Third Party Financing

Ethical & Legal Ramifications in Collective Actions

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About the Institute for Legal Reform

The Institute for Legal Reform ("ILR") is a not-for-profit public advocacy organization affiliated with the United States Chamber of Commerce, the world's largest business federation, representing more than three million members, including many European-owned businesses. Additionally, many of ILR's members have European affiliates that do a substantial amount of business in Europe and will be directly affected by any changes to litigation-financing mechanisms in Europe.

I. EXECUTIVE SUMMARY

"Third party litigation financing" is a term that describes the practice of providing money to a party to pursue a potential or filed lawsuit in return for a share of any damages award or settlement. Litigation financing companies provide financing for myriad litigation costs, including attorneys' fees, court fees and expert witness fees. Funding arrangements also may involve financing the party's living expenses while the trial and any appeals are pending.

Although third party funding is not widespread in Europe, it is playing an increasingly visible—and potentially

harmful—role in European litigation. These concerns are aggravated by the fact that the Directorates General for Competition and for Health and Consumers of the European Commission, as well as the national governments of several European Union Member States, are considering legislation that would dramatically expand aggregate litigation in Europe. Combined with third party funding, such aggregate litigation would encourage abusive litigation, causing serious economic damage to the EU and its Member States and to the non-EU members of the European Free Trade Association. Of particular concern is DG Comp's proposed Directive on damages actions for anti-competition infringement. As drafted, the proposal includes permissive aggregate-litigation requirements and broad discovery provisions that would encourage frivolous litigation. If such actions were also subject to financing by third parties, they would be all the more susceptible to lawsuit abuse.

"Europe is at a critical juncture. The time to decide third party funding's future is now."

Europe is at a critical juncture. The time to decide third party funding's future is now. In this paper, ILR explains why third party financing must be prohibited in the area of aggregate litigation:

- **Third party litigation financing encourages lawsuit abuse.** Like contingent attorney's fees, third party funding reduces—and even eliminates—the claimant's downside risk of testing questionable claims in court. Moreover, unlike individual claimants, funding companies are able to spread the cost of litigation over a broad portfolio of cases and among numerous investors and can also hedge against downside risk by demanding a higher percentage of any eventual recovery. Accordingly, third party funding companies have a higher risk appetite, and are more likely to file frivolous claims, than self-funded claimants. Indeed, third party funders have an incentive to file frivolous claims that will benefit their investors, even if those claims will not benefit any injured parties. Third party funders will work with claimants' attorneys to design and prosecute cases that benefit them, regardless of whether they actually promote justice for consumers.

- **Third party litigation financing prolongs litigation.** The presence of a third party funder in a case encourages claimants to reject reasonable settlement offers because of the need to share their proceeds with the funder. By the same token, third party funding companies will look askance at settlement offers that do not reimburse their complete investment. Either way, the presence of a third party with a profit motive will make early, beneficial settlements less likely—just as contingent attorneys' fees do in the United States.

- **Third party litigation financing poses serious ethical dilemmas.** Third party financing weakens the traditional attorney-client relationship and raises serious questions concerning the funder's place in that relationship. This is so because the funders have no historical duty to represent their clients zealously and guard their confidences. Rather, funders are only in the business of making money for their investors.

- **Third party litigation financing would put European civil justice on a slippery slope.** Third party financing inserts a third party into the attorney-client relationship that is not a fiduciary of the client and has no interest, other than a pecuniary one, in the parties' dispute. Eventually, third party funding would require a relaxation of the rules governing attorney professional responsibility, compensation, and the attorney-client privilege to accommodate the financier's presence. Australia introduced third party financing for limited purposes in the 1990s. Today, across the civil landscape in Australia, third party financiers regularly make strategic decisions for clients and control all aspects of their claims, including when to file cases and when to settle—even going so far as to prevent the clients from speaking with their own attorneys. Relaxing the historical rules governing the attorney-client and adversarial relationships threatens to chip away at—and eventually eradicate—critical safeguards that have so far prevented abusive litigation in Europe.

For all of these reasons, Europe must take this historic opportunity to prohibit third party financing in collective litigation. Collective actions are inherently more vulnerable to litigation abuse than other types of litigation procedures because a defendant in collective litigation frequently faces exposure exponentially greater than what it would face in a proceeding with just one individual claimant. This enables claimants to exercise substantial leverage even if their claims are substantively meritless. By permitting claimants and their attorneys to offload risk and thus encouraging them to file non-meritorious claims, third party financing would be particularly damaging to the orderly administration of justice in the collective litigation context.

This paper begins with an overview of third party litigation financing. It next examines the current third party financing practices of a number of European jurisdictions. Then, it sets forth ILR's critique of the practice, particularly the incentives it creates to engage in frivolous and abusive litigation. ILR also presents a case study of the Commonwealth of Australia, the first jurisdiction to permit third party litigation funding, where such funding has dramatically increased litigation and given investors pervasive—even total—control over a claimant's case. Finally, the paper concludes that such funding should be prohibited altogether in collective litigation.

II. OVERVIEW OF THIRD PARTY LITIGATION FINANCING

A. Historical Antecedents

Third party litigation financing was forbidden at common law under the ancient doctrines of maintenance and champerty, which generally prohibited intermeddling in another's lawsuit. Maintenance forbade supporting or assisting a party to prosecute litigation. Champerty was a type of maintenance in which a third party maintained a litigant in return for any part of the judgment.[1] According to Blackstone, third party lawsuit financing was "an offense against public justice, as it keeps alive strife and contention, and perverts the remedial process of the law into an engine of oppression."[2]

In civil law countries, the ancient prohibition against third party financing was rooted in Roman law, which punished persons who "maliciously conspire to bring suit against others, agreeing to split the damages with the party who wins."[3] Those who violated these laws were punished by "forfeiture of a third party of their goods," and "infamy."[4]

B. The Modern Practice

Today, third party funding companies offer loans to parties to pursue litigation in the form of contingent, non-recourse financing. This means that the financier's profit is a pre-determined percentage of the party's recovery, and that the party does not have to repay the loan if it does not recover. In this sense, third party litigation funding is similar to a contingent attorneys' fee—but whereas the attorney acting on contingency invests his or her time and resources in prosecuting a case in return for a share of any award, the funder invests a specific amount of money. Thus, like the attorney-time investment in contingency-fee cases, the amount of money invested by the third party funder tends to set the "value" of the claim, instead of substantive developments in the litigation that reveal its merits—or lack thereof.

