Discussion Paper: Alternative Litigation Finance and the Malpractice Risks for Law Firms

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Alternative Litigation Finance ("ALF") is an emerging area of litigation risk for law firms and a subject that generates differing views in the rapidly growing area of litigation financing. In response to requests from clients to provide our perspective on this topic as a professional liability insurer, we have identified various areas that firms should consider when they and/or their clients are considering a litigation funding arrangement.

What is ALF?

ALF involves the funding of litigation expenses by third parties other than the litigants themselves, their counsel, or other parties with a preexisting contractual relationship, such as an insurance company. These transactions are normally between a party to litigation and a funding entity with an assignment of an interest in proceeds awarded in the lawsuit in exchange for an agreed amount to fund expenses and fees incurred during the pendency of the lawsuit.

ALF has been used for a number years in the UK and Australia where it has become an accepted form of litigation finance. We are now seeing greater use in the U.S., although it currently represents a very small percentage of the litigation market.

Ethical and Other Issues

Many law firms prefer not to take on a prospective client who wants to use ALF because they see this as an indication that the client does not have the ability to afford their fees and the expense of litigation. However, there are other concerns that firms have expressed as well:

- The prospect that litigation financing undermines the civil system by encouraging frivolous law suits;
- The potential that funders will meddle with the conduct of the litigation;
- Uncertainty whether funders will live up to their obligations to fund the costs of litigation as the law firm's bills become due;
- Potential conflicts of interests between their duties to the client and to the funder particularly if the funder directed or influenced the decision to engage the law firm. The conflict concern is compounded if the firm handles both the litigation as well as advising the client in connection with the funding (see discussion about conflicts below).
- Criticism that the arrangement will actually raise the costs of litigation and settlements, thus making settlements more difficult to achieve.
- The protection of attorney-client communications where the funder is receiving information directly from the firm or through the client.

Proponents argue that ALF permits access to the justice system for those who cannot otherwise afford legal representation. It is also asserted that ALF provides for a thoughtful analysis of a plaintiff's chances of success, which can discourage frivolous litigation if the funder concludes the case may not have sufficient merit. Support of a funder to take on a case is a great benefit to the plaintiff as it provides financial strength, which is particularly helpful against well-funded defendants. As a further benefit, ALF presents a plaintiff with an alternative means to finance litigation.

Several resources provide a more detailed view of the merits of ALF and overall, conclude that ALF is ethical:

- The American Bar Association: Commission on Ethics 20/20 report on alternative litigation finance;
- The Association of the Bar of the City of New York Committee on Professional Ethics, Formal Opinion 2011-2: Third Party Litigation Financing; and
- An article, "Other People's Money: The Ethics of Litigation Funding" by Douglas R. Richmond.

In addition, the ABA report provides lawyers with a high-level outline of ethical duties to guide their actions:

> "Lawyers must adhere to principles of professional independence, candor, competence, undivided loyalty, and confidentiality when representing clients in connection with ALF transactions. In the event that the lawyer's involvement in the funding process significantly limits the lawyer's capacity to carry out these professional obligations, the lawyer must fully disclose the nature of this limitation, explain the risks and benefits of the proposed course of action, and obtain the client's informed consent."

Brief Review of Funding Concepts and Criteria

It is common that third party funding is set-up as investment vehicles, arranged by private equity firms and hedge funds with target returns as high as 300% if their client is successful. However, the funds advanced to finance litigation are non-recourse, so a failure to succeed in the litigation means the funder absorbs the part of the litigation costs subject to its funding. What the funder is "absorbing" is some of the risk that the client will not come into possession of the expected proceeds from the litigation.

In deciding whether to advance funds, the funder needs sufficient information to determine the chances of success of the case, as well as an assessment of the liquidity of the defendants, which can include an analysis of available insurance coverage. The funder will also determine the reputation and relevant experience of counsel, and could rely on the firm's reputation as well as the opinion of the firm as to the likelihood of success in the litigation, based on the firm's assessment of the factual and legal position. Funders have commented that they generally turn-down a high percentage of requests for funding and seek out only those cases that are both high on merit and economically viable.

While a defendant must normally reveal the existence of insurance that protects them, a plaintiff is not normally required to reveal they have secured ALF, although in California cases involving plaintiffs' class actions in federal court such disclosure is required per HR 985. The required disclosure of insurance by defendants may make them a more attractive target, and therefore, law firms (as well as others) could see more cases brought against them, particularly in matters where the cases would not have been brought in the absence of ALF.

