The Third Party Litigation Funding Law Review

Editor
Leslie Perrin

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PREFACE

Just as you start to think it might be safe to assume that everyone who needs to understand third party funding of litigation and arbitration really does understand it, you stand, as I did the other day, in one of London's finest clubs chatting socially to a Circuit Judge, who asks what you are doing these days and you reply that you invest capital in the costs of litigation in return for a share of the proceeds contingent on success. He looks you magisterially in the eye and asks, as if you would never have thought of it, 'isn't that unlawful?'

The task of proselytising third party funding, as anyone directly involved in it will tell you, goes on. Right across the global reach of third party funding, every meeting or conference, with lawyers or with potential claimants, can be expected to require a run through of the basics of how it is done. The process is not assisted by the silo mentality of most major law firms, where it is absolutely not possible to make the assumption that, having spoken to one, or even several partners, you have spoken to the firm.

This past year has also meant for most funders, a merry-go-round of encounters with investors, as blue-chip pension funds, family offices, endowments and seemingly all known fund management vehicles have realised that it might be possible to invest in an asset that is not only non-correlated with other asset classes, but also, where concentrations are properly managed, one where the individual assets in a portfolio are not internally correlated. Eye-catching returns are being reported by the listed funders, while rumours of similar performance circulate around the private funders.

Individual managers and underwriters of litigation risk with a track record of success are rarer than the proverbial hens' teeth though. Some observers estimate that in the entire world there are no more than about 35 people with a 10-year investment management record delivering the sort of results that investors are seeking. This has led to an aggressive global hiring spree by funders in an attempt to remedy this shortage, aimed at the cream of senior associates (and occasionally partners) from all types of firm, including the very largest.

As the pipeline to equity narrows at all law firms, but especially at the largest and most profitable, and that pathway comes to depend on ever greater commitments of time to the firm, over all else, many lawyers outside law firm equity have begun to be tempted by the stories they hear of the opportunities to earn an equity stake at a litigation funder where hard work and dedication are, of course, an absolute requirement, but where an 18-hour-day time commitment is not expected.

All this has led to a debate within funders as to what ingredients make up the ideal senior recruit from a law firm. Does it have to be a litigator? Not really. Third party funding can be seen as a corporate finance transaction where competitive advantage for a funder may lie in being able to field top-class transactional input to the way a deal is negotiated from the outset. Does it have to be a lawyer? No. Experienced finance professionals should play a role in case assessment, not just in the process of understanding the true quantum of a claim but in establishing the return that will be required by the investors in given time and quantum outcomes.

Interesting business pressures are also mounting in consequence of the global nature of third party funding. Although the Association of Litigation Funders of England & Wales (of which I remain the chairman) continues to provide voluntary regulation to the third party funding sector that seems to be respected and understood in the senior ranks of the judiciary and beyond in the Ministry of Justice and in other government circles, it is becoming clear that some form of international trade association is now required, to give a collective global voice (albeit, not as a regulator) to the interests of the third party funding industry. It would not surprise me if such a body were to be launched in the coming months, possibly in the wake of the inquiry currently being run by the Australian Law Reform Commission (ALRC), which might only directly affect the Australian market but will achieve global significance because so many non-Australian funders are active in that market. The ALRC's final report is likely to be highly influential on what happens next, not only in the regulation of third party funding in Australia but also how the entire third party funding industry will organise its approach to marketing and opinion forming in the global market.

This all adds up to a remarkable 12 months since the first edition of the *Third Party Litigation Funding Law Review* was published. Awareness of the industry has spread, not just in the context of the funding of the legal costs of a single case from its inception through to resolution (what might be called Litigation Funding 101) but in the monetisation of judgments and awards. In civil law jurisdictions, monetisation of claims can also be achieved. In the common law countries, by and large, monetisation of a claim would still, even in these enlightened times, offend against maintenance and champerty.

Businesses have learned that there is a way out of the accounting bind that contingent claims against you must (as a matter of principle) be accounted for as a debit in your balance sheet but contingent assets can be ascribed no value until they are turned into cash. This fact of business life, combined with what could be described as 'litigation fatigue' (which requires no explanation!), means that monetisation transactions are very much on the rise.

A modest extension of the market in monetisations takes you squarely into consideration of secondary markets, where funders might sell their interest in an investment to (say) a hedge fund at a price that appeals to both sides of the transaction. The development of monetisations and the development of secondary markets might well be major themes for the year ahead.

Leslie Perrin
Chairman
Calunius Capital LLP and Association of Litigation Funders of England amd Wales
November 2018

Chapter 21

UNITED STATES

Sean Thompson, Dai Wai Chin Feman and Aaron Katz[1]

I MARKET OVERVIEW

The US market for third party litigation finance has grown at an increasing rate over the past several years.[2] Although the current size of the asset class is unknown, it is estimated that over US$1.75 billion has been collectively raised by dozens of commercial funding entities since 2016, contributing to overall commercial funding commitments of up to US$5 billion.[3]

i Types of claims

Third party funding is typically used for two main categories of claims: commercial and consumer. Commercial claims predominantly consist of business-to-business disputes with substantial amounts in controversy (often in excess of US$10 million). Common commercial claims include breach of contract, business torts, antitrust violations, intellectual property infringement and trade secret theft. Funding also exists in insolvency and distressed scenarios. For example, liquidation trustees may obtain funding to pursue claims on behalf of bankruptcy estates. Commercial funders also frequently finance *qui tam* or 'whistle-blower' suits.

By contrast, consumer claims that receive funding are brought on behalf of individual claimholders and are typically mass tort or personal injury in nature. Individually, such claims tend to be far smaller in magnitude than funded commercial claims.

ii Funding entities

In the commercial arena, major litigation funders can be generally categorised as follows:

a large, publicly traded entities (such as Burford Capital and Bentham IMF);
b US-based private funds (such as Parabellum Capital, Longford Capital and Lake Whillans);
c privately held foreign-based funders (such as Therium);
d funders focused on smaller opportunities (such as LexShares and Legalist); and

1 Sean Thompson is director of intellectual property strategies and general counsel, Dai Wai Chin Feman is director of commercial litigation strategies, and Aaron Katz is co-founder, chief investment officer and managing principal at Parabellum Capital LLC.