Because third party funding involves non-recourse loans, the financiers avoid prohibitions against charging excessive interest. If the party recovers, however, either by receiving a damages award at trial or by settling on favorable terms, the funding contract entitles the financing company to a share of the proceeds. The financier's share is calculated based on several factors, including the amount of money advanced, the length of time until recovery, the potential value of the claimant's case, and

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[1] *See, e.g.*, BLACK'S LAW DICTIONARY 213, 954 (6th ed. 1990).

[2] SIR WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND, Book IV, *quoted in* Stephen Presser, "A Tale of Two Models: Third Party Litigation in Historical and Ideological Perspective," paper presented at the Public Policy Roundtable on Third Party Financing of Litigation at the Searle Center on Law, Regulation, and Economic Growth at Northwestern University Law School, Sept. 24-25, 2009, at 7.

[3] JUSTINIAN'S DIGEST, Ff. 48.7.6 .

[4] JUSTINIAN'S DIGEST, Ff. 48.7.1.

whether the case settles or goes to trial. In Europe, third party funders generally seek anywhere from 20% to 50% of the claimant's recovery, which can constitute a return on investment—and an effective interest rate on the loan—upward of 200%.[5]

In recent years, a number of well-known financial institutions have begun offering third party litigation financing. Some of the bigger names in the industry include Allianz ProzessFinanz (an affiliate of German insurer Allianz), Harbour Litigation Funding, IM Litigation Funding, and Juridica Capital Management. Swiss banking giant Credit Suisse also has a litigation finance unit. Many hedge funds also are investing actively, but quietly, in litigation financing. John Jones, a technical director at Aon, a risk consultancy, has described the phenomenon this way:

> In a typical case[,] a hedge fund, acting on behalf of already wealthy investors, will seek to accumulate yet more money—not by investing in business enterprise or wealth creation—but by gambling on the outcome of a legal action for damages. They have no interest in the justice . . .—only in the chances of success—as they will demand a share of the damages awarded in return for putting up the stake money.[6]

These financial institutions have enjoyed favorable results. Juridica, which is based in Guernsey—and which invests only in commercial cases, mainly in the United States—raised £74 million in its December 2007 initial public offering on the London Stock Exchange's small companies market and another £33.2 million with a second offering in 2009. Juridica has seen its share price grow by 24% since it began trading in London and enjoys annual returns in excess of 20%. Another Guernsey-based funder, Burford Capital Ltd., recently raised £80 million in an initial public offering of shares to be traded on the London Alternative Investment Market. Burford invests in commercial disputes in the United States. In 2007, New Jersey-based, London-run hedge fund MKM Longboat, which manages $2.3 billion in assets, retained Susan Dunn, a litigator and the former managing director of

"In recent years, a number of well-known financial institutions have begun offering third party litigation financing."

[5] Julia H. McLaughlin, *Litigation Funding: Charting a Legal and Ethical Course*, 31 Vt. L. Rev. 615, 620-21 (2007) (explaining that the financier's share of any recovery can be more than 200% of the amount financed).

[6] Joshua Hamerman, *Hedge Funds: A Litigious Bunch*, Investment Dealers' Digest, Dec. 17, 2007, Gale Group Document Number: A172510098.

IM Litigation Funding, to direct investments of $100 million in European legal disputes.[7] Allianz ProzessFinanz has received approximately 3,000 financing requests, representing approximately €5 billion in claims, since it began financing litigation in 2002. The European market in which these institutions operate is largely unregulated, owing in part to the small fraction of cases in Europe that actually involve third party funding.

III. THIRD PARTY LITIGATION FINANCING IN EUROPE

Although cases funded by third parties constitute the distinct minority of cases litigated in Europe, the practice of third party financing exists to varying degrees in a number of European jurisdictions. The following is an overview of third party funding practices in a number of European jurisdictions based on the relevant literature, including a survey contained in the *Preliminary Report* by the Right Honourable Lord Justice Jackson of Her Majesty's Courts of Justice of England and Wales, who is conducting an ongoing review of civil litigation costs. Third party funding may exist in other European jurisdictions, but not, apparently, in a noteworthy way.

"…the practice of third party financing exists to varying degrees in a number of European jurisdictions."

Austria

In Austria, third party litigation financing is legal but rare. The practice received a boost recently, after the Austrian Supreme Court issued an opinion permitting some third party funding in aggregate litigation. Nevertheless, few third party funders exist in Austria, and most of those that do are German-based companies. Damages awards in Austria are traditionally low, and legal costs usually are funded through insurance. Typically, funders in Austria only invest in cases with a high chance of monetary recovery and where the amount in dispute is more than €50,000. ILR has not seen evidence that third party funding is used in collective actions in Austria.

Belgium

Belgian law does not appear to prohibit third party funding, but the practice does not exist to any notable extent in Belgium. As of Fall 2008, neither the Belgian legislature nor the Bar had debated third party financing, and current attorneys' professional rules make implementing third party funding arrangements difficult. ILR has not seen evidence that third party funding is used in collective actions in Belgium.

[7] Michael Herman, "Former litigator hired to invest $100m in court cases for UK hedge fund," *Times Online*, Nov. 28, 2007, http://business.timesonline.co.uk/tol/business/industry_sectors/ banking_and_finance/article2957156.ece.

England and Wales

England and Wales have only recently embraced third party litigation financing, but the industry is growing in part as a result of the prohibition against contingency fees and the decreasing availability of legal aid. Generally, litigation funders in England and Wales offer non-recourse, contingent financing, and are subject to orders for costs, up to the amount they financed,[8] if their claimant loses.

