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DETERT, MORAN & ARNOLD LLP

Commercial Litigation Funding and a New Legal Costs Landscape

ALTHOUGH YOU WOULD BE FORGIVEN FOR BEING MISLED BY ITS TITLE, the new *Legal Aid, Sentencing and Punishment of Offenders Bill* marks the government's adoption of Lord Justice Jackson's costs reform proposals. This article takes a look at these changes with a particular focus on the growing commercial litigation funding market in the UK, boosted by supportive decisions in the courts and also endorsed by Lord Justice Jackson.

Historical context

Until recently, commercial litigation funding had been held back by the legal issues of champerty and maintenance. A person is guilty of maintenance if he or she supports litigation in which they have no legitimate concern without just cause or excuse. Champerty occurs when the person maintaining another asks for a share of the proceeds of the action or suit. These common law doctrines had been developed as a matter of public policy to prevent what was termed "trafficking in litigation". Although the Criminal Law Act 1967 decriminalised these acts, contracts amounting to maintenance or champerty remained unlawful.

The Courts

In the last decade, the courts have addressed the issues of champerty and maintenance in respect of third party funders.

Hamilton v Al-Fayed (Costs) [2002] demonstrated the beginning of a more liberal stance of the courts towards third party funding. Here, the Court of Appeal rejected an attempt by Al Fayed to make Hamilton's financial backers liable for costs of Hamilton's failed libel action. The court decided that the unfunded party's ability to recover his costs had to give way to the funded party's right of access to the courts in order to bring litigation in the first place.

The Court of Appeal gave further judicial steer in *Arkin v Borchard Lines Ltd and Others* [2005]. This case differed on its facts to *Hamilton v Al Fayed* as it involved a commercial litigation funder who had financed part of a claimant's costs of litigation. The court considered it unjust that a funder, who purchases a stake in an action for a commercial motive, should be protected from all liability for the costs of the opposing party if the funded party loses.

A "just and practicable" approach was taken by the court, which neither denied a successful opponent all his costs nor deterred commercial litigation funders from providing help to impecunious claimants seeking access to justice.

The court decided that a funder should be potentially liable for the costs of the opposing party only to the extent of the funding provided. Justice would be better served in this manner than by leaving defendants in a position where they had no right to recover any costs from a commercial litigation funder whose intervention had permitted the continuation of a claim which had proved to be without merit.

This reasoning was on the basis funding had been provided through a non-champertous agreement. However, the court indicated that if such an agreement was found to be champertous, then the funder would expose itself to an adverse costs order without limit.

An agreement is likely to be non-champertous if:

- **The claimant is left as the party primarily interested in the result of the litigation.**
- **The claimant is the party in control of the conduct of the litigation.**
- **It facilitates access to justice.**
- **It is "not otherwise objectionable".**

These factors will be determined by the court in accordance with the facts peculiar to a particular funding arrangement. Perhaps the most difficult factor for potential commercial litigation funders to predict is whether a funding arrangement will be viewed by the court as "not otherwise objectionable".

The Court of Appeal acknowledged that this decision would mean commercial litigation funders were likely to cap the funds that they provided in order to limit their exposure to a reasonable amount, with the effect that costs should be kept proportionate. Another likely effect is they would also take greater care in considering whether the prospects of success in litigation were sufficiently good to justify the support they were asked to give.

The overall message to be taken from these decisions is the funding of litigation, including by commercial litigation funders, is in principle accepted by the courts, but it is clear that there is to be a balancing act between access to justice, holding funders accountable for their investment, and also ensuring unmeritous claims are not pursued through the courts.

Lord Justice Jackson's Review and the Legal Aid, Sentencing and Punishment of Offenders Bill

Lord Justice Jackson proposed substantial reforms to costs in civil litigation matters in his report published in January 2010. His proposals covered almost every area of civil litigation ranging from small personal injury claims to high value complex commercial litigation.

He made recommendations to abolish the recoverability of after the event (ATE) insurance premiums and conditional fee agreement (CFA) success fees, introduce a form of contingency fee based on the "Ontario model", and provided an endorsement of third party funders in principle, as being a benefit to the legal costs framework.

> **Third party funding is beneficial and should be supported**
> *— Lord Justice Jackson*

In June 2011, the government announced its *Legal Aid, Sentencing and Punishment of Offenders Bill* (the "Bill"), and confirmed the government's intention to support Lord Justice Jackson's wide ranging proposed reforms.