2 Roy Strom and Ben Hancock, Litigation Funders Face Their Hardest Sell: Big Law, *The American Lawyer* (28 June 2018), available at https://www.law.com/americanlawyer/2018/06/28/litigation-funders-face-their-hardest-sell-big-law.

3 Ben Hancock, Who Rules the World of Litigation Funding?, *The American Lawyer* (30 March 2017), available at www.nationallawjournal.com/supremecourtbrief/id=1202782561037/Who-Rules-the-World-of-Litigation-Funding?mcode=1202615549854&curindex=8&slreturn=20170916103347.

e lesser known, smaller entities, some of which are backed by single investors or raise capital on an investment-by-investment basis.

iii Other funding-side market participants

The commercial market also includes various other actors beyond litigation funders. Entities functioning as brokers are increasingly present. Multi-strategy investment funds such as Fortress Investment Group and DE Shaw & Co are also active in the litigation finance space. Others, including Soros Fund Management, have expanded their involvement to consumer funding.[4]

Moreover, a growing secondary market exists, in which hedge funds and other investment managers increasingly participate.[5] For example, in June 2018, funder LexShares launched LexShares Private Market, an exchange for secondary market transactions available to qualified institutional buyers.[6] The Special Situations Group of investment bank Jefferies brokers secondary transactions as well.

iv Consumers of litigation funding

Litigation funding has traditionally been described as a means for low-resourced claim holders to pursue affirmative litigation they may not otherwise be able to afford. In recent years, however, consumers of funding have grown to include parties of all sizes and wherewithal that seek to finance litigation for various reasons. Motivations may include unlocking working capital, monetising the value of legal claims on an accelerated basis, and obtaining favourable accounting treatment for legal expenditures. Consumers currently span the spectrum from capital-constrained corporate claimholders, to pro bono legal services organisations, to publicly traded Fortune 500 companies.

The law firm market has also evolved. Whereas law firm consumers of funding were once thought to be boutique or plaintiff-contingency focused in nature, some of the largest US law firms now utilise litigation finance.[7]

v Products

While single-case, early-case financing remains a common model for the financing of attorneys' fees or out-of-pocket expenses or some combination of the two, major funders have increasingly shifted toward portfolio funding. Portfolios allow a law firm or corporate to obtain funding for a collateral pool of multiple cases. Portfolios generally provide more

4 Miles Weiss, Soros Backs Personal Injury Lawsuits in Market With 20% Returns, Bloomberg (27 June 2018), available at https://www.bloomberg.com/news/articles/2018-06-27/soros-backs-personal-injury-lawsuits-in-market-with-20-returns.

5 Natalie Rodriguez, Attys Must Tread Carefully in Litigation Funding's Next Stage, Law360 (3 April 2018), available at https://www.law360.com/articles/1025663/attys-must-tread-carefully-in-litigation-funding-s-next-stage.

6 Business Wire, LexShares Launches Private Institutional Litigation Finance Exchange (7 June 2018), available at https://www.businesswire.com/news/home/20180607005672/en/LexShares-Launches-Private-Institutional-Litigation-Finance-Exchange.

7 Stephanie Russell-Kraft, Big Law Embraces Litigation Finance, Bloomberg (23 March 2018), available at https://biglawbusiness.com/big-law-embraces-litigation-finance.

limited returns in exchange for greater principal protection via cross-collateralisation.[8] In addition, the funding of domestic class actions, while still uncommon, is widely regarded as only available on a portfolio basis due to ethical concerns.

Some funders also provide loans to law firms against legal receivables. Such loans may provide returns akin to fixed income investments rather than the equity-like-returns sought by traditional litigation finance. While law firm lending is hardly a new phenomenon, the participation of commercial litigation funders in the lending market creates new options for law firms to borrow money on a non-recourse basis, albeit at a potentially higher interest rate than traditional legal lenders and lines of credit.

The commercial market has also experienced an uptick in claim monetisation, through which funds are advanced on a non-recourse basis against settlement or judgment. Monetisation may occur in conjunction with or independently of traditional litigation funding. Common in appeal and enforcement proceedings, monetisation may also be available earlier in the litigation process to access value inherent in otherwise illiquid legal claims. While monetisation funding is typically thought to be used as working capital, funding proceeds are often unrestricted in use.

Finally, funders are actively working to market defence-side products. Such products have yet to become mainstream, perhaps due to difficulties in defining success, negotiating returns or limiting a defendant's ultimate exposure.

II LEGAL AND REGULATORY FRAMEWORK

Litigation finance in the United States is primarily governed by three areas of law: state common law and statutory limitations on providing financial assistance to litigants; state statutes governing debtor-creditor arrangements; and attorney ethics rules.

i Maintenance, champerty and barratry

The most widely discussed limitations on litigation finance have been the common law doctrines of maintenance, champerty and barratry. Such doctrines are relevant for US litigation finance because they were common law torts under English law at the time of the founding and thus incorporated into the laws of many US states. '[M]aintenance is helping another prosecute a suit; champerty is maintaining a suit in return for a financial interest in the outcome; and barratry is a continuing practice of maintenance or champerty.'[9]

The original rationale for these restrictions was to prevent feudal lords from funding claims by their retainers as a means of increasing their real estate holdings.[10] With the decline of the feudal system, and with it feudal lords supporting large numbers of retainers, the original impetus for restrictions on helping others prosecute suits fell away, '[b]ut champerty, now joined with maintenance in a sort of indissoluble hendiadys, remained an offense for

8 Matthew Denney, Portfolio Finance May Minimize Litigation Funding Risks, Law360 (20 February 2018), available at https://www.law360.com/articles/1013718/portfolio-finance-may-minimize-litigation-funding-risks.

9 *In re Primus*, 436 U.S. 412, 425 (1978).