Even though England and Wales abolished maintenance and champerty as crimes and torts in 1967, courts still may strike down a third party funding agreement if contrary to public policy or otherwise illegal.[9] Unlike Australian courts, the courts of England and Wales consider as part of this policy question whether a funding agreement produces the "evils" that maintenance and champerty were intended to guard against—i.e., the corruption of public justice.[10]

Today, third party litigation funders in England and Wales finance not only insolvency cases (their historical domain) but also commercial litigation and arbitration, as well as professional negligence cases. Funders are prohibited from financing personal injury cases. Third party funders in England and Wales reportedly have expressed interest in financing low-value claims through collective litigation, but current collective redress procedures involve administrative costs and procedural hurdles that generally are too high to make such claims worthwhile.[11] Third party funding of "group"[12] litigation exists in England and Wales, but, because of these procedural hurdles, the practice is not growing rapidly. In addition, a new firm called Independent Litigation Funding has announced plans to start up to eight new funds to invest in medium-sized corporate law cases.

Substantial attention has been paid in recent years to the evolution of third party litigation

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[8] *See Arkin v. Borchard Lines* [2005] EWCA Civ. 655.

[9] Criminal Law Act 1967 (c. 58) § 14(2) (Eng.). The Criminal Law Act abolished maintenance and champerty only in England and Wales. The doctrines were abolished in Northern Ireland under the Criminal Justice (Miscellaneous Provisions) Act (Northern Ireland) 1968 (c.28) (N.I.). Neither statute had any applicability to Scotland, which, alone in the United Kingdom, is governed by Scots law, a unique amalgam of common and civil law. The Republic of Ireland abolished maintenance and champerty in 1997. Third party funding thus would not be unlawful there, but we have not seen evidence that the practice exists.

[10] *See Regina (Factortame Ltd and others) v. Secretary of State for Transport, Local Government and the Regions (No. 8)* [2002] EWCA Civ. 932; Mansell v. Robinson [2007] EWHC 101 (QB). *Compare id. with Campbells Cash and Carry Pty Ltd v. Fostif Pty Ltd* [2006] 229 CLR 386.

[11] Freshfields, Bruckhaus Deringer, *Recent Developments in Class Actions and Third Party Funding of Litigation: A Rapidly Evolving Landscape*, at 9, Feb. 2008, http://www.freshfields.com /publications/pdfs/2008/feb20/21722.pdf.

[12] In England and Wales, courts can issue "Group Litigation Orders" providing for standardized, centralized management of numerous cases involving similarly situated claimants. Group Litigation Orders can govern how courts will treat future similar claims and whether and to what extent any order the court issues respecting one claimant will be binding on the other claimants in the group.

funding and whether and how it should be regulated to prevent abuses. In a 2007 analysis, the Civil Justice Council, a public organization created under the Civil Procedure Act 1997 that advises the Secretary of State for Constitutional Affairs on matters of civil justice and civil procedure, recommended regulating the practice.[13] The Council is debating whether such regulation need be formal, or whether funders can regulate themselves with a voluntary professional code.[14] The Council's work on a draft code is currently suspended pending the ongoing review of civil litigation costs in England and Wales that is being conducted by Jackson LJ. That review is expected to be complete in December 2009. In his preliminary report, released in May 2009, Jackson LJ observed that "third party funding has a part to play in promoting access to justice."[15]

France

French law does not explicitly prohibit third party litigation funding. But because French lawyers can only be paid by their clients or a client's agent,[16] third party litigation funding appears possible only where the third party pays the attorneys' fees directly to the claimant for apportioning to the attorney. Third party funding is not developed in France.

Germany

Third party litigation financing has existed in Germany since 1998 and the industry comprises about twelve entities, the largest of which is Alianz ProcessFinanz. Generally, litigation funding companies in Germany advance court costs and attorney's fees in exchange for a 25% to 30% share of any recovery (again, functioning like an attorney contingency-fee arrangement). If the claim is unsuccessful, the funding company usually provides the claimant with funds to pay the opponent's attorneys' fees under Germany's loser-pays rule, as well as any lay- and expert-witness costs. Whether Germany's loser-pays rule *requires* funding companies to reimburse these costs directly to the opposing party when the claimant cannot do so and the funding contract does not require it has not been resolved by the German courts. Common types of cases financed by third party litigation funding companies include copyright, contract, labor and employment, trade, corporate, insolvency, and commercial matters.

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[13] Civil Justice Council, *Improved Access to Justice – Funding Options & Proportionate Costs, The Future Funding of Litigation – Alternative Funding Structures*, at 12, June 2007, http://www.civiljusticecouncil.gov.uk/files/future_funding_litigation_paper_v117_final.pdf.

[14] Civil Justice Council, *Submission to the Review of Civil Litigation Costs: The Regulation of Third Party Funding Agreements*, at 25-26, Aug. 25, 2009, http://www.civiljusticecouncil.gov.uk/files/Submission_to_the_Review_of_Civil_litigation_Costs.pdf.

[15] The Right Honourable Lord Justice Jackson, *Civil Litigation Cost Review: Preliminary Report*, at 160, May 8, 2009, http://www.judiciary.gov.uk/about_judiciary/cost-review/preliminary-report.htm.

[16] Article 11.3 of the National Bar Association Rules.

Third party funding does not appear to be widely used in Germany. A 2007 Soldan Institute study determined that third party funding is used in approximately 0.4% of cases.[17] In his *Preliminary Report*, Jackson LJ explained that third party funding is relatively rare in Germany because litigants perceive that financiers take too high a share of their recoveries and funding companies tend only to support cases with high probabilities of monetary recovery. In addition, the widespread use of litigation insurance[18] in Germany largely obviates the need for third party funding.[19] Along with these factors, the relatively low cost of litigating a claim in Germany (owing in part to statutory tariff fees for attorneys and competition in the legal market), and the availability of legal aid further reduce the need for third party financing. Germany's lawyer remuneration law also permits self funding in the form of contingent attorney fees in those limited circumstances where the claimant could not otherwise vindicate his or her rights but does not qualify for legal aid. While Germany does allow aggregation of claims in securities cases, third party funding does not appear to be used in the collective action context.

