatment and taxable event is deferred until the litigation is resolved.

Policy Concerns and Regulations

The use of third-party litigation is not without controversy.

On one hand, some believe that litigation financing will help shrink the widening gulf many face in accessing justice where a drastic disparity exists in the financial means between parties. On the other hand, concerns abound regarding speculative lawsuits, conflicts of interest and potential interference from investors.

Third-party litigation funding is not currently the subject of much regulation. The Northern District of California adopted a new, first-of-its-kind rule on Jan. 23, 2017, mandating the disclosure of third-party funding agreements in proposed class action lawsuits. As of the time of this article, no other jurisdiction has adopted litigation-funding disclosure rules, be it for class action suits or otherwise.

Trends

Champerty Is a Decreasing Risk: But Not in Kentucky

Concerns over claims of champerty, an old common law doctrine that prohibits third parties from “stirring up” others by financing possibly frivolous lawsuits, are becoming somewhat less worrisome, on the wane in several states, but remains strong in others.

As the U.S. Court of Appeals for the Ninth Circuit has stated, the “consistent trend across the country is toward limiting, not expanding, champerty’s reach.” *Del Webb Communities, Inc. v. Partington*, 652 F.3d 1145, 1156 (9th Cir. 2011). It was reported in 2015 that 27 out of 51 jurisdictions allowed some form of champerty. Even in states that recognize champerty as a living doctrine, courts may be inclined to take a kinder view of third-party litigation funding deals that protect the plaintiff’s right to maintain ownership of the cause of action and direct and control the litigation. Litigation funders wishing to maintain a practice in such states would be well advised to scrupulously follow that structure in order to avoid cries of champerty.

The Case in Kentucky

Christopher Boling was severely burned when vapors from a gas can ignited upon coming into contact with hot metal. Boling and his wife sued the gas can manufacturer. During the course of that litigation, Boling entered into several legal funding agreements with defendant Prospect Funding Holdings, LLC and Cambridge Management Group, LLC to borrow funds secured by Boling’s prospective recovery in litigation. Prospect Holdings later purchased Cambridge Management Group’s contracts with Boling.

In *Boling v. Prospect Funding Holdings, LLC*, 14-cv-00081, Boling sued Prospect Funding in the Western District of Kentucky, seeking a declaratory judgment that the legal funding agreements were unenforceable under Kentucky law (which the district court had previously ruled applied to the agreements). On March 30, 2017, the court granted summary judgment to Boling on two issues: 1) that the legal funding agreements were void for violating Kentucky’s prohibition on champerty; and 2) that the agreements contained a usurious interest rate. The court made these rulings based on its “best prediction â€¦ of what the Kentucky Supreme Court” would do if confronted with the question, as well as past district court guidance on the issue.

Kentucky courts have “long recognized the common law doctrine of champerty,” which is still viable as a defense under Kentucky law. *See Scott v. Davis*, 2015 WL 3631136, at *6 (Ky. June 11, 2015). The court also considered a Kentucky statute, KRS 372.060, which states in relevant part: “Any contract … made in consideration of services to be rendered in the prosecution or defense … by any person not a party on record in the suit, whereby the thing sued for or in controversy … is to be taken, paid or received for such services or assistance, is void.” KRS 372.060.

The court noted its concern that litigation funding potentially discourages settlement because an injured party may be disinclined to accept a reasonable settlement offer where a large portion of the proceeds would go to the firm providing the loan. The “plaintiff could feel compelled to try the case and ultimately run the risk of receiving no recovery for his or her injuries.” Therefore, the court believed that the Kentucky Supreme Court would find the contracts were champertous and void.

The court rejected Prospect’s argument that it was not financing the litigation but instead merely providing money for living expenses and medical care during the case. The court noted that the money was explicitly intended to sustain the plaintiff financially during the litigation. Therefore, the loans “unquestionably” aided the plaintiff’s prosecution of the case and were void as champertous. The district court also found unpersuasive Prospect’s argument that other states authorize legal funding, as Kentucky still recognizes the doctrine of champerty.

This decision falls in line with similar ones from states that still recognize champerty as a valid defense, such as Minnesota. Such states have broadly barred any type of third-party litigation financing.

Discoverability of Third-Party Litigation Financing Arrangements

Another issue with which courts are grappling with is disclosures regarding third-party litigation financing arrangements during discovery. Two federal cases — *Kaplan v. S.A.C. Capital Advisors, L.P.*, No. 12-CV-9350 VM KNF, 2015 WL 5730101 (S.D.N.Y. Sept. 10, 2015) and *Gbarabe v. Chevron Corp.*, No. 14-CV-00173-SI, 2016 WL 4154849 (N.D. Cal. Aug. 5, 2016) — illustrate a current split over a plaintiff’s duty to disclose third-party litigation financing agreements.

In *Kaplan v. S.A.C. Capital Advisors, L.P.*, the District Court for the Southern District of New York rejected the defendant’s request to compel class-action plaintiffs to produce third-party litigation funding documents. The defendants asserted that documents should be disclosed to explore the possibility that the funding agreement could affect decisions on behalf of the plaintiffs and to determine if counsel had any potential conflicts of interests with the class. The defendants further asserted that disclosure of the documents was relevant to determine if counsel was fit to represent the class. Despite these arguments, the court stated that these concerns were “purely speculative” and that the plaintiffs’ simply admitting they entered into a third-party litigation financing agreement was not enough to call into question counsel’s ability to adequately fund the litigation.

However, in *Gbarabe v. Chevron Corp.*, the Northern District of California reached the opposite conclusion. The defendant asked the court to order plaintiffs to produce documents related to the third-party litigation finance agreements to fund class-action litigation arising from damages from an oil rig explosion. During discovery, plaintiffs initially produced a redacted copy of the agreement. The defendant was not satisfied and argued that the redactions made it impossible to assess “the resources that counsel will commit to representing the class.”

The court then rejected plaintiffs’ proposal to submit an unredacted copy for in camera review, believing that the defendant would be deprived of making its own assessment and arguments as to the impact of the funding agreement and the plaintiffs’ ability to adequately represent the class, and ordered the agreements to be disclosed.

Portfolio Financing

Third-party litigation funding originally involved the funding of single cases. There is, however, a growing trend of third-party litigation funders investing in portfolios of litigation. Portfolio funding can be mutually beneficial to both the law firm securing the funding and the third-party litigation funder. A law firm that secures portfolio funding on a pool of cases is offered significantly more flexibility than a firm receiving funding for a single case. A third-party litigation funder, on the other hand, is able to deploy capital faster and at the same time hedge its overall risk by investing in a portfolio of cases.

Conclusion

Third-party litigation funding is not only here to stay, but primed to expand. But the practice is young and evolving rapidly; terms and practices vary widely. In-house counsel who are considering looking for or negotiating such financing would be well-advised to seek advice from an experienced tour guide.

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