Types of Litigation that Funders Prefer

Some funders prefer litigation between corporations in matters such as breach of contract, patent infringement, securities, international arbitration and antitrust disputes. These cases generally result in damages that can be readily measured compared to cases that involve injunctive relief, seek business solutions or emotional matters such as divorce cases. That said, the case where Hulk Hogan sued Gawker magazine for invasion of privacy is the interesting exception to typical funding motives. The costs of that case were funded by a third party who was the subject of the Gawker article. Gawker lost the case, went bankrupt, and the case reportedly ended in a significant settlement to Hogan.

Many funders avoid class action plaintiffs, but a small part of the funding market will fund such plaintiffs. We have even heard of a situation where the funder helped the law firm buy books of class action claims from other law firms in a bid to leverage the scale of litigation against multiple defendants.

Leading funders often look for large cases that involve at least $10 million in potential damages, with litigation investments starting at $2 million. There is a case pending in the UK with damages estimated in the billions and an agreement to fund costs in excess of $50 million. A sufficient valuation threshold is important because any recoveries normally inure to the funder first, and there is the concern by funders that a successful outcome with little recovery by the client would mean that the economic ends are not properly aligned. Of course, this threshold assessment by the funder may force up the cost of settlement as the client may not accept a modest settlement (below the amount they have agreed to pay the funder) on the basis that they will not financially gain anything. As mentioned above, funders have argued that their “services” can mean that claimants can have access to the justice system that otherwise would be financially beyond their reach. However, in practice, claims are often funded for large corporations, and arguably provide the corporation with an unbiased, experienced opinion about the likelihood of success as the funder only succeeds if the client succeeds.

Law firms using ALF benefit from prompt payment of fees, helping the firm’s cash flow, and gain access to a new stream of clients that they otherwise may not have secured. In addition, where defendants are aware that the plaintiff is well funded, the result may be earlier settlements.

Potential Scenarios and Associated Mitigation Strategies

1) **A firm agrees to defend a client (or defends itself, if a defendant) and the firm is aware the plaintiff has received ALF.**

   Consideration may be given to advising the client-defendant as to whether it would be useful to challenge the arrangement (see, for example, Miller UK Ltd and Miller International Ltd. v Caterpillar, Inc., No. 10-cv-03770, (U.S Dist. Ct. N.D. Illinois, Eastern Division (2014)). There are a number of areas of inquiry that could challenge an ALF arrangement, including:

   a. What information was required to be disclosed by the plaintiff in its discussions with the funder;

   b. Is the funder a party at interest;

   c. Is the funding contract void due to application of the doctrines of champerty or maintenance (see below);

   d. Are the relationships created by the funding arrangement considered the same as insurance;

e. Does attorney client privilege apply, and has it been waived if documents have been shared with a third party funder; and

f. What is the impact of a non-disclosure agreement?

The legal defense of champerty, which is an old, common-law legal principle, is intended to prevent third parties from funding litigation in which they are not a party, and to discourage frivolous cases. However, challenges to ALF arrangements seeking to void such agreements are rarely successful. In order to avoid application of this doctrine, funders typically do not initiate the suit; they review all available information to avoid cases without merit, they do not control the defense nor the appointment of the law firm handling the claim, and they try to structure the funding so that the interest of funder and client is aligned. Only if these elements are missing would there be a basis for a reasonable objection to the funding contract on champerty grounds. However, it is typically only the contracting party to the agreement that has legal standing to raise the argument. For an example of a case where the adverse party did have standing , see Toste Farm Corp. v. Hadbury, Inc., 798 A.2d 901 (R.I. 2002).

With regard to communications, it is common that funders operate under a non-disclosure agreement, which attempts to preserve work product protection. This does not guarantee that communications cannot be required to be disclosed, and firms should be careful not to inadvertently waive the protection of information (consider for example that the routine task of issuing bills, which may contain confidential information, could be an issue if disclosed to a funder). The funding agreement itself may also be discoverable, although it is often not discoverable due to its lack of relevance to the underlying case.

2) **A law firm represents a client in litigation, and the client has secured funding without the help or advice of the law firm.**

In this instance, it would be prudent if any engagement letter stipulated that the firm was not involved with the funding arrangement, that the funder is not a client, and that the firm has no obligation to consult with the funder during the course of litigation or settlement. The firm, while not opining on the funding agreement, should discuss with the client and be clear that any funding agreement does not create an obligation on the part of the law firm to consult with the funder. Depending upon the sophistication of the client, the firm should also consider cautioning the client about the risks associated with the client's disclosure of protected communications to the funder, even under a non-disclosure agreement.

3) **A client has retained the law firm to handle the litigation, but not to secure the funds or be involved with drafting the funding agreement, although requests that the firm provide information about the case to the funder in order to help persuade the funder to advance funds.**

The risk here is potentially waiving the attorney-client and work product privileges. It is suggested that the firm address these risks with the client and that the client provide a waiver or indemnity for any inadvertent breach. The firm should also secure a non-disclosure agreement with any funder or potential funder, noting to the client the risks associated with such an arrangement. In addition, it is suggested that the firm not provide a warranty regarding the accuracy or completeness of any information provided to the funder or any evaluation or opinion the firm may provide about the litigation, including the outcome, while ensuring that appropriate disclaimers are included in any funding agreement.