Italy

Third party litigation financing has received little attention from the Italian government, the press, or scholars. Third party funding is not prohibited, but is apparently not common. Italy's new class action law, which was finalized in July 2009 after considerable delay and is scheduled to take effect in January 2010, might attract third party financiers to Italian litigation when it becomes effective.

The Netherlands

In the Netherlands, litigation financing is generally used in settlement proceedings under the 2005 Act on Collective Settlement of Mass Damages.[20] Typically in these cases, funding companies seek 15% to 30% of any recovery by the claimant. The Act on Collective Settlements permits parties to seek court-approved settlements of disputes, but not to litigate them. It is unclear whether third party litigation financing plays any role in traditional court litigation in the Netherlands, and ILR has not seen evidence that third party funding is used in collective actions in the Netherlands. Currently, only one entity is known to provide financing there.

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[17] Jackson LJ, *Preliminary Report* at 564.

[18] Litigation insurance generally is available as before the event ("BTE") or after the event ("ATE") insurance. Insureds may purchase BTE insurance to protect themselves in the event they become party to a lawsuit. ATE insurance is a type of insurance that can be purchased after the event that gives rise to the litigation. In return for the premium, the insurance provider will assume the insured's litigation costs, including attorneys' and witness fees.

[19] *Id.*

[20] Dutch Code of Civil Procedure §§ 7:907-910, 1013-1018.

Spain

Third party litigation financing is legal but rare in Spain as well. Although collective actions are gaining popularity in Spain, they typically are financed through public subsidies. As a result, a corresponding third party funding industry has not developed.

Sweden

Third party litigation financing is permitted in Sweden, but it is not commonplace. Although Sweden permits collective litigation, aggregate proceedings are uncommon and have not attracted third party financiers.

Switzerland

Third party litigation financing is a relatively novel concept in Switzerland. To date, few Swiss cases appear to have been supported by third party litigation funding, and ILR has not seen evidence that third party funding is used in collective actions in Switzerland. That may change in the future, however, as financiers from the United States, the United Kingdom, Germany, and the Netherlands reportedly have expressed interest in expanding into the Swiss market.

IV. THE PROBLEMS INHERENT IN THIRD PARTY LITIGATION FINANCING

Third party financing incentivizes lawsuit abuse and poses serious ethical concerns. These problems are most acute in the context of collective litigation, and, as a result, ILR believes third party funding should be prohibited entirely in collective actions. The Commonwealth of Australia offers a case study of the dangers and perverse incentives that flow from third party funding.

A. Third Party Financing Encourages Frivolous and Abusive Litigation

1. Third Party Financing Leads to the Filing of Frivolous Claims

"…third party financing increases the volume of questionable claims."

Third party litigation financing increases the volume of litigation in any jurisdiction where it is available. This has been shown empirically in Australia and is moreover a matter of simple economics: by increasing the amount of money available to pay attorneys to litigate claims, third party funding necessarily increases the volume of claims litigated. What is more, third party financing increases the volume of questionable claims. This is because, absent such financing, attorneys have two disincentives to bring such claims. First, they have a duty to advise clients when potential claims would be frivolous. And second, in countries that permit success fees, attorneys obviously would rather spend their finite time on cases that are likely to be successful, as opposed to cases with a low probability of success. Accordingly, absent

third party funding, claimants and their attorneys are more likely to focus their efforts on claims with potential merit. Conversely, because third party litigation financing increases the overall financing available for litigation and reduces the attorney's own risk, the disincentives for bringing frivolous claims are significantly reduced.

In this respect, third party funding arrangements are potentially more likely to invite frivolous litigation than the contingent attorneys' fees such funding arrangements mimic. This is so because a lawyer who agrees to pursue a questionable claim on contingency has only a finite amount of time to devote to that case, as well as to other cases in the lawyer's caseload. A prudent lawyer will therefore focus his or her efforts on claims with a likelihood of success. But if the attorney is paid on an hourly basis by a third party funder, the attorney is compensated for all the time spent on a questionable claim, regardless of success. And unlike attorneys, third party funders are able to tap numerous investors to finance litigation and to spread the cost of doing so among all of them. This danger is heightened if funding companies are able to securitize their litigation loans or otherwise sell any derivative interest in them in the capital markets. In such circumstances, the financiers would have little incentive to investigate whether the claims they finance are frivolous, because the risk of loss would be spread among hundreds of thousands, if not millions, of investors.

2. Third Party Financing Companies Do Not Invest Solely in Claims with Strong Merits

Proponents of third party funding argue that the practice does not encourage frivolous lawsuits because a litigation financing company has no incentive to make a non-recourse loan to fund a meritless case.[21] They are wrong.

Although providing non-recourse loans to fund litigation is inherently risky, it does not follow that litigation finance companies will only finance claims that are likely to succeed. These companies—like all sophisticated investors—will base their funding decisions on the present value of their expected return, of which the likelihood of a lawsuit's success is only one component. The other component is the potential amount of recovery. If that is sufficiently large, the lawsuit will be an attractive investment, even if the likelihood of actually achieving that recovery is small. Put simply, the present value (excluding inflation and opportunity cost) of a €500 million claim

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[21] Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should be Tamed Not Outlawed*, 10 Fordham J. Corp. & Fin. L. 55, 77 (2004); Douglas R. Richmond, *Other Peoples' Money: The Ethics of Litigation Financing*, 56 Mercer L. Rev. 649, 661 (2005); Mariel Rodak, *It's About Time: A Systems Thinking Analysis of the Litigation Finance Industry and Its Effects on Settlement*, 155 U. Pa. L. Rev. 503, 518-19 (2006) (summarizing proponents' argument and collecting sources); Michael Herman, *Fear of third party litigation funding is groundless*, Times Online, Oct. 25, 2007, at http://business.timesonline.co.uk/tol/business/ law/article2738493.ece (arguing that the claim that litigation funding will encourage frivolous suits is unfair because litigation funding companies seek to invest in commercial, rather than personal, disputes).

with only a 10% chance of success is still €50 million. Moreover, litigation finance companies can further hedge their investments in risky lawsuits by demanding higher percentages of any award where recovery is less certain. Indeed, if investors were only attracted to low-risk investments, the high-yield junk-bond market never would have existed.