The Bill makes a number of changes, including:

- **ATE insurance: Abolishes recoverability of ATE premium.**
- **CFAs: Abolishes recoverability of success fees.**
- **Contingency Fees: Permits damage based agreements (DBAs) in civil litigation.**

The Bill has finished its second reading in the House of Commons and is now at the Committee stage. Although the Bill seems to be moving through quite quickly, it may still be some time before any final amendments are known, and the legislation is implemented and in force.

Commercial Litigation Funding

Increasingly in the current economic climate, businesses with good claims are put off pursuing litigation due to concerns at the level of financial risk they have to undertake to pursue a claim. As an example, the costs of taking a claim to its conclusion in the courts in England and Wales are said to be three to ten times the cost in Germany and the Netherlands. Commercial litigation funders can take on a large part of the financial risk of pursuing a claim, in return for the funded claimant giving up some of the potential upside if they win their claim.

Access to justice has become a prevailing public policy concern and developing the market in commercial litigation funding can assist in addressing this issue. In this regard, Lord Justice Jackson commented "I remain of the view that, in principle, third party funding is beneficial and should be supported". He also conceded it was better for a claimant to pass over a percentage of his or her damages in a successful claim to the third party funding the litigation, than for the claimant to be unable to pursue a claim. However, this endorsement was contingent on limitations on the funder's ability to withdraw funding, or to force funded parties to settle, in ongoing litigation and the introduction of appropriate capital adequacy requirements. Further, Lord Justice Jackson recognised that the doctrines of maintenance and champerty could still cause some confusion for commercial litigation funders as to how they should properly conduct themselves.

Criticism of *Arkin v Borchard*

Although this is the pivotal case in terms of guidance for commercial litigation funders, it has attracted some criticism. This centres on the limitation on the amount of opposing party's costs a commercial litigation funder will be liable for in an unsuccessful case (where an agreement is non-champertous). The criticism was that, rather than leveling the playing field, this created an uneven playing field and could be unjust to both the opposing party and the funded client (that would have a shortfall in funds to meet its liabilities). **Lord Justice Jackson recommended that funders should be liable for the full amount of adverse costs,** and that this should not be limited to the amount of the funding investment. It was suggested that this could be achieved through new legislation.

Voluntary or Statutory Regulation?

It was recognised by Lord Justice Jackson that third party funding is still nascent in England and Wales. For this reason he recommended that a **vol-**

untary code of conduct was appropriate, but should be something that all commercial litigation funders signed up to.

The code should provide greater certainty to funders in terms of the way they can operate and the rules they must adhere to. So long as commercial litigation funders comply with whatever regulations are eventually put in place, their funding arrangements should not be overturned on the basis of maintenance or champerty.

Overall, the voluntary code is designed to ensure responsible funders and provide protection for funded parties whilst promoting access to justice. The Civil Justice Council (CJC) has coordinated the preparation of a draft voluntary code and its consultation.

In June 2011 a *Summary of Responses* to the CJC's consultation was released. Responses came from commercial litigation funders, the legal profession, and insurance industry amongst others. The majority of respondents recognised the need for regulation of third party funding and that a code of conduct was an important step forward. There was general acceptance that at this stage self-regulation was the most practical solution, but that statutory regulation may be required if the market for litigation funding were extended to consumers. Almost all respondents did not endorse the voluntary code in its current draft form. The main concern was that it did not strike the right balance between the rights of funders and claimants so that litigants were not disadvantaged. The CJC's conclusions are not expected until October 2011.

Professional funders

In 2007, the commercial litigation fund, Juridica Investments, was the first fund to list when it raised £80 million on the Alternative Investment Market (AIM), before raising a further £35 million in March 2009. Similarly, Burford Capital also listed on AIM in October 2009 raising £80 million, and then raised a further £110 million in November 2010. However, these two funds predominantly invest in disputes in the US.

Leslie Perrin, chairman of Calunius Capital LLP, another commercial litigation funder, has seen requests by claimants for funding increase. In contrast to Juridica and Burford Capital, Calunius Capital invests approximately half its funds in litigation in the UK and the other half in litigation in mainland Europe. It considers funding cases valued at six times the cost of pursuit through trial and which carry a quantum of at least £3 million and has this year raised £40 million from a private fundraising in Guernsey.