10 Max Radin, Maintenance by Champerty, 24 *Cal. L. Rev.* 48, 64 (1935) (noting that the torts were 'specifically directed [to] the support given by a feudal magnate to his retainers in all their suits, without any reference to their justification,' which 'became in fact one of the means by which powerful men aggrandized their estates . . . .').

which a new basis had to be found'.[11] That new basis was 'the fundamental distrust of legal procedure and of lawyers' and the desire to reduce litigation, on the grounds that litigation itself was a vice to be avoided.[12]

In the US, '[t]he consistent trend across the country is toward limiting, not expanding, champerty's reach.'[13] Courts in a number of states, including Arizona, California, Connecticut, New Jersey, New Hampshire, New Mexico and Texas, have determined that those states never incorporated those torts from English law.[14] Other states, such as Massachusetts, have expressly abolished the doctrines.

In states where restrictions on maintenance and champerty persist, they do not typically constitute independent torts. Instead, they tend to exist as either criminal offences or, more commonly, defences to a contract action.[15]

There is a high degree of variation among states that continue to enforce restrictions on maintenance and champerty as to what constitutes a violation. For instance, New York continues to recognise champerty as a contractual defence, but the doctrine is limited in a number of important ways. Under New York law, individuals and companies may not 'solicit, buy or take an assignment of, or be in any manner interested in buying or taking an assignment of a bond, promissory note, bill of exchange, book debt, or other thing in action, or any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon'.[16] Nonetheless, the statute does not apply where 'things in action, or any claims or demands' have a purchase price in excess of US$500,000.[17] Additionally, the New York Court of Appeals has held that for an assignment or purchase to be champertous, the 'primary purpose' of the purchase or assignment must be 'for the very purpose of bringing such suit'.[18] Thus, in practice, champerty is 'limited in scope'.[19] Particularly because almost all commercial litigation transactions involve claims in excess of US$500,000 and almost never involve the assignment of the claim, very few commercial transactions, if any, would run afoul of New York law.

11 id. at 66.

12 id.

13 *Del Webb Communities, Inc. v. Partington*, 652 F.3d 1145, 1156 (9th Cir. 2011).

14 Ethics Committee of the Commercial and Federal Litigation Section of the New York State Bar Association, Report on the Ethical Implications of Third-Party Litigation Funding (2013).

15 *Burnes v. Scott*, 117 U.S. 582, 589 (1886) ('The question raised by the present assignment of error is not whether a champertous contract between counsel and client is void, but whether the making of such a contract can be set up in bar of a recovery on the cause of action to which the champertous contract relates. We must answer this question in the negative.'); *Malibu Media, LLC v. Zumbo*, No. 13-729, 2014 WL 2742830, at *5 (M.D. Fla. 17 June 2014) ('[A] plaintiff does not forfeit a valid claim against a defendant merely by entering a champertous contract with a third party').

16 N.Y. Judiciary Law §§ 488-89.

17 N.Y. Judiciary Law § 489(2).

18 *Justinian Capital SPC v. WestLB AG*, 65 N.E.3d 1253, 1256 (N.Y. 2016) (internal quotations omitted).

19 *Trust for the Certificate Holders of Merrill Lynch Mortg. Investors, Inc. v. Love Funding Corp.*, 918 N.E.2d 889, 894 (N.Y. 2009).

ii Usury

Although it is very uncommon for a commercial litigation transaction to be structured as a loan, it is conceivable that, in some situations, parties would wish to use a traditional debt structure for their transaction. Such transactions may implicate state laws against usury, which limit the rate of interest that can be charged to borrowers.

Generally, for a transaction to be usurious, it must involve '(1) a loan of money, (2) an absolute obligation to repay the principal, and (3) the exaction of a greater compensation than allowed by law for the use of the money by the borrower'.[20] A key element in determining whether the transaction involves a loan 'is whether repayment was based on a contingency'.[21] If repayment is based on a contingency, then it is considered an investment rather than a loan, and it is accordingly not subject to usury laws.[22]

Usury laws are generally not implicated in commercial litigation finance because it is typically non-recourse in nature. The lack of an absolute obligation to repay has led most courts to characterise these transactions as investments, rather than loans.[23]

iii Attorney ethical rules

Professional conduct rules governing lawyers may also affect transactions between funders and law firms. Rules directed to the professional independence of a lawyer are often the most relevant to litigation finance transactions.

Rule 5.4(a) of the Model Rules of Professional Conduct provides that '[a] lawyer or law firm shall not share legal fees with a nonlawyer' other than in certain specified circumstances, such as payments to a lawyer's estate after the lawyer's death or compensation payments to non-lawyer employees of a law firm. The comments to Rule 5.4 note that the Rule's provisions 'express traditional limitations on sharing fees,' which 'are to protect the lawyer's professional independence of judgment', as well as place 'limitations on permitting a third party to direct or regulate the lawyer's professional judgment in rendering legal services to another'. Every state has implemented some form of a professional responsibility rule that tracks the language of Model Rule 5.4 to some degree.

Courts have generally found that a lawyer's execution of a commercial litigation contract does not violate Rule 5.4. For example, in *Hamilton Capital VII, LLC, I v. Khorrami, LLP*, the New York Supreme Court held that a transaction in which a loan to a law firm in exchange for 'a percentage of the [l]aw [f]irm's gross revenue' did not violate Rule 5.4(a), notwithstanding that the firm's gross revenue was 'essentially composed of contingent fees earned on client settlements and verdicts'.[24] The court noted that '[p]roviding law firms access to investment

20 *Anglo-Dutch Petroleum Intern., Inc. v. Haskell*, 193 S.W.3d 87, 96 (Tex. App. Houston [1 Dist.] 2006).

21 id.

22 id.