Already, the third party funding market bears this out: some hedge funds specialize in financing "speculative" cases.[22] MKM Longboat's Susan Dunn explains that hedge funds "want to invest, and it is those [hedge funds] that were involved in the distress[ed] debt market, so they are used to it. This is just a new class of risk to them."[23] As Mick Smith of third party litigation funder Calunius Capital has observed, "the perception that you need strong merits is wrong—there's a price for everything."[24]

Moreover, third party funding companies are able to mitigate their downside risk in two ways: they can spread the risk of any particular case over their entire portfolio of cases, and they can spread the risk among their investors. For this reason, litigation finance companies have a high appetite for risk and may be willing to fund speculative, high-yield cases. As one commentator has observed, litigation financing companies "staffed by a litigation savvy business person and a skilled litigation claims adjuster could reduce, even eliminate, the risk of loss by adroitly valuing the range of recovery in a personal injury action and by advancing only a fraction of the carefully calculated range of recovery dollars."[25]

3. Third Party Financing Prolongs Litigation

Third party financing proponents also argue that third party funding does not promote frivolous lawsuits because litigation financing companies often enter the picture after the claimant has chosen to file a lawsuit and has retained counsel.[26] With respect to this argument, the financing proponents are not only wrong; they also miss the key point.

Third party funders make money when they invest in lawsuits. Thus, they have every incentive to induce claimants to file them.

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[22] Hamerman, Hedge Funds.

[23] *Legal Report – A get out of jail for a fee card?*, Europe Intelligence Wire, at 3, Mar. 8, 2007; Gale Group Document Number A160316059 (no author listed)

[24] Edward Smerdon, *Third Party Litigation Funding*, Reynolds Porter Chamberlain LLP D&O Update, Mar. 2008, http://www.rpc.co.uk/FileServer.aspx?oID=649&lID=0.

[25] McLaughlin, Litigation Funding, 31 Vt. L. Rev. at 621.

[26] *See, e.g.,* Rodak, *It's About Time*, 155 U. Pa. L. Rev. at 519.

[27] Below, ILR discusses the Fostif decision in Australia. There, the third party funder conceived of the litigation, induced the claimants to agree to file suit, and secured the claimants' counsel.

This is precisely what occurred in the Fostif case in Australia, discussed in detail below.[27] Since there is no way to prevent funders from contacting potential claimants and encouraging them to file actions, they will obviously continue to do so.

More importantly, however, even if a funder does not influence a claimant's decision to *commence* litigation, the funder's presence almost certainly will *prolong* the litigation beyond what is fair or necessary. This is so because third party litigation funding creates a disincentive for claimants to settle at an amount below the value suggested by the financing arrangement, irrespective of whether that amount reflects a fair value for the claim. This problem would be particularly acute if third party funding were allowed in collective or representative cases brought under the Directorate General for Competition's proposed directive on damages actions for antitrust violations, which empowers claimants to seek broad discovery from defendants, thereby driving up defendants' litigation costs.

"A claimant who must pay a finance company out of the proceeds of any recovery can be expected to reject what may otherwise be a fair settlement offer…"

A claimant who must pay a finance company out of the proceeds of any recovery can be expected to reject what may otherwise be a fair settlement offer and hold out for a larger sum of money. By the same token, the financing company can be expected to pressure claimants only to accept settlement offers that are sufficient to cover the amount financed after subtracting the claimant's share of the recovery. Thus, the amount the company has financed sets the "floor" for acceptable settlement offers, and the company will pressure the claimant not to accept any settlement offer below the floor.[28] For example, if a funder provides a claimant €1 million to pursue litigation in return for 50% of any award, the funder naturally will set the settlement-recovery floor at €2 million. This amount, moreover, is entirely a function of the litigation funder's return on investment; it has nothing whatsoever to do with the merits of the claim. The €1 million investment thus sets the "value" of the case in the investor's mind, even if the progress of the litigation shows the claim to be worth far less, if anything at all. In this respect, litigation funding presents the same settlement disincentive as contingent attorneys' fees do in the United States: attorneys working on contingency have a perverse incentive to convince their clients only to accept settlement amounts greater than

[28] Australia provides a case study of where these incentives ultimately will lead: there, some fund-ing companies' financing contracts specifically provide that the companies have the power to accept or reject settlement offers.

the time-value the attorney has invested in pursuing the case.

In addition, from the defendant's perspective, by guaranteeing that claimants will have sufficient funding to prosecute even questionable claims through trial, third party funding creates pressure on defendants to settle all but the most frivolous claims, often on sub-optimal terms, and at an amount much higher than the merits-based value of the claim. Ordinarily, under the loser-pays rule that prevails in European jurisdictions, an unsuccessful claimant must pay all or part of the costs the successful defendant incurred in defending the litigation. Thus, when the defendant analyzes its range of outcomes in connection with considering settlement, its best-case scenario is that it will pay nothing (since the claimant will reimburse its attorneys' fees) and its worst-case scenario is that it will have to pay damages to the claimant, plus the claimant's court costs.

If the claimant's case is funded by a third party, however, the range of potential outcomes is narrowed in a way unfavorable to the defendant. If the defendant loses, it still must pay damages plus the claimant's attorneys' fees. But, if the defendant wins, it is unclear that its costs will be reimbursed. The courts of England and Wales only require third party funders to pay successful opposing parties' attorneys' fees up to the amount financed. In Germany, third party funding contracts generally provide that the funder will extend financing to the client to satisfy any order for costs. But it is unclear whether Germany, and indeed the other jurisdictions where third party funding exists, would ***require*** a third party funder to satisfy an order for costs if its client does not do so.