Mr. Perrin sees that commercial litigation funders play a vital role in ensuring that the "David and Goliath" situation is avoided where, for example, a cash strapped SME claimant struggles to sustain the monetary resources in pursuing a claim against a cash rich multi-national defendant. Commercial litigation funding can allow an SME to negotiate a settlement as an equal party.

Commercial litigation funders are also well placed to orchestrate group actions. The problem at the moment in forming a group action is how to ensure that a group will make appropriate contributions to be able to pursue an action. If a commercial litigation funder is brought on board, it eliminates such issues and provides appropriate funding for a group to pursue a legitimate claim which otherwise may have never taken off.

Overall, Mr. Perrin welcomes Lord Justice Jackson's comments on commercial litigation funding and adds that he sees formulating appropriate funding regimes as important for ensuring London's future as a centre for dispute resolution.

ATE Insurance and CFAs

What is ATE insurance?

ATE insurance provides cover for the legal costs incurred in the pursuit or defence of legal proceedings. It is purchased after a legal dispute has arisen. ATE insurers offer a variety of cover that is tailored to the specific needs of the client. The insurance will typically cover the client's own disbursements and perhaps most crucially its liability to pay an opponent's legal costs in the event that the opponent wins. Own costs cover can be obtained but this is less common.

Calunius Capital, as an example, often utilises ATE insurance as part of the funding package for litigation. This has resulted in a slight shift towards commercial litigation funders, as opposed to claimants, purchasing ATE insurance in respect of higher value litigation. ATE insurance providers can work well with commercial litigation funders, their only concern being to collect the premium and ultimately not to lose the case and be liable for costs.

The premium is factored into the equation when a commercial litigation funder "prices" the cost of going to trial. The risk factor in assessing chances of success at trial is obviously fundamental to a commercial litigation funder's business. ATE insurance providers are increasingly relying on the funder to carefully evaluate a case's chances of success. In fact, there is an increasing trend for commercial litigation funders to seek approval from ATE insurance provid-

ers, of the standard terms on which they agree to fund a client, in order that ATE insurance will more readily be approved.

What is a CFA?

A CFA is essentially a written agreement whereby legal fees and expenses only become payable in certain circumstances. The particular circumstances in question will depend on the type of CFA entered into.

The most common type of CFA is a "no win, no fee" agreement, which effectively provides that legal fees become payable only if the case is won. However it is important to note that out of pocket expenses paid for by the legal adviser will usually be payable in any event, and are likely to include disbursements such as counsel's fees and court fees.

CFAs ordinarily provide for a success fee which is an additional amount payable for the legal services, over and above the amount which would normally be payable if there was no CFA, usually in circumstances where the client wins the case. A success fee must be expressed as a percentage uplift on the amount which would be payable if there was no CFA.

Solicitors readily use CFAs in conjunction with ATE insurance. The net result is that the client is able to proceed with litigation while paying nothing (or paying a reduced rate) to the solicitor and nothing to the ATE insurer (i.e., the premium payment is deferred) until the conclusion of the case. If the case is won, the client will pay the solicitor the success fee, and the insurer the premium which are, until the new Bill is implemented, both currently recoverable from the losing party. If the case is lost, then the client does not pay the solicitor any success fee and the ATE insurer picks up any costs award against the client and the cost of the ATE insurance premium.

The road to reform and the impact of the *Legal Aid, Sentencing and Punishment of Offenders Bill*

Lord Justice Jackson initially reviewed whether ATE insurance premiums and CFA success fees should continue to be recoverable from the losing party. In respect of CFAs, such agreements are important for personal injury cases and there are arguments that CFAs promote access to justice and help safeguard successful claimants' damages. Solicitors and PI liability insurers are among those generally opposed to recoverability.

Flaws were identified in the overall recoverability regime such as the lack of eligibility criteria and the lack of control on costs incurred, amongst others. Lord Justice Jackson commented that it represented an "extremely expensive form of one way costs shifting". Litigation under the current rules was identified as being risk free for claimants with defendants picking up the costs.

In June 2011, the government's new Bill followed Lord Jackson's recommendation that recoverability of ATE insurance premiums and success fees be abolished, effectively re-adopting the pre April 2000 regime. Support for this change had come from the European Court of Human Rights (ECHR). The ECHR decided in January 2011, in respect of a dispute between **Mirror Group Newspapers and Naomi Campbell (*MGN Ltd v UK, Application no. 39401/04, 18 January 2011*)**, that the UK CFA regime breached European rules on human rights. The ECHR ruled that the £1 million costs the paper had to pay, which was partly the lawyers' success fees, were disproportionate. The ECHR said that the fee violated the right to freedom of expression. The ECHR was particularly influenced by Lord Justice Jackson's review and it was thought, following this decision, only a matter of time until UK legislation was drafted in line with his proposals in this regard.