23 *Dopp v. Yari*, 927 F. Supp. 814, 823 (D.N.J. 1996) ('[T]he collection of interest in excess of the lawful rate is not usurious if collection of the entire interest is at risk and depends upon a contingent event and provided and the contract was entered into in good faith and without the intent to evade the usury laws'); *Kraft v. Mason*, 668 So. 2d 679, 684 (Fla. App. 4 Dist. 1996) ('[W]hen the loan was given, any talk of recovery was pure speculation. Quite possibly, there would be no successful recovery from the antitrust litigation, and [plaintiff] might have collected nothing beyond the pay back of the loan. This contingent nature of any 'interest' to [plaintiff] makes the agreement non-usurious.'); *Nyquist v. Nyquist*, 841 P.2d 515, 518 (Mont. 1992) (rejecting argument that a transaction was usurious because '[n]o certainty ever existed that the plaintiffs in that litigation would prevail and receive a damage award').

24 No. 650791/2015, 2015 WL 4920281, at *4 (N.Y. Sup. Ct. 17 Aug. 2015).

capital where the investors are effectively betting on the success of the firm promotes the sound public policy of making justice accessible to all, regardless of wealth'.[25] Similarly, in *Lawsuit Funding, LLC v. Lessoff*, the New York Supreme Court found that a litigation funding agreement providing that the funder would 'receive a portion of the contingent legal fee that [attorneys] were expected to receive if five specifically named lawsuits were adjudicated in favor of [the attorneys'] clients' did 'not violate Rule 5.4(a) and was not unenforceable as against public policy'.[26]

In contrast, on 30 July 2018, the Professional Ethics Committee of the New York City Bar Association (the Association) published a non-binding advisory opinion stating that certain non-recourse agreements between law firms and funders violate Rule 5.4(a)'s prohibition on fee-sharing.[27] The Association distinguished between 'traditional "recourse" loan agreement[s] . . . in which a lawyer's payments are not contingent on the receipt or amount of legal fees in particular matters', which it concedes are permissible under the Rule, from 'funding arrangement[s] in which the lawyer's payments are contingent on the lawyer's receipt of legal fees'. The Association concluded that the latter is impermissible where 'the lawyer's payments are tied to the lawyer's receipt of fees in one or more matters',[28] which would apply to single-case and certain portfolio transactions. In support, the Association reasoned that '[r]ightly or wrongly, the rule presupposes that when nonlawyers have a stake in legal fees from particular matters, they have an incentive or ability to improperly influence the lawyer.'[29]

No court or other bar association has considered the Association's opinion to date. It therefore remains to be seen what, if any, influence the Association's opinion has on courts, disciplinary bodies or the industry. However, several leading legal ethicists have criticised the opinion – with some even calling for its withdrawal – on three main grounds.[30]

First, commentators have taken issue with the Association's suggestion that litigation funding arrangements involving payments that are contingent on a lawyer's receipt of legal fees could impinge on a lawyer's independence. The opinion does not explain how litigation funding can improperly influence lawyers, so it is not clear what specific issues the Association finds problematic. In practice, all reputable commercial litigation funders expressly disclaim by contract any ability to control litigation.

Moreover, commentators argue that it is difficult to reconcile the Association's view that traditional, recourse lending from banks complies with Rule 5.4, while non-recourse commercial funding does not. As one noted, banks often require law firms to agree to terms

25 id. at 5.

26 No. 650757/2012, 2013 WL 6409971, at *1, *6 (N.Y. Sup. Ct. Dec. 4, 2013).

27 New York City Bar Association Committee on Professional Ethics, Formal Opinion 2018-5: Litigation Funders' Contingent Interest in Legal Fees (30 July 2018), available at https://www.nycbar.org/member-and-career-services/committees/reports-listing/reports/detail/formal-opinion-2018-5-litigation-funders-contingent-interest-in-legal-fees.

28 id. at 2, 4.

29 id. at 5-6.

30 Anthony E. Davis and Anthony J. Sebok, New Ethics Opinion on Litigation Funding Gets It Wrong, *The New York Law Journal* (31 August 2018), available at https://www.law.com/newyorklawjournal/2018/08/31/new-ethics-opinion-on-litigation-funding-gets-it-wrong; Peter R. Jarvis and Trisha Thompson, New York City Bar Opinion on Commercial Litigation Funding Raises Concerns, Holland & Knight LLP Client Alert (20 August 2018), available at https://www.hklaw.com/publications/New-York-City-Bar-Opinion-on-Commercial-Litigation-Funding-Raises-Concerns-08-20-2018.

that pose far more serious risks to a lawyer's independent judgment than non-recourse litigation funding.[31] In addition, to the extent the perceived issue is lawyers improperly allowing their own financial considerations to drive settlement considerations, commentators maintain that the risks of a lawyer's independence being compromised are more salient with respect to traditional bank lending.

Second, with respect to the Association's assertion that litigation funding arrangements are not within the enumerated list of acceptable arrangements set forth in Rule 5.4(a), commentators have observed that the enumerated practices set forth in the list are not a comprehensive list of practices that are permissible under the rule. As stated in Comment [14] to the ABA Model Rules, the rules of professional conduct are 'rules of reason' that 'should be interpreted with reference to the purposes of legal representation and of the law itself'. Notably, the American Bar Association's Standing Committee on Ethics and Professional Responsibility had long recognised two types of arrangement presently enumerated in Rule 5.4 – non-lawyer employee participation in profit-sharing plans and the sharing of court-awarded legal fees with non-profits – as permissible under the rule before it was amended to expressly permit such arrangements. Accordingly, commentators note that litigation finance arrangements – which did not exist in the United States at the time Rule 5.4 was promulgated – need not be explicitly enumerated by the rule to be permissible.[32]

Third, commentators have criticised the Association's characterisation of the relevant case law. In particular, commentators have remarked that the Association mischaracterised the leading New York cases on litigation funding agreements, including Hamilton Capital and Lawsuit Funding, as standing only for the proposition that lawyers who enter into agreements that allegedly violate Rule 5.4 cannot use the fact that the agreements are unethical to avoid the repayments required by the agreements. Instead, the courts in both Hamilton Capital and Lawsuit Funding expressly found that the litigation funding agreements at issue complied with Rule 5.4.[33]

III STRUCTURING THE AGREEMENT

The structure of litigation finance transactions remains largely opaque. The private nature of the industry is largely attributable to the relative immaturity of the market, combined with concerns related to disclosure. As a result, there are few instances of funding agreements in the public domain. For example, in 2017, the production of a Therium investment contract

31 Davis and Sebok, *supra*.

32 See also Roy D. Simon, Simon's New York Rules of Professional Conduct Annotated (2017 ed.), at 1420 ('New York courts have created what I call a 'litigation funding exception' to Rule 5.4(a)').