Moreover, it can be expected that a claimant who utilizes third party funding may not have sufficient funds to satisfy any order to pay costs. In such circumstances, even if the defendant prevails, the claimant has no money to pay the defendant's attorneys' fees, and the third party funder is not required to do so (or, in England and Wales, is required to do so only up to the amount financed). Effectively, then, third party litigation financing modifies the loser-pays rule in a way that is unfair to defendants. If a claimant wins, its costs are reimbursed, but if a defendant wins, it still may lose a portion of its costs. By thus increasing the defendant's—but not the claimant's—costs of trial, third party funding incentivizes defendants to seek to avoid trial, even if that means settling on sub-optimal terms.

B. Third Party Litigation Funding Raises Ethical Concerns

The common-law and civil-law prohibitions on third party litigation funding seem to have fallen by the wayside, but serious ethical concerns about the litigation financing industry remain. The most troubling of these concerns are: (1) the potential for funders to exercise strategic control over litigation; (2) the likelihood that attorneys will face conflicts between the interests of funders and the interests of claimants; and (3) the potential for compromising confidential communications between an attorney and client.

1. Third Party Funders Try to Control Claimants' Cases

Third party control over lawsuits reduces a system designed to adjudicate cases on their merits to one that is effectively controlled by parties who are interested solely in profit. After all, third party financiers are nothing more than investors in the claimant's case. And because their primary goal is to protect their investment, they will inevitably seek to exert control over strategic decisions. Timothy Hart, Vice President, Accounting & Financial Consulting for Huron Consulting Group, has said that clients may have to relinquish some decision-making authority to the funder and that "the client's interests may diverge from the funder in that other business reasons may suggest that they might settle a claim for less than the funder has targeted."[29] Arndt Eversberg, a managing director of Allianz ProzessFinanz, has touted claimants' ability to draw on the company's "legal knowledge and experience" as an added benefit of obtaining litigation financing from it.[30] One financing company's marketing presentation goes so far as to tout its ability to provide a "2nd opinion" on the attorney's advice.

"Third party funding thus places the power to make strategic decisions about litigation in the hands of the funder."

Third party funding thus places the power to make strategic decisions about litigation in the hands of the funder, whose duties are to its investors, as opposed to the attorney, whose duties are to the allegedly aggrieved claimant. Such a perverse approach to litigation not only harms defendants' interests by prolonging litigation (as discussed above), but it is also inimical to the rights of legitimately injured claimants whose efforts to seek commensurate, effective redress are hijacked by funding companies interested solely in profit.

2. Third Party Funders Create Conflicts

Obtaining funds from a third party to finance a case may also create conflicts of interest for the claimant's attorney, particularly the attorney's duty of loyalty owed to the client. This is especially true where the attorney has contracted directly with the funding company and thus has contractual duties to it that are independent of the attorney's professional duties to the claimant. Moreover, because both third party funders and attorneys are repeat players in the litigation market, it can be expected that relationships among them will develop over time. Attorneys can be expected to "steer"

[29] Anne Urda, *Legal Funding Gains Steam But Doubts Linger*, Law360, Aug. 27, 2008.

[30] Allianz Deutschland AG, *Risk-free Litigation Financing*, Aug. 17, 2007, http://www.allianz.com/en/press/news/business_news/insurance/news_2007-08-17.html.

clients to favored financing firms, even if the client's particular circumstances suggest a different firm may be more appropriate, and vice versa.

3. Third Party Funding Makes Providing Candid Legal Advice Less Likely

Finally, third party litigation financing arrangements also raise confidentiality concerns insofar as they require claimants to disclose privileged information to the financier. In order to evaluate a claimant's claim and determine whether and on what terms to finance the case, a litigation financing company generally will ask to evaluate confidential, and possibly privileged, information belonging to the claimant. If the claimant elects to provide the information to the financing company, any privilege protecting it likely would be waived. Indeed, courts in England and Wales have held that communications with third party litigation funding companies are not privileged. Attorneys advising a client at the outset of a case may be reluctant to provide the client full and candid advice in writing, knowing that any communications could be viewed by the funder as part of its diligence, and then would be available to the opposing party in discovery.

C. Third Party Funding in Collective Actions: A Recipe for Abuse

Third party financing is most troubling in the context of collective actions, which already pose substantial risks of abuse.

Collective actions are particularly attractive to third party litigation funders because of the potential for high returns on their investment. The funding company's costs of pursuing a collective action increase only marginally as claimants are added to the case, while its potential return can increase significantly.

But that is also why mixing the two is so dangerous. The claimants in collective actions can threaten the defendant with staggering exposure on potentially thousands of claims. By helping would-be claimants shift their costs to others, third party funding encourages claimants' attorneys to test claims of questionable merit, knowing that the enormity of the potential risk will often force defendants to settle collective actions on sub-optimal terms rather than roll the dice at trial. In this respect, contingent third party funding arrangements are even ***more*** likely to invite frivolous litigation than contingent attorneys' fees, which bear a significant share of the blame for the United States's out-of-control tort system.

In addition, in an individual case, the claimant presumably hires the third party funding company—or at least knows and understands the arrangement. By contrast, in a suit involving thousands of claimants, there is no practical way to obtain permission from all the potential claimants before entering the third party funding agreement. Thus, the funding arrangement is essentially occurring without the consent of the claimants.

Relatedly, third party financing also exacerbates one of the fundamental problems with aggregate litigation—*i.e.*, that it is generally controlled by attorneys rather than claimants. In a large collective action, the

average claimant often has very little money at stake, and, as a result, the lawyers fully control the case—not the individual claimants.

The concerns raised by such an arrangement are all the greater when the person driving the litigation is not even a lawyer with obligations to the supposed clients or the court. In a case with a legitimately aggrieved claimant who is following the litigation and concerned about its outcome, there is, at least, someone watching the lawyer and the funding company—and that person can raise concerns if the funding company acts against his or her interests. In a collective action, by contrast, there is often no interested individual claimant. Thus, the funding company can effectively run the litigation with no check on its actions.

