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More Money, More Problems: Overcoming the Risks of Alternative Litigation Financing

INTRODUCTION

The alternative litigation finance (ALF) industry has undergone a significant growth spurt in the last few years, in terms of both claims funded and dollars invested. Use of ALF increased fourfold between 2013 and 2016[1] and the investment pool of the largest funder exceeds $1 billion.[2] Dubbed by one commentator as the "Wild West of Finance,"[3] ALF has expanded to include a wider variety of cases, defense-side financing, and even crowdsourcing. While it has its critics, most legal insiders expect the industry to continue its upward trajectory.[4]

In view of this growing trend, and for the protection of both attorney and the client, an attorney must be mindful of the pitfalls inherent in the third-party financier relationship. Equipped with an understanding of the funding process and guided by the American Bar Association Model Rules of Professional Conduct, attorneys should be well-suited to litigate cases financed by ALF while minimizing legal malpractice and disciplinary exposure.

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THE BASICS

At its most basic, ALF consists of a third party ("the funder") providing money to a cash-needy claimant in exchange for a financial stake in the outcome of the case. The contours of ALF are best explained by defining what it is not: ALF is not a claim assignment, as the claimant remains a party to the case while the funder is not made a party; ALF is not a traditional loan, as all funds advanced are non-recourse, meaning the funder is only paid in the event of a recovery; and ALF is not an advance on a structured settlement, as all funds are disbursed prior to any judgment. In reality, ALF is much like an attorney working on a contingency basis, financing litigation costs upfront for a piece of the judgment later. The level of an attorney's involvement in the funding process will vary, and likely depends on the size of the claim or the sophistication of the client, but the attorney's obligations and considerations are largely the same.

In addition to funding an individual consumer or business pursuing a claim, ALF providers may also offer funds or lines of credit directly to the law firm itself. While these loans also finance litigation, they are secured by the firm's assets, including real estate, office equipment, or accounts receivable, and are not contingent on the outcome of any specific litigation. In this way, they are just like traditional loans and stand in contrast to the non-recourse loans provided to plaintiffs with respect to both the terms of the transaction and the resulting ethical implications. This article concerns only non-recourse funding provided to claimants.

1 Burford Capital LLC. *2016 Litigation Finance Survey*. 3 May 2016:1 (survey of 142 private attorneys, in-house counsel, and financial executives from 60 of the top 500 law firms and 80 U.S.-based companies revealed increase from 7% to 28%).
2 Channick, Robert. "Chicago investment firm wins big bankrolling other people's lawsuits" Chicago Tribune, 9 Jan. 2017.
3 Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 Fordham J. Corp. & Fin. L. 55 (2004).
4 Burford Capital LLC. *2016 Litigation Finance Survey*: 7 (75% of outside counsel and 61% of corporate counsel predict growth over the next five years.).

LEGALITY

Before referring a client to a funder or identifying ALF as a financing solution, an attorney must ensure that the transaction is legal. States are roughly split on whether they allow ALF, if they have addressed the issue at all, as the transaction may run afoul of champerty, barratry or maintenance prohibitions. These seldom-invoked doctrines generally prevent outside parties from supporting litigation for a share of the award.[5] The national trend had been toward severely limiting or abolishing these doctrines, but a few recent decisions may signal an increased willingness of courts to enforce them.[6] Attorneys, therefore, should verify that their jurisdiction permits ALF or that the agreement is structured in such a way that it does not violate state law.[7]

Only Arkansas, Indiana, Maine, Nebraska, Ohio, Oklahoma, Tennessee and Vermont currently have regulatory frameworks in place that specifically address ALF, while New York funders operate under a quasi-regulatory agreement with the State Attorney General. Statutes typically address notice and disclosure requirements, contract language, attorney-client privilege and the prohibition of referral fees, and have been ostensibly welcomed by funders who seek to bolster consumer confidence in the industry. The Arkansas and Tennessee legislatures, however, have priced ALF out of their states with the adoption of rate caps.

Usury laws set the maximum lending interest rate in each state and despite interest rates that run as high as 280% of the amount disbursed,[8] ALF is typically exempt from such restrictions due to the non-recourse nature of the funds. These laws may come into play, however, where the transaction begins to resemble a loan. Courts have struck down ALF agreements as usurious loans where funding commenced after a jury had already found in favor of the claimant[9] or even pre-judgment funding where the outcome of the case appeared too certain.[10] In November of 2015, the Supreme Court of Colorado concluded that ALF, under any conditions, constitutes a loan subject to usury laws, effectively precluding ALF activity in the state.[11] An attorney must be aware of these potential limitations on ALF in his or her jurisdiction and, of course, ABA Rule 1.2(d) prohibits an attorney from knowingly counseling a client to enter an unlawful agreement.