33 The Lawsuit Funding court cited the Delaware Superior Court for the propositions that '[t]he Rules of Professional Conduct ensure that attorneys will zealously represent the interests of their clients, regardless of whether the fees the attorney generates from the contract through representation remain with the firm or must be used to satisfy a security interest' and 'there is no real 'ethical' difference whether the security interest is in contract rights (fees not yet earned) or accounts receivable (fees earned) in so far as Rule of Professional Conduct 5.4, the rule prohibiting the sharing of legal fees with a nonlawyer, is concerned'. See PNC Bank, *Delaware v. Berg*, No. 94C-09-208-WTQ, 1997 WL 527978, at *10 (Del. Super. Ct. January 21, 1997).

in litigation was a newsworthy event.[34] Furthermore, funding agreements are widely regarded as bespoke in nature, as they are highly customised to the particular idiosyncrasies of a given litigation, counterparty or jurisdiction.

Nevertheless, funding agreements will typically be structured to address certain core issues. Such issues are discussed below, but may vary depending on the type of product at issue. For instance, the issues raised by early-stage funding differ from those attendant to monetisation or appeal hedging.

i Single-case or portfolio

Single-case and portfolio transactions differ considerably. As an initial matter, the funder's counterparty in a single-case is the claimholder, whereas a portfolio counterparty is typically a law firm.

Portfolios are typically cross-collateralised to protect a funder's investment principal. To mitigate against adverse case selection, portfolios may be exclusive, contain rights of first refusal, or require the inclusion of additional cases over time.

ii Ethical and regulatory issues

Depending on the nature of the transaction, various ethical and regulatory issues should be addressed. For example, funders would be well advised to cede all litigation control to parties and their counsel to avoid champerty challenges, as well as provide claimholders the opportunity to seek independent counsel in negotiating the agreement. Structuring the agreement as a purchase of claim proceeds – rather than a purchase or assignment of the claim itself – is another common means of avoiding champerty challenges. Also, in the class action context, funding on a single-case basis is discouraged due to restrictions on fee-sharing with non-lawyers. Further, some jurisdictions have limits on maximum contingency stakes which should be considered in structuring returns.

Some states also have various requirements regarding the disclosure of key financial terms and use of disclaimers, as well as registration and fee caps.[35] Such requirements are geared toward consumer transactions, rather than commercial.

To address jurisdiction-specific issues, a funding agreement may contain a choice-of-law clause designating a favourable state's laws. Provided that the chosen state bears a connection to the transaction, the choice-of-law clause may enhance the funding agreement's enforceability.

iii Recourse

The commercial funding market largely advertises itself as non-recourse in nature. However, recourse arrangements do exist, and the nature of such recourse would be addressed by a funding agreement.

34 Ben Hancock, How Jones Day Unmasked a Litigation Funding Deal and Won, *The American Lawyer* (29 October 2017), available at https://www.law.com/americanlawyer/sites/americanlawyer/2017/10/29/how-jones-day-unmasked-a-litigation-funding-deal-and-won.

35 Ark. Code Ann. §§ 4-57-104, 4-57-109; Ind. Code §§ 24-4.5-1-201.1, 24-4.5-1-301.5, 24-4.5-3.-110, 24-4.5-3-110.5, 24-4.5-3-202, 24-4.5-3-502, 24-12 et. seq.; Me. Rev. Stat. tit. 9-a, §§ 12-101 – 107; Neb. Rev. St. § 25-3301-3309; Ohio Rev. Code § 1349.55; Okla. Stat. tit. 14-A, §§ 3-801 – 3-817; Tenn. Code §§ 47-16-101 – 110; Vt. Stat. tit. 8, §§ 2251 – 2260.

iv Return and waterfall

Returns are typically structured as a multiple of capital invested or committed, a percentage of the gross or net recovery, an interest rate or internal rate of return, or any combination of the foregoing. Portfolios have less risk due to cross-collateralisation, and accordingly tend to have lower returns. The higher the perceived risk – which could be based upon merits, jurisdiction, adversary or collectability – the greater return a funder will seek. A funder's return may also increase over time to account for duration risk.

With respect to the waterfall, funders may demand priority for a portion or all of their return, and inhibit a claimholder's ability to grant junior interests on the litigation proceeds. Following the funder's initial recovery, the next levels in the waterfall may be apportioned on a complete or percentage basis to any of the funder, the claimholder, and the law firm. Some claimholders may also negotiate the right to pre-pay a funder's return.

v Funding commitment, budget and counsel compensation

Funders may limit their maximum commitment to a certain dollar amount, as well as commit to fund some or all legal fees or expenses, or both. Counsel may be compensated on an hourly, reduced fee or hybrid-contingency basis. In any scenario, funding agreements may set a case budget to which counsel must adhere. Budgets may limit expenditures on an aggregate basis or through various case stages, helping to hedge risk and mitigate the effects of information asymmetry.

