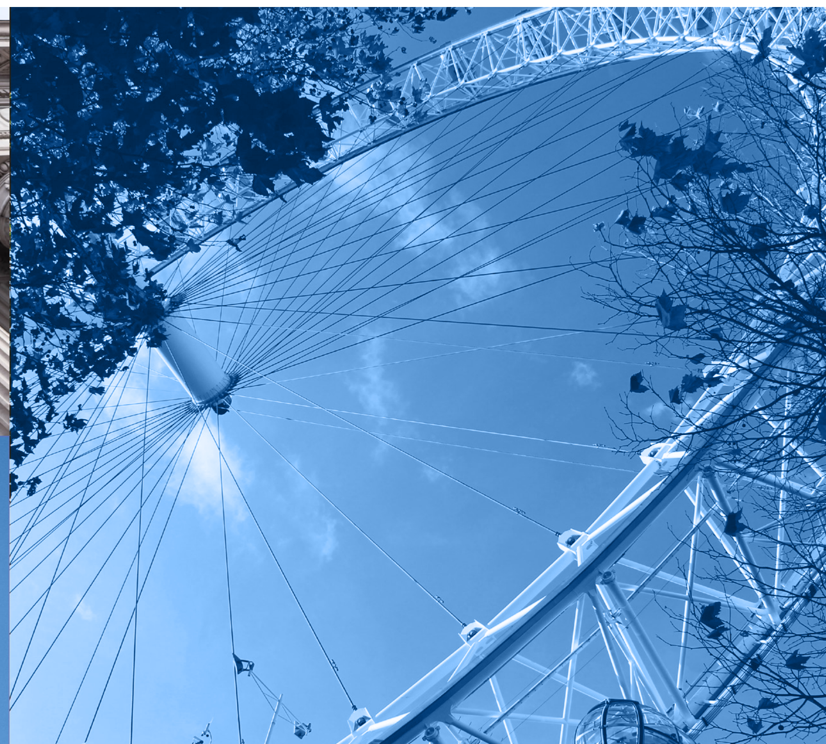
Sedgwick LLP

Litigation Funding and Its Implications for US and UK Insurers



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Litigation funding is growing rapidly with the emergence of new funds and wealthy individuals willing to back cases in an ever-expanding number of jurisdictions, including in the US and the UK. It is enabling claims to be brought by private individuals and small to medium sized companies with limited resources. It is being used by large, publicly listed companies as a source of working capital for claims, a tool for managing their legal spending, and a means of moving the costs off their balance sheets.

The involvement of funders is having an impact on insurers' approach to cases backed by them and the tactics used in defending such claims.

In this article we provide an overview as to how litigation funding operates, consider its global use, and discuss the specific implications for US insurers and UK insurers.

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OVERVIEW

What is litigation funding?

Litigation funding is the financing of claims by third parties such as investment funds and wealthy individuals. Until recently, it was almost always provided by law firms running cases on a contingency basis whereby their fees were only payable if the cases succeeded.

Contingency-based agreements are popular in the US, particularly in consumer class actions such as product liability claims brought against pharmaceutical companies. Conditional fee agreements have fallen out of favor in the UK since 2013, when reforms were introduced which prevented plaintiffs from recovering their lawyers' success fees from defendants. Whilst damages-based agreements, whereby a plaintiff's lawyer takes a cut of any damages recovered, were introduced in the UK as an alternative, their take-up has been limited as there are restrictions on their use which make them less attractive for lawyers.

Who are litigation funders and what are they funding?

Litigation funders are usually investment funds that pay a plaintiff's costs of bringing a claim in return for a share of the proceeds. Most professional funders like to incentivize lawyers through modified forms of contingency-based agreements which include provisions for uplifted hourly rates if cases are successful.

Many of the largest funds are based in the US, including Burford Capital, which recently acquired another fund, Gerchen Keller, for $175M. There are large funds in the UK, such as Calunius, which has just completed a £100M fund-raising round. Australia, which was at the forefront of litigation funding, is the home of Sydney-based IMF Bentham, which recently launched a £200M vehicle to fund US cases.

There are some wealthy individuals who back cases on an ad hoc basis often for personal reasons. In those cases, they often have little interest in the amounts recovered.

The co-founder of PayPal and early Facebook investor, Peter Thiel, backed Hulk Hogan's case against Gawker regarding its publication of salacious videotapes. The former president of Formula One, Max Mosley, supported a number of phone hacking cases brought against UK newspapers that illegally obtained unauthorized access to voicemails left on celebrities' mobile phones.

Private citizens are using crowdfunding platforms to help fund cases in the US and the UK. In the US, charitable and political organizations often create crowdfunding events to facilitate the support of litigation addressing political and social issues, such as voting rights or immigration. These crowdfunded litigations differ from other types of litigation funding in that they do not seek a return on investment.

Jill Stein, the Green Party nominee for US president in the 2016 election, quickly raised over $4.5M through crowd-funding for recount challenges in several battleground states. The successful challenge to the UK government's decision to trigger Article 50, which starts the UK's formal exit process from the EU, without a parliamentary vote was supported by £170,000 in crowdfunding.

Some startup companies in the US are facilitating crowd-funding litigation as a form of investment, including Lexshares, Trial Funder and Invest4Justice. Invest4Justice has received pledges exceeding $3.2M since it was founded in early 2014.

How does litigation funding work?