ETHICS

Consultation

As a preliminary matter upon accepting a new engagement, or once a client's previous source of funds has been exhausted, an attorney and client may consider alternative means of funding the case. As long as the transaction is legal, an attorney may inform a client about ALF, but must also provide candid advice to the client on whether ALF is in the client's best interests. A typical ALF contract is structured so that the funder's stake in the recovery increases over time, so while ALF eases the financial burden of litigation on the front end, it can put pressure on a client to accept a premature or inadequate settlement offer. Even the most patient client faces the prospect of a drastically reduced or nonexistent award after all other parties are paid.[12] A thorough discussion of the downsides of ALF at the case's outset is critical to avoiding malpractice allegations at its conclusion, and the client's signed acknowledgement of this discussion is similarly vital.

ALF transactions, and particularly the risks associated with each individual case, are often highly complex. Depending on an attorney's familiarity with ALF, it may be necessary to conduct independent research, consult an attorney with knowledge of the process, or refer the client to such an attorney. One way or another, an attorney must be certain that the client understands the terms of the contract and the accompanying risks well enough to make an informed decision whether to accept funding.

The extent of an attorney's role in the process should be clearly defined in the engagement letter. As noted by the ABA Commission on Ethics 20/20, where an attorney's role reaches beyond education to include representing the client in negotiations with the ALF provider, and negotiated terms touch on how or how much the attorney will be paid, the attorney has likely acquired a "pecuniary interest adverse to a client" and must comply with the requirements of Rule 1.8(a).[13] The Rule demands that the attorney, in addition to ensuring the client understands the terms, verify the terms are fair to the client, advise the client to seek independent

5 *See In re Primus*, 436 U.S. 412, 425 (1978) ("Put simply, maintenance 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.").

6 *See, e.g., WFIC, LLC v. LaBarre*, 148 A.3d 812 (Pa. Super. Ct. 2016) (denying a funder's claim to attorney's fees on, *inter alia*, champerty grounds); *Justinian Capital SPC v. WestLB AG*, 28 N.Y.3d 160 (2016) (applying New York's champerty statute against a funder who purchased notes for the right to sue the issuer of those notes); *but see Charge Injection Techs., Inc. v. E.I. Dupont De Nemours & Co.*, No. CV NO7C-12-134-JRJ, 2016 WL 937400 (Del. Super. Ct. Mar. 9, 2016) (declining to find a funding agreement champertous because the claim was not assigned nor could the funder direct, control, or settle it).

7 *See generally* Terrence Cain, *Third Party Funding of Personal Injury Tort Claims: Keep the Baby and Change the Bathwater*, 89 Chi.-Kent L. Rev. 11, 24 (2014) (discussing choice of law provisions that allow funders to operate even in states where ALF is not authorized).

8 Jenna Wims Hashway, *Litigation Loansharks: A History of Litigation Lending and A Proposal to Bring Litigation Advances Within the Protection of Usury Laws*, 17 Roger Williams U. L. Rev. 750, 751 (2012).

9 *Lawsuit Fin.*, L.L.C. v. Curry, 261 Mich. App. 579, 588-591 (2004).

10 *Echeverria v. Estate of Lindner*, No. 018666/2002, 2005 WL 1083704, at *8 (N.Y. Sup. Ct. Mar. 2, 2005).

11 *Oasis Legal Fin. Grp., LLC v. Coffman*, 2015 CO 63.

12 *E.g.*, Appelbaum, Binyamin. "Investors Put Money on Lawsuits to Get Payouts." The New York Times, 14 Nov. 2010 (discussing a personal injury plaintiff who was awarded $169,125, but ended up owing the funder $221,000).

13 ABA Commission on Ethics 20/20. *Informational Report to the House of Delegates*, Feb. 2012: 18-19.

legal advice, and provide the client an opportunity to secure such advice. The attorney must also obtain the client's written, informed consent to both the contract's terms and the attorney's role in the negotiations.

Referral

An attorney may direct a client to a particular funder, but must not do so blindly. Rule 1.1 imparts a duty on an attorney to provide competent advice to the client, and while an attorney cannot guarantee the client a favorable result, the attorney should have an independent basis to believe the funder is above board and will provide the client with quality service. In any event, the attorney must not have reason to suspect that the funder is incompetent or predatory, or may face malpractice liability stemming from the negligent referral. To further safeguard against alleged negligence or impropriety in the referral, an attorney may elect to provide the client with a list of several capable and sufficiently vetted funders from which the client can choose.