Funding may be disbursed as fees accrue on a monthly or quarterly basis, or may be tied to milestones. Milestones may include major events in the litigation, such as filing the complaint, defeating a motion to dismiss, and defeating summary judgment and *Daubert* motions. Milestones may also vary by case type. For example, in patent litigation, payment may be contingent on surviving inter partes review or receiving a favourable claim construction. Funding may also include commitments to finance the defence of counterclaims.

vi Representations and warranties

In light of information disparity between claim holders and funders, funding agreements commonly contain representations and warranties regarding various pertinent issues, such as the claim holder's creditworthiness and disclosure of material information regarding its claims. Such representations and warranties are not typically available in portfolio transactions.

vii Control

Sophisticated funders typically disclaim any right to control litigation or settlement for ethical and regulatory reasons. However, they may obtain contractual entitlements to be apprised of major developments (including settlement discussions), as well as receive material non-privileged information and work product throughout the course of the litigation for investment monitoring purposes.

viii Non-monetary consideration

A case may be resolved on non-monetary terms. For example, a contract dispute may result in the reinstatement of the parties' agreement. Where such a scenario is possible, funding agreements may provide metrics to value non-monetary consideration. In addition, where settlements or judgments create future cash streams (e.g., future royalties or licensing fees), such streams may be assigned in whole or in part to the funder to achieve its return.

ix Common interest and confidentiality

Funding agreements routinely provide that the existence of the parties' arrangement is confidential. Further, to enhance privilege protections afforded to materials shared with funders and mitigate the risk of waiver, funding agreements may provide that any exchange of information is pursuant to a common legal interest.

x Termination rights

Litigation funders typically reserve the right to terminate funding. Funding agreements may delineate circumstances justifying termination, such as the occurrence of a materially adverse event, fraud or bad faith. Agreements may also allow unilateral termination in exchange for a penalty.

xi Dispute resolution

In keeping with the private nature of third party funding, funders may insist that disputes related to funding agreements be subject to confidential arbitration.

IV DISCLOSURE

i Federal regulations

At the federal level, no Federal Rule of Civil Procedure mandates the automatic disclosure of funding arrangements. Legislative and lobbying efforts to require the disclosure of litigation finance have been largely unsuccessful.[36]

Roughly half of federal circuit courts[37] and one-quarter of federal district courts[38] require the disclosure of outside parties with a financial interest in the outcome of a litigation.[39] The purpose of that disclosure is to avoid judicial conflicts of interests.[40] Accordingly, court rules are typically restricted to the disclosure of publicly owned outside parties, which would not apply to the vast majority of litigation funding entities.

36 In 2014 and 2016, the Advisory Committee on Rules of Civil Procedure declined to adopt proposals to amend Fed. R. Civ. P. 26 to 'require the disclosure of third-party litigation funding arrangements in any civil action filed in federal court'. See Minutes of Advisory Committee on Civil Rules at 13 (30 October 2014).

37 3rd Cir. L. R. 26.1.1(b); 4th Cir. L. R. 26.1(2)(B); 5th Cir. L. R. 28.2.1; 6th Cir. L. R. 26.1(b)(2); 10th Cir. L. R. 46.1(D); 11th Cir. L. R. 26.1-1(a)(1); 11th Cir. L. R. 26.1-2(a).

38 Ariz. Form - Corporate Disclosure Statement; C.D. Cal. L. R. 7.1-1; N.D. Cal. L. R. 3-15, Standing Order for All Judges of the N.D. Cal.; M.D. Fla. Interested Persons Order for Civil Cases (does not apply to all judges); N.D. Ga. L.R. 3.3; S.D. Ga. L. R. 7.1; N.D. Iowa L. R. 7.1; S.D. Iowa L. R. 7.1; Md. L. R. 103.3(b); E.D. Mich. L. R. 83.4; W.D. Mich. Form – Corporate Disclosure Statement; Neb. Form – Corporate Disclosure Statement; Nev. L. R. 7.1-1; E.D. N.C. L. R. 7.3; M.D. N.C. Form – Disclosure of Corporate Affiliations; W.D. N.C. Form – Entities with a Direct Financial Interest in Litigation; N.D. Ohio L. Civ. R. 3.13(b); S.D. Ohio L. R. 7.1.1; E.D. Okla. Form – Corporate Disclosure Statement; N.D. Okla. Form – Corporate Disclosure Statement; N.D. Tex. L. R. 3.1.(c), 3.2(e), 7.4; W.D. Va. (Form – Disclosure of Corporate Affiliations and Other Entities with a Direct Financial Interest in Litigation); W.D. Wis. (Form – Disclosure of Corporate Affiliations and Financial Interest).

39 The Western District of Texas permits parties to use interrogatories to inquire regarding financially-interested non-parties. See W.D. Tex. L.R. CV-33.

40 See, e.g., 5th Cir. L. R. 28.2.1 ('The certificate of interested persons provides the court with additional information concerning parties whose participation in a case may raise a recusal issue'); C.D. Cal. L.R.

With the exception of the Northern District of California, which requires parties to disclose the identity of funders in class and collective actions only,[41] court rules mandating disclosure of financially-interested outside parties do not expressly apply to litigation funding.[42] Nor do court rules require disclosure beyond the identity, and sometimes the nature of the financial interest, of the outside parties. Thus, while the existence of a funder's interest may be subject to disclosure, details of the funding arrangement remain confidential absent court order.

ii State regulations

At the state level, Wisconsin is the only state requiring the disclosure of litigation funding in commercial litigation. Wisconsin passed a law in March 2018 requiring parties in civil litigation to disclose funding arrangements. The 2017 Wisconsin Act 235 requires parties, '[e]xcept as otherwise stipulated or ordered by the court', to 'provide to the other parties any agreement under which any person, other than an attorney permitted to charge a contingent fee representing a party, has a right to receive compensation that is contingent on and sourced from any proceeds of the civil action, by settlement, judgment, or otherwise'. This disclosure is automatic and does not require a discovery request from the adverse party.

With respect to privilege issues, Indiana, Nebraska and Vermont have enacted statutes providing that litigation funding arrangements do not undermine the attorney-client privilege or work-product doctrine.[43]

iii Discovery disputes

The rising popularity of litigation funding has led to defendants increasingly seeking discovery concerning funding agreements. Defendants' stated rationales vary from the desire to determine if privilege has been waived via disclosure to a funder, to challenging adequacy requirements under Fed. R. Civ. P. 23, to seeking transparency regarding the control of litigation. Plaintiffs, on the other hand, resist disclosure on the grounds of relevance, confidentiality, and privilege. Plaintiffs further argue that motions to compel disclosure of funding are motivated purely by voyeurism and lead to unnecessary ancillary litigation that needlessly prolongs and increases the cost of disputes.