Effect of proposed qualified one way costs shifting

It has been noted by some that if Lord Justice Jackson's proposal to implement "qualified one way costs shifting" in personal injury claims is taken forward by the courts (there is no reference in the Bill), this could cause an adverse effect on the insurance industry in terms of an overall loss of ATE insurance business. This is because if a claimant is protected from having to pay the defendant's costs should the claim fail, then there would be less need to purchase ATE insurance. This might have the effect of reducing the affordability/availability of ATE products required for non-personal injury claims. However, many argue that parties involved in high value commercial litigation, including commercial litigation funders, will not be put off by increases in ATE premiums or by non-recoverability. They are still likely to opt to bear the cost of purchasing ATE insurance, mainly to protect them from the greater expense of being subject to an adverse costs order. Furthermore, in respect of commercial litigation funded cases specifically, if the funders continue to carry out careful assessments of a claim's merits, and ATE insurance providers become increasingly confident in these assessments, the premium will be kept low.

ATE insurance providers

JLT Specialty Limited is a leading broker of ATE insurance products. They acknowledge that with recoverability abolished, ATE insurance premiums will become subject to market forces, with claimants shopping around more. **Chris Hammond** and **Clive Petty**, both senior consultants with JLT, believe that this will necessarily

change the role of the broker, shifting their focus to tailoring ATE products to different types of litigation and providing renewed impetus on brokering the best deals for their clients. This should bring a transparency to the marketplace.

The growth in commercial litigation funding will also necessitate a change in ATE insurance products and will see the packaging of products together with the bringing on board of a commercial litigation funder. They believe that ATE insurance will continue to play a significant role in leveraging a large proportion of the required funds to run a claim. Of more concern will be how smaller value claims (e.g. below £500,000) will be funded if ATE premiums and success fees need to be paid out of a low recovery. The concern is that good claims by, for example, insolvency practitioners who may be looking to recover funds from directors on behalf of creditors and HMRC, may not be pursued. The likelihood is also that before the event legal expenses insurance will begin to emerge as a possible alternative.

Rocco Pirozzolo is a senior underwriter at **QBE** who has been working in the ATE insurance market for a number of years and has been involved in the leading forums in the legal expenses and funding market.

Mr. Pirozzolo was delighted by Lord Justice Jackson's endorsement of third party funders. This is certainly a view shared by many, none more so than commercial litigation funders, who welcome the legitimacy that Lord Justice Jackson's endorsement has brought to commercial litigation funding, and will no doubt be pleased by the government's tacit support of the reforms as a whole. They view this as a necessary move in forging a new legal costs landscape in which commercial litigation funding plays a significant role. The one slight "pull back" on this endorsement was Lord Justice Jackson's criticism of the *Arkin v Borchard* judgment, as it to some extent shakes the certainty commercial litigation funders had in knowing that any potential adverse costs order against them would be limited to their investment.

However, Lord Justice Jackson's comments in this regard do not alter the fact that *Arkin v Borchard* is still good law. Certainly, funders do not seem to have been put off, as observers noted an increase in the commercial litigation funding market last year. Mr. Pirozzolo comments that "after Lord Justice Jackson's Review, there was a sense that the views expressed about third party funding were a mixed blessing given his criticism of the *Arkin* judgment. However, since January 2010, when his Final Report was published, there have been a number of new entrants into the market as well as a growing number of cases being funded".

Non-recoverability and any increase in ATE premium is unlikely to affect the growth of commercial litigation funding. It may make funders slightly more cautious in assessing the type of cases they take on, but this can be seen as a positive step to encourage the "responsible funders" sought by Lord Justice Jackson. Even if it is later decided by the courts that third party funders should be liable for adverse costs above their level of investment, ATE insurance can provide the necessary protection to offset this risk.

Contingency Fees

What are they?

Contingency fee agreements, in their simplest form, allow the claimant's lawyer, if successful, to receive a percentage of the overall damages recovered by the claimant. These differ from CFAs currently used in civil litigation, whereby the successful party's legal costs are paid by the losing party based on the successful party's actual costs plus a percentage uplift, i.e., the success fee.