Under no circumstances may an attorney accept anything in exchange for a referral. The most obvious example would be a referral fee, but an attorney should also avoid less discernible benefits like using the ability to refer clients to a specific funder as a means of attracting clients. An attorney must not have an interest in an ALF company providing funds to the attorney's client, notwithstanding the client's consent, as such an arrangement would almost certainly constitute a non-waivable conflict under Rule 1.7. It would also likely violate Rule 1.8(e) which generally precludes attorney-client lending in connection with litigation. Even a non-financial preexisting relationship between the attorney and the funder must be disclosed to the client, in which case the referral should only move forward upon the client's informed, written consent.

Additional Fees

Whether an attorney may charge the client an additional fee for services related to ALF depends on the level of services provided and the engagement letter. Cases suitable for ALF are more often than not charged on a contingency basis, so it is possible that ALF services fall into a category of work for which the attorney and client have already contracted. A narrowly defined engagement letter, however, may not contemplate ALF-related services and will require an addendum, signed by the client, to address the additional work as prescribed by Rule 1.5.

Document Sharing

In its initial evaluation, the funder will request documents and information from the attorney to help it gauge the potential merits, duration and damages of the claim. The funder will then periodically request additional materials as a way of monitoring the investment. This step in the funding process, while essential from the funder's perspective, poses a substantial professional liability risk to the attorney. As Rule 1.6 protects all information relevant to the representation from unauthorized disclosure, no information, not even the client's identity, should be disclosed to the funder without the client's informed, written consent, indicating that the client fully appreciates the risks inherent in sharing documents with a third party.

The funder will require access to work product during its evaluation, which risks waiving protection unless the attorney has a reasonable basis to believe that the recipient will keep the material confidential. This standard would likely be met by virtue of the fact that the funder and claimant share a common litigation interest,[14] but an attorney would be wise to further protect the documents by entering into a non-disclosure agreement with the funder. Other sensitive documents not constituting work product should likewise be shared subject to a non-disclosure agreement.

The funder may or may not request materials subject to the attorney-client privilege as such documents typically have little or no bearing on the investment strength of the case. In fact, it is not uncommon for a funder to specifically request that it not receive any privileged documents in order to guard against accidental waiver.[15] Although some courts have applied the common interest exception in holding that the privilege survives disclosure to a funder, existing authority is mixed and scant.[16] An attorney should avoid disclosing privileged documents where possible, or else carefully examine local case law and only disclose such documents pursuant to the client's informed, written consent.

14 *See United States v. Deloitte LLP*, 610 F.3d 129, 141 (D.C. Cir. 2010).

15 Weinstein, Boaz. "Protecting Privilege in Litigation Finance." Lake Whillans Litigation Finance, 2 Dec. 2014.

16 *See Devon IT, Inc. v. IBM Corp.*, No. CIV.A. 10-2899, 2012 WL 4748160, at *1 n.1 (E.D. Pa. Sept. 27, 2012) (applying the common interest exception to privileged documents shared with a funder); *but see Leader Technologies, Inc. v. Facebook, Inc.*, 719 F. Supp. 2d 373, 376-77 (D. Del. 2010) (finding no error in conclusion that common interest exception did not apply); *Miller UK Ltd. v. Caterpillar, Inc.*, 17 F. Supp.3d 711, 731-34 (N.D. Ill. 2014) (finding same).

Maintaining Control

Throughout the course of litigation, the attorney must be wary of any control exerted upon case decisions or strategy by the funder. In accordance with Rules 1.8(f) and 5.4(c), an attorney may only accept funding from a third party where the transaction does not interfere with the attorney's independent professional judgment or the attorney-client relationship, as the attorney's obligations of representation remain solely with the client. A well-drafted ALF contract will contain language disclaiming any right held by the funder to impact decisions concerning the underlying case, including the decision to terminate the attorney-client relationship.

The decision to settle or for what amount, perhaps the aspect of litigation strategy most prone to funder influence, belongs to the client regardless of the funder's potentially conflicting incentives. With respect to the funder's stake in the award, an attorney may, at the client's request, confirm notice of the client-funder arrangement. However, an attorney should avoid signing a letter of protection or similar document that promises to protect the funder's interest in the recovery, as such an agreement would invite a conflict. In the event of a funder-client dispute regarding the recovery, an attorney should withhold the funds from both parties until the dispute is resolved in conformity with Rule 1.15(e).

CONCLUSION

ALF is tied to litigation, and therefore it is impossible to ensure that the client will come out ahead when all is said and done. However, by proceeding with caution and keeping a close eye on local statutes and rules of professional conduct, an attorney can effectively manage the ethical risks inherent in these transactions.

This article was authored for the benefit of CNA by:
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