Courts have largely shielded funding-related documents from disclosure on the basis of privilege.[44] Such courts have held that case-related communications with a funder are

7.1-1 (instituting disclosure requirements '[t]o enable the Court to evaluate possible disqualification or recusal').

41 N.D. Cal. L. R. 3-15 ('In any proposed class, collective, or representative action, the required disclosure includes any person or entity that is funding the prosecution of any claim or counterclaim').

42 In 2016, the Northern District of California declined to amend its rules to expressly enumerate litigation funders as entities with financial interests in civil actions. US District Court for the Northern District of California, Notice Regarding Civil Local Rule 3-15, available at www.cand.uscourts.gov/news/210.

43 Ind. Code Ann. § 24-12-8-1; Neb. Rev. St. § 25-3301; Vt. Stat. tit. 8, § 2255.

44 See, e.g., *Space Data Corp. v. Google LLC*, 2018 WL 3054797, at *1 (N.D. Cal. 2018) (denying motion to compel on grounds of relevance and proportionality); *Lambeth Magnetic Structures, LLC v. Seagate Technology (US) Holdings, Inc.*, Nos. 16-538, 16-541, 2018 WL 466045, at *1-2 (W.D. Pa. 18 Jan. 2018) (affording work-product protection to funding agreement and communications with funder); *Viamedia, Inc. v. Comcast Corporation*, No. 16-5486, 2017 WL 2834535, at *3 (N.D. Ill. 30 June 2017) (holding that communications with funders are entitled to work-product protection); *Odyssey Wireless, Inc. v. Samsung Elecs. Co., Ltd.*, No. 15-01735, 2016 WL 7665898, at *5 (S.D. Cal. 20 Sept. 2016) (noting that many

entitled to work-product or common interest protection, or both.[45] Claims to work-product are enhanced when materials are shared following execution of a non-disclosure agreement.[46] Courts have also found that documents related to litigation funding are irrelevant as a matter of law and therefore not subject to disclosure.[47]

Notably, a federal court recently balanced competing interests by ordering the production of litigation funding agreements on an *ex parte* and in camera basis. In *In re National Prescription Opiate Litigation*, 2018 WL 2127807, at *1 (N.D. Ohio 2018), District Judge Dan Polster required attorneys to 'submit to the Court *ex parte*, for *in camera* review, the following: (A) a letter identifying and briefly describing the [third-party] financing; and (B) two sworn affirmations – one from counsel and one from the lender – that the [third-party] financing does not: (1) create any conflict of interest for counsel, (2) undermine counsel's obligation of vigorous advocacy, (3) affect counsel's independent professional judgment, (4) give to the lender any control over litigation strategy or settlement decisions, or (5) affect party control of settlement.'

V COSTS

The United States generally follows the 'American Rule', under which attorneys' fees are not shifted to prevailing parties absent a contractual or statutory basis, or egregious or frivolous conduct. While prevailing parties may be entitled to recover costs at the conclusion of a litigation, such costs are typically limited to certain statutorily enumerated line items that comprise a miniscule proportion of the total costs incurred.[48]

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courts have found that work product protection is applicable to litigation finance documents); *United States v. Homeward Residential, Inc.*, No. 12-461, 2016 WL 1031154, at *6 (E.D. Tex. 15 Mar. 2016) ('The Court finds that the litigation funding information is protected by the work product doctrine. The litigation funding documents were between [litigant] and actual or potential litigation funders and were used to possibly aid in future or ongoing litigation.'); *United States v. Ocwen Loan Serv., LLC*, No. 12-543, 2016 WL 1031157, at *6 (E.D. Tex. 15 Mar. 1 2016) (same); *In re Int'l Oil Trading Co.*, 548 B.R. 825, 835 (Bankr. S.D. Fla. 2016) (concluding that the documents concerning the negotiation of a litigation funding agreement were protected by the attorney-client privilege and the work-product doctrine and citing the 'common enterprise' approach); C*harge Injection Techs., Inc. v. E.I. Dupont De Nemours & Co.,* No. 07C-12-134-JRJ, 2015 WL 1540520, at *4 (Del. Super. Ct. 31 Mar. 2015) (concluding that litigation funding documents were protected by the attorney-client privilege and the work-product doctrine); *Doe v. Soc'y of Missionaries of Sacred Heart*, No. 11-02518, 2014 WL 1715376, at *3 (N.D. Ill. 1 May 2014) ('[T]he Financing Materials identified by Plaintiff in his privilege log constitute opinion work product. These materials incorporate opinions by Plaintiff's counsel regarding the strength of Plaintiff's claims, the existence and merit of certain of Defendants' defenses, and other observations and impressions regarding issues that have arisen in this litigation.') (internal quotations omitted); *Mondis Tech., Ltd. v. LG Elecs., Inc.*, Nos. 07-565, 08-478, 2011 WL 1714304, at *3 (E.D. Tex. 4 May 2011) ('All of the documents were prepared . . . with the intention of coordinating potential investors to aid in future possible litigation. The Court holds that these documents are protected by the work product protection.').

45 See id.; but see *Acceleration Bay LLC v. Activision Blizzard, Inc.*, Nos. 16-453, 16-454, 16-455, 2018 WL 798731, at *2-3 (D. Del. Feb. 9, 2018) (rejecting common interest and work product privilege assertions); *Leader Techs., Inc. v. Facebook, Inc.*, 719 F. Supp. 2d 373, 376 (D. Del. 2010) (rejecting common interest privilege assertion with respect to materials shared prior to the consummation of a funding agreement).

46 See *Mondis Tech., Ltd.*, above.

47 See, e.g., *Kaplan v. S.A.C. Capital Advisors*, L.P., 12-9350, 2015 WL 5730101, at *5 (S.D.N.Y. 10 Sept. 2015).

48 See 28 U.S.C. § 1920 (providing that the following categories of costs are taxable: clerk and marshal fees, transcript fees, printing and witness fees, copying costs, docket fees, and compensation of court-appointed experts and interpreters).