The road to reform and the impact of the *Legal Aid, Sentencing and Punishment of Offenders Bill*

It was considered by Lord Justice Jackson whether contingency fees should be permitted for contentious business. Such regimes are permitted in a number of overseas jurisdictions, perhaps most notably in the US. Lord Justice Jackson recommended that something akin to the Canadian "Ontario model" should be adopted in the UK. The new Bill introduces DBAs in civil litigation, a form of contingency fee agreement, based on the "Ontario model".

DBAs mean the lawyer's fee is related to the damages awarded, as opposed to the work done by the lawyer and the government will lift the restriction on their use in civil litigation. Successful claimants will recover their base costs (the lawyer's hourly rate fee and disbursements) from defendants, whether funded under a CFA or otherwise, but in the case of a DBA, the costs recovered from the losing side would be offset against the DBA fee, reducing the amount payable by the claimant to any shortfall between the costs recovered and the DBA fee.

A number of recommendations were made by Lord Justice Jackson to address the impact this would have on the net damages the client would actually receive, including increasing general damages awards. He recognised the need to implement such safeguards to control the proportion of damages that can be taken and prevent unfair terms and conditions being applied. Although there is no specific mention in the Bill, it is expected that a

10 percent uplift on general damages, the figure put forward by Lord Justice Jackson, will be delivered by judges through case decisions.

Overall, it seems the government agrees with Lord Justice Jackson that the potential benefits of permitting contingency fees in carefully targeted areas of litigation, outweighs any potential pitfalls. Whilst some see this as a useful additional form of funding for claimants, others are concerned this might represent another step to further changes that will give rise to a far more litigious environment in the UK.

The Future

Commercial litigation funding is likely to continue to play an important role in the legal costs landscape, especially in light of the changes to be brought about by the *Legal Aid, Sentencing and Punishment of Offenders Bill*. Many see commercial litigation funders as an important contributor to ensuring better access to justice. Those who have reservations that such funding might lead to the creation of "super claimants" may take comfort from the self regulatory code currently in the hands of the CJC, designed to ensure responsible funders. Further, it should be noted that it is in commercial litigation funders' interests to ensure that they only take on claims that have a good prospect of success that will allow them to turn a profit for their investors.

Some do however see potential dangers around the corner, not least the arrival of the *Legal Services Act 2007* (the "Act"). There is concern that the potential to secure external investment as a result of the Act could lead to a rise in the number of "claims companies" that will be quick to adopt the commercial litigation funding model, including targeting lower value claims, with the potential to increase the number of unmeritous actions that are pursued through the courts.

Debate has also arisen on whether commercial litigation funding and contingency fee arrangements can work alongside each other. Certain commentators believe that with contingency fees available, there will be no need for commercial litigation funding which is currently restricted in its availability to high value commercial claims (with funders needing to ensure they maximise the chances of securing a good return for their investors). Contingency fees by contrast can cater for a broad spectrum of litigation and the introduction of alternative business structures as of October 2011 allowing greater capital risk taking, may encourage legal firms to pursue more litigation on a contingency fee basis. In other jurisdictions such as the US, contingency fees and commercial litigation funding successfully co-exist, giving potential litigants the option to choose the most appropriate funding method for their case.

The changes being implemented by the government mark a tentative first step down the road of an erosion of one way costs shifting and the "loser pays" principle, particularly in abolishing recoverability of CFA success fees and ATE insurance premiums. Some quarters voice concerns that the eventual effects of the Bill coinciding with these other changes to the legal costs and funding system marks the beginning of a slide towards a "US style" claims culture. It is, however, too early to tell. For now, we note certain things to watch out for in the near future:

- **The CJC's conclusions on voluntary code for commercial litigation funders: capital adequacy requirements or other safeguards to be prescribed in the expected redraft.**
- **The *Legal Aid, Sentencing and Punishment of Offenders Bill*: amendments to the provisions of the Bill once read by Parliament.**
- **The Arrival of the Legal Services Act 2007: the impact of alternative business structures in October 2011.**

Contacts

Ed Smerdon
Partner
edward.smerdon@sedgwicklaw.com
Tel: +44 207 398 8927

Simon Fish
Associate
simon.fish@sedgwicklaw.com
Tel: +44 207 398 8934

Sedgwick London
Fitzwilliam House, 10 St. Mary Axe
London EC3A 8BF, England
+44 207 929 1829 t
+44 207 929 1808 f
www.sedgwicklaw.com