In addition to increasing the risk of abusive aggregate litigation, third party funding in collective actions also eats into any damages that are justifiably awarded to claimants. Already, the actual payout to collective action claimants is often negligible, because so much of the settlement pie goes to attorneys' fees. If a third party funder is added to the mix, the slice that goes to claimants would be even smaller, and the proceeds would essentially be divided between the lawyers and the funders.

As numerous EU Member States, including Italy and the United Kingdom, as well as the Directorates General for Competition and for Health and Consumers of the European Commission, press ahead with proposals to introduce collective actions, policymakers should pay particular care to the problem of third party funding in this arena. Permitting third party litigation funding in collective actions removes the risk of economic loss for pursuing such actions and will increase the number of claimants willing and able to prosecute them. Third party financing also vitiates safeguards that aim to discourage frivolous and abusive litigation such as the requirement to cover a successful opponent's costs. For these reasons, third party funding simply should not be permitted in collective actions.

D. Case Study: The Commonwealth of Australia and the Dangers Inherent in Third Party Litigation Financing

Third party financing originally developed in Australia in the 1990s for use in insolvency litigation. Australian courts, however, soon allowed the practice in group litigation. Today, claimants use it primarily in commercial litigation and in group proceedings. One study has concluded that the average volume of litigation in Australia has risen significantly as a result of the practice.[31]

The third party funding industry has flourished in Australia in part because Australia prohibits attorneys from charging contingency fees, but that prohibition does not extend to contingent returns on investment for funders. The practice thus provides a mechanism for claimants to finance litigation on contingency.

[31] David Abrams and Daniel L. Chen, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes* (unpublished article), http://home.uchicago.edu/~dlc/papers/MktJustice.pdf (last visited Sept. 29, 2009) (finding that the average number of lawsuits in Australia for every 100,000 people is 201, and that every AUD 10 million of third party funding increases the number of lawsuits per 100,000 people by 16.5).

Currently, the Australian Corporations Act 2001 requires funding companies to: (1) provide claimants with a financial-services guide and disclosure statement; (2) provide information about the company's principals; (3) provide information about the company's compensation; (4) disclose the benefits, risks, and costs of third party funding; and (5) provide information about alternative dispute resolution and the tax implications of litigation financing.[32] Third party funding companies that finance collective actions as investment schemes are also required to register those schemes with the Australian Securities and Investment Commission and provide a constitution and compliance plan for the scheme.[33]

"The High Court's majority opinion reveals that Firmstones itself…conceived of and planned the litigation, set it in motion, and exercised pervasive control over the retailers' claims."

1. The High Court's Fostif Decision Upheld Pervasive Third Party Control over Litigation

The evolution of third party funding in Australia led in 2006 to the High Court decision in *Campbells Cash and Carry Pty Ltd v. Fostif Pty Ltd.*[34] In *Fostif*, a five-to-two majority of the High Court held that a third party funder may exercise significant control over the litigation, and that this control is not an abuse of process and does not offend public policy in states that have abolished maintenance and champerty as crimes and torts.

Fostif involved a third party litigation financier called Firmstones & Feil, Consultants, which financed a collective action brought on behalf of tobacco retailers to recover licensing fees they had paid to tobacco wholesalers. Firmstones actually had sought out the retailers and convinced them to grant it authority to bring an action on their behalf. Ultimately, Firmstones financed the litigation on a contingent, non-recourse basis.[35]

Under the financing agreement, Firmstones exercised considerable control over the litigation. The High Court's majority opinion reveals that Firmstones itself, which had no

[32] No. 50, 2001, §§ 941A, 1012B, 92B, and 1031D (Austl.).

[33] *Id.*, § 601EA (Austl.); *Brookfield Multiplex Limited v International Litigation Funding Partners Pte Ltd* [2009] FCAFC 147. See Vicki Waye, *Conflicts of Interest between Claimholders, Lawyers and Litigation Entrepreneurs*, 19 Bond L. Rev. 223, 268 (2007).

[34] [2006] 229 CLR 386.

[35] *Id.* at 389-90.

stake in the underlying dispute of the case, conceived of and planned the litigation, set it in motion, and exercised pervasive control over the retailers' claims. Indeed, it is questionable that the retailers ever would have sued the wholesaler-defendants at all without Firmstones' encouragement. The majority highlighted these troubling facts:

- Firmstones contacted the claimant-retailers and encouraged them to pursue refunds from the defendant-wholesalers, offering to finance this effort in return for a share of any recovery;
- Firmstones selected and retained the retailers' trial counsel;
- Firmstones prohibited counsel from contacting the retailers directly;
- Firmstones instructed counsel throughout the proceeding; and
- Firmstones retained the power to settle the proceeding with the wholesalers on behalf of the retailers.[36]

On appeal, the wholesalers argued that the retailers' funding agreement was impermissible and that the trial court's approval of the arrangement was an abuse of process and contrary to public policy. The High Court disagreed. The majority held that Firmstones's efforts to seek out claimants and retain control over the litigation did not abuse any process or violate any public policy because—and this reasoning is unprecedented—seeking to profit from another's litigation (as lawyers do and have always done) is not against public policy.[37] Three of the Justices in the majority held that in states that had abolished the crimes and torts of maintenance and champerty, those concepts could not be used to challenge the funding agreement; the only policy question in such circumstances is whether the agreement is enforceable among its parties.

The minority opinion harshly criticized third party litigation funding and the majority's holding, stating that the "purpose of court proceedings is not to provide a means for third parties to make money by creating, multiplying and stirring up disputes in which those third parties are not involved and which would not otherwise have flared into active controversy." The minority also stated that "public confidence in, and public perceptions of, the integrity of the legal system are damaged by litigation in which causes of action are treated merely as items to be dealt with commercially."[38]

At its core, the minority opinion in *Fostif* was a forceful reminder that the third party financier is a stranger, an "alien"[39] to the traditional adversarial relationship between claimant and defendant. But in this respect,

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36 *Id.* at 390, 413, 424.

37 *Id.* at 433-34.

38 *Id.* at 488.