Litigation funds pay a plaintiff's legal costs on a non-recourse basis in return for a fee payable from the amounts recovered. This fee can be a percentage of the damages received, a multiple of the funding provided or a hybrid of the two.

In the UK case of ***Norscot v. Essar [2016]***, which was backed by a UK fund, Woodsford, the litigation funding fee was the higher of 300 percent of the funding provided (£647,000), or 35 percent of the damages recovered. The amount ultimately paid to Woodsford was £1.94M.

There is typically a litigation funding agreement in place between the funds and the plaintiffs detailing the terms on which finance is provided, and the grounds on which it can be withdrawn. Additionally in the US, the funder will often require the plaintiff to enter into a non-disclosure agreement in an effort to protect the terms of the funding agreement from the defendant and potentially the court.

Withdrawal is usually only permitted where there is a significant change in the prospects of a claim succeeding, and the enforcement of any judgment obtained. In the UK, this occurred in ***Harcus Sinclair v. Buttonwood [2013]*** where the funder was permitted to terminate the funding agreement having reasonably formed the view that the chances of the claim succeeding had fallen below 60 percent.

Funding is provided to private individuals, small to medium-sized companies with limited resources and also large publicly listed companies. They use it as a source of working capital for claims, a means of moving the costs off their balance sheets and a tool for managing their legal spending.

Funding is not always in place from the start of a case. Funders often come in at a later stage, once the merits are clearer or assistance is required.

In the UK, plaintiffs sometimes seek assistance where they are required by the courts to provide security for a defendant's costs if their claim is unsuccessful. In the US bankruptcy courts, trustees have utilized litigation funders to support ongoing efforts to recover monies, and thereby increase the size of the estate available to repay creditors.

How do litigation funders assess claims?

Professional funders take a cautious approach in deciding whether to finance claims as they only make a return where the cases they back are successful. Factors they typically consider include:

- The quantum of a claim and its realistic value taking account of arguments as to quantum and causation. It is unusual to see them backing cases worth less than a seven-figure sum.

- The claim's merits and the likelihood of a successful outcome. As this is easier to assess where written evidence is central to the merits, they are more willing to back such claims than those cases where oral testimony or expert evidence is likely to be significant.

- The defendant's ability to meet a judgment, and whether there is likely to be any insurance in place. Cases against insurance backed defendants, large corporations such as banks, and successful technology companies are more attractive for professional funders.

- The time it may take to obtain a judgment and enforce an award. This is a particular focus where judgments would have to be enforced in less sophisticated jurisdictions.

- The likely costs of backing the case, any adverse costs they could be liable for and the risk of an overrun. In the UK, where adverse costs are an issue, they may look to take out "after the event" (ATE) insurance to protect against this risk. In the US, there is little need for such insurance as parties are not entitled to recover costs unless specifically provided for by statute or contract.

The UK case of ***Excalibur v. Texas Keystone [2016]*** illustrates why professional funders carry out due diligence before investing in cases. In this claim, a collection of wealthy individuals and investment funds were persuaded by a Clifford Chance partner to provide $50M for a £1.6B dispute concerning the ownership of a Kurdish oilfield. He advised them that this was the best case he had seen with a 90 percent chance of success. The case failed on every point and the funders were ordered to pay the defendant's costs, which were in excess of £20M.

How are litigation funders regulated?

In the US, the courts and regulators are still grappling with the ethical and logistical implications presented by litigation funding. Some jurisdictions are starting to address the possibility of implementing disclosure requirements for matters being funded by a third party. The existence of litigation funding is a hot topic for discovery disputes and related motion practice.

Regulators have commenced actions against funders challenging their business models, including the legality and appropriateness of the rates charged to consumers. Funders have challenged the power and reach of these regulators, including in actions brought by the New York Attorney General, and the US Consumer Financial Protection Bureau.

In the UK, there are relatively few restrictions on litigation funders' involvement in cases other than the doctrines of champerty and maintenance which prohibits funders from taking full control of claims. The use of litigation funding has been broadly welcomed by the courts, which consider it is in the public interest. There are settled rules on when the identity of funders should be disclosed, and their liability for defendants' costs where they back unsuccessful actions. Regulators seem content, at present, with the self-regulatory system, set up by the Association of Litigation Funders, which most major litigation funds adhere to.

GLOBAL USE OF LITIGATION FUNDING

US

In the US, litigation funding is still at an early stage, with contingency fee agreements with law firms the most popular option. The ability of a litigant to enter into litigation funding arrangements differs on a state-by-state basis. The common law offenses of maintenance and champerty are prohibited in 15 states.

Minnesota's Court of Appeals has held that repayment of a litigation loan is dependent upon a plaintiff's recovery in that litigation, that loan is champertous (***Johnson v. Wright***, Minn. Ct. App. 2004). In Pennsylvania, the doctrine of champerty continues to be viable and can be raised as a defense (***Fleetwood Area School Dist. v. Berks County Bd. of Assessment Appeals***, Pa. Cmwlth. 2003). In Arizona, personal injury and wrongful death claims are not assignable because of the increased risk of promoting maintenance and champerty (***Lingel v. Olbin***, AZ Ct. Ap. 2000).

At least 28 states and the District of Columbia, however, permit litigation funding with certain limitations, including Delaware, New York and California.

Delaware state courts have advised litigation funders of specific pitfalls that would place funding