Accordingly, where a funder backs a losing case, it is rare that the party in litigation itself is liable for significant costs. Funding agreements thus rarely – if ever – provide security for adverse costs. To the contrary, litigation funders typically disclaim any liability for adverse cost awards. Moreover, third party funding is typically restricted to cases with extremely strong merits, thereby reducing the likelihood of fee-shifting on the basis of frivolous claims.

However, funders frequently finance prevailing parties that ultimately obtain an award of attorneys' fees (as well as costs). Indeed, the availability of attorneys' fees under a contractual or statutory fee-shifting provision, or otherwise under the common law in circumstances warranting punitive damages, is a feature that litigation funders find attractive in underwriting cases. In those circumstances, the funding agreement will likely provide that the fee award be added to the litigation proceeds and treated as ordinary damages. Then, the fees will be recovered pursuant to the agreed-upon return and waterfall structure.

To date, no US court has considered whether the existence of third party funding affects a prevailing party's entitlement to recover attorneys' fees in a commercial case. Nor has a US court considered whether a prevailing party is entitled to an enhanced recovery by virtue of additional costs incurred due to third party commercial funding.[49] In the event either issue is litigated, the procurement of funding should not affect a prevailing party's recovery. That is because fee awards are traditionally decided independently of the means that a case is funded – whether from the claimant's own funds, a loan, a line of credit, an attorney contingency arrangement or a third party funder.

VI THE YEAR IN REVIEW

Over the past 18 months, the litigation finance market has experienced significant growth through increasing adoption by litigants, law firms, and investors. Existing players, including LexShares and Lake Whillans, announced the closures of funding rounds,[50] and the market also saw several new entrants.

The industry's growth has been accompanied by attempts to regulate disclosure and interpret relevant ethical rules. In addition to Wisconsin's recent legislation and the New York City Bar Association's advisory opinion, discussed above, Senate Judiciary Committee Chairman Chuck Grassley and Senators Thom Tillis and John Cornyn proposed federal legislation requiring disclosure of funding agreements in civil lawsuits.[51] The Litigation Funding Transparency Act of 2018 would require counsel in federal class actions to produce funding agreements and 'disclose in writing to the court and all other named parties to the class action the identity of any commercial enterprise, other than a class member of class counsel of record, that has a right to receive payment that is contingent on the receipt

49 However, a court has taken third-party funding into account in awarding fees to a prevailing party in public interest litigation. See *NorCal Tea Party Patriots v. Internal Revenue Service*, No. 13-341, 2018 WL 3957364, at *2 (S.D. Ohio 17 Aug. 2018) ('there is an important societal interest in rewarding attorneys and third party funders who engage in public interest litigation').

50 Darcy Reddan, Litigation Finance Platform Closes US$25M Fund, Law360 (25 January 2018), available at https://www.law360.com/articles/1005586/litigation-finance-platform-closes-25m-fund; Darcy Reddan, Lake Whillans Closes US$125M Litigation Funding Round, Law360 (4 January 2018), available at https://www.law360.com/articles/998726/lake-whillans-closes-125m-litigation-funding-round.

51 The text of the bill is available at https://www.judiciary.senate.gov/imo/media/doc/115.xxx%20-%20Litigation%20Funding%20Transparency%20Act%20of%202018.pdf.

of monetary relief in the class action by settlement, judgment, or otherwise'.[52] It would also require the same disclosure in multi-district litigations. The bill was introduced on 10 May 2018 and referred to the Senate Judiciary Committee, which has yet to take any action on the measure.[53]

Furthermore, while commercial litigation funding has continued to gain widespread endorsement, the consumer market segment has faced enhanced scrutiny in light of concerns specific to transacting with individual claimholders.[54] New York legislators have also introduced potential consumer-side legislation to regulate interest rates, impose registration requirements, and implement disclosure requirements for key funding terms.[55]

VII CONCLUSIONS AND OUTLOOK

The current consensus is that the US litigation funding industry will continue to grow for the foreseeable future. Funding entities are proliferating in response to the influx of demand from investors seeking high, non-correlated returns, and more jurisdictions are endorsing funding as permissible and supportive of public policy. Moreover, awareness of funding among claimholders and law firms still remains relatively low, indicating that a significant proportion of the market remains ripe for growth.

The next year will likely witness material developments in the issue of disclosure, as more courts are confronted with discovery motions regarding third party funding and proposed legislation undergoes review. Ethical questions may continue to percolate, particularly in the event that model rules of professional conduct are amended to expressly address the permissibility of portfolio funding. Finally, as capital continues to flow to the industry, funders will likely develop new strategies to increase demand and gain market share.

52 id.

53 www.congress.gov/bill/115th-congress/senate-bill/2815/committees.

54 Matthew Goldstein and Jessica Silver-Greenberg, Prosecutors Investigate Firms That Offer Plaintiffs Early Cash, *The New York Times* (19 March 2018), available at https://www.nytimes.com/2018/03/19/business/litigation-finance-subpoena-settlement-advance.html; Matthew Goldstein and Jessica Silver-Greenberg, How Profiteers Lure Women Into Often-Unneeded Surgery, *The New York Times* (14 April 2018), available at https://www.nytimes.com/2018/04/14/business/vaginal-mesh-surgery-lawsuits-financing.html; Matthew Santoni, Litigation Funder Seeks Bond for Ex-NFLer's US$500K Advance, Law360 (20 July 2018), available at https://www.law360.com/articles/1065623/litigation-funder-seeks-bond-for-ex-nfler-s-500k-advance.

55 Andrew Denney, NY Lawmakers Considering Bills to Regulate Consumer Litigation Funding, *New York Law Journal* (29 May 2018), available at https://www.law.com/newyorklawjournal/2018/05/29/ny-lawmakers-considering-bills-to-regulate-consumer-litigation-funding.

Appendix 1

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