39 *Id.*

the minority ultimately was talking past the majority. The minority complained that third party financing presents the evils that the doctrines of maintenance and champerty were designed to prevent. But the majority held that once those doctrines are abrogated, whatever practices grow up are no longer considered evil. To frame it in the majority's terms: once maintenance and champerty are abolished as crimes and torts, they no longer reflect a nation's policy of what litigation should be. *Fostif* thus demonstrates the slippery slope of embracing third party funding.

2. Fostif's Aftermath

In the wake of *Fostif*, critics have expressed concern about the lack of regulation over third party funders, the substantial fees they earn, and the unfair manner in which they negotiate funding contracts with claimants.[40] Others have observed that third party litigation funding has increased the number of class actions in Australia, which is already the second most popular jurisdiction for such suits outside of North America.[41]

"In the wake of Fostif, critics have expressed concern about the lack of regulation over third party funders, the substantial fees they earn, and the unfair manner in which they negotiate funding contracts with claimants."

Especially since *Fostif*, third party litigation financiers in Australia generally reserve the right to withdraw funding unilaterally at any time. They also generally require that they be apprised of and consulted regarding proposed settlements, with some companies going so far as to require the claimant to obtain the funder's consent before settling the case. Funders also often advise the claimant on selecting counsel. And at least one Australian litigation funding company goes so far as to determine case strategies, evaluate and approve key witnesses, and conduct settlement discussions.[42]

Perhaps most damagingly, *Fostif* has awakened a debate in Australia on whether or not contingent attorneys' fees

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[40] Stuart Clark and Christina Harris, *The Push to Reform Class Action Procedure in Australia: Evolution or Revolution?*, 32 Melb. U.L. Rev. 775, 810 (2008).

[41] S. Stuart Clark, *Thinking Locally, Suing Globally: The International Frontiers of Mass Tort Litigation in Australia*, 74 Def. Counsel J. 139, 139-40 (2007).

[42] Waye, *Conflicts of Interest between Claimholders, Lawyers and Litigation Entrepreneurs*, 19 Bond L. Rev. at 223 (includes an appendix detailing responses of six Australian third party litigation funding companies to several questions about industry practices).

should be allowed. Europe and Australia historically have prohibited contingency fees, which give a claimant's attorney a direct financial interest in the claimant's potential award. Contingency agreements create a potential conflict between the attorney's ethical duty to zealously represent the client in pursuit of justice and the attorney's own financial interest in maximizing any recovery. This problem is particularly acute in the collective-litigation arena because contingency fees incentivize attorneys to commence collective actions that may result in high contingency fees, even though the resulting award to individual claimants may be negligible.

"Perhaps most damagingly, *Fostif* has awakened a debate in Australia on whether or not contingent attorneys' fees should be allowed."

Since *Fostif*, however, some Australian commentators have pointed out that allowing non-lawyer third party financiers to control litigation and collect contingency fees, while denying such fees to the attorneys themselves, is illogical.[43] This development highlights ILR's critical concern that third party financing is a "back door" to the introduction of contingency fees in Europe.

3. Potential Limitations on Third Party Funding in Australia?

As a result of concerns over *Fostif* and its aftermath, Australian courts are belatedly considering rules to govern funding agreements. In addition, in 2006, the Standing Committee of Attorneys-General published a discussion paper on regulating litigation funding in Australia and invited public comment.[44] The Committee's efforts toward recommending a regulatory structure for third party litigation funding companies are moving slowly. In its March 2008 Communiqué, the Committee reported that a working group is drafting a litigation funding regulation impact statement that will outline strategies for regulating the industry.[45]

In addition, on October 20, 2009, the Federal Court of Australia handed down its opinion in

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[43] Clark and Harris, *The Push to Reform Class Action Procedure in Australia*, 32 Melb. U.L. Rev. at 788.

[44] Standing Committee of Attorneys-General, *Litigation Funding In Australia*, May 2006, http://www.lawlink.nsw.gov.au/lawlink/legislation_policy/ll_lpd.nsf/vwFiles/Litigation_Funding_Discussion_paper_May_06.doc/$file/Litigation_Funding_Discussion_paper_May_06.doc.

[45] Standing Committee of Attorneys-General, *Summary of Decisions March 2008*, Mar. 28, 2008, http://www.scag.gov.au/lawlink/SCAG/ll_scag.nsf/pages/scag_meetingoutcomes.

Brookfield Multiplex Limited v International Litigation Funding Partners Pte Ltd,[46] a collective action, that opponents of third party financing are hoping will augur a more conservative approach toward such funding in Australia. The Brookfield court held that third party funding arrangements in collective actions must be registered with the Securities and Investment Commission as investment vehicles in part to provide assurance to defendants that claimant groups' counsel is authorized to represent all claimants, and that neither any individual claimant nor the Securities and Investment Commission will later claim that group counsel was not authorized. This decision has the potential, at the least, to delay pending third party-funded collective actions in Australia until those funding arrangements are registered.

[46] [2009] FCAFC 147; see also Australian Corporations Act 2001 No. 50, 2001, § 601EA (Aust.).

V. CONCLUSION

Litigation abuse is fundamentally driven by financial incentives—it occurs in jurisdictions where it is profitable to engage in abusive litigation, and it does not occur in jurisdictions where it is not. Legal culture and social conventions may mitigate such incentives to some degree, but ultimately they will not deter parties from bringing meritless claims as long as doing so offers the prospect of lucrative financial rewards. Third party financing is dangerous for just this reason—it holds out the prospect of financial rewards for bringing litigation. Moreover, because third party financing vitiates traditional safeguards against frivolous claims, much of this increased litigation volume consists of claims of questionable merit.

These risks are particularly acute in the context of collective actions. Collective litigation is already prone to abuse because there is a tremendous amount of money at stake and very little accountability to the supposed claimants. Combining third party funding with collective actions would exacerbate the risks of such abuse by permitting would-be claimants to shift their costs to others and encouraging them to test claims of questionable merit, knowing that defendants often will choose to settle rather than risk trial.

For these reasons, policymakers at the EU and Member State levels should prohibit third party financing in collective litigation.

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NOTES

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