4) The client requests that the law firm secure financing, negotiate the terms of the financing agreement and represent the client in any dispute with the funder.

To avoid a potential conflict of interest claim (which among other things would likely involve a claim to disgorge all fees) it would be prudent for the firm not take on the litigation aspect and solely manage the contractual arrangement with the funder.

We do, however, think it is prudent for a firm to avoid choosing/vetting funders and opining on the commercial value of the transaction, which is better handled by independent experts. Representing a client in a funding arrangement, essentially an investment advisory risk, may raise issues whether the firm's malpractice coverage would respond to any claim arising out of an issue. If such services are undertaken, the firm should ensure:

a. There is a non-disclosure agreement with any funder or potential funder;

b. The funder does not control the appointment of counsel, nor control the ongoing litigation or settlement;

c. There is an alignment of interest between the client and funder;

d. The circumstances are clear under which the funder can withdraw from funding, how the client would address that situation, as well as how alternative counsel would be chosen if the original counsel were to withdraw;

e. How the law firm handling the litigation will be paid and how settlements will be processed. It would be preferable for the law firm to avoid acting as escrow agent for the funds provided and to use the services of a third party agent.

There is a further risk to the firm should it fail to secure funding as the client could allege such failure resulted in its having to forego a viable opportunity to recover in the proposed suit. On this point, we have heard of a suit against a law firm arising from these circumstances and ironically, the client was able to secure funding to sue the firm for malpractice!

5) A funder approaches a law firm directly, offering to finance its clients in any proposed litigation.

Our concern is that the client could later allege that more competitive terms could have been secured from another company. The firm also runs the risk of being sued by the client, and in addition, by the funder, for any malpractice which would raise the cost of settlement. It is suggested that the firm make full disclosure to the client of any relationship with the funder and for the client to secure separate advice on the terms of the funding agreement from an independent party.

Conflict of Interest

Assuming the firm represents the client and not the funder, there should never be a binding written legal obligation between a law firm representing the interests of both the client and a funder. Nevertheless the law firm could view the funder as responsible for having recommended or even selected them, and as a potential future source of business, irrespective of whether the funder either directly or indirectly pays their fees. The dynamics of the relationship may also place the firm in a conflicted position with regard to settlement opportunities if a potential settlement is advantageous to the client, but not the funder. The firm's advice to the client may be subject to after-the-fact criticism by the client and/or the funder. While funders are normally extremely careful to state that they do not direct the litigation and make settlement decisions, they are often involved during the course of litigation, and their involvement could indirectly influence client decisions.

Firms may also be requested by clients to opine about the quality of the funder. There are differences based on experience, both in finance and legal acumen, size and track record of following through on commitments (particularly in litigations that take a long time to resolve). It is probably worthwhile for the firm to seek the views of other law firms and clients that have used ALF or independent consultants who consult on funding.

A recent case in the UK highlighted this issue (see, Excalibur Ventures LLC v. Texas Keystone Inc. and others, EWHC 4278 (Comm)(2013),) which involved a novice funder that had agreed to advance funds and security for the loser pays portion of a case if the client was unsuccessful (the losing party is required to pay the opponent's costs). The client lost the case and the judge issued harsh criticism, holding that the "spurious" claims had been "speculative and opportunistic" and had "no sound foundation in fact or law." The funder was not only required to pay millions of Euros in defense costs, but also was required to post millions of Euros as security. There are some notable take away points from this case. While acknowledging that funding is a necessary part of litigation, the UK judge criticized the funder for lack of vetting and lack of experience in the type of litigation funded. The court further noted that the lack of assets of the plaintiff caused their opponent to target the funder for recompense. Finally, with respect to the law firm involved, which had agreed to represent the client on a partial contingency fee basis (apparently the first time this very large law firm had done so), the trial judge went on to state that the firm "… suffered from the outset an acute conflict of interest and their partner with misplaced zeal".

Conclusion

ALF is a growing industry and is perceived as having great value by certain clients and law firms, but many are still reluctant to make use of these services. A review of articles discussing the ethics of ALF can lead one to a conclusion that ALF, while not unethical per se, does however raise issues that a lawyer needs to consider. These include conflict of interest, potential waiver of privilege and interference in a law suit by a third party. Further, inexperienced funders can create additional problems for law firms. Firms should take into account these and other factors when accepting a client. Consideration should also be given to referring the matter to internal counsel or outside advisors to assist in determining the level of risk and what loss mitigation measures should be taken in connection with a prospective client who is looking to ALF for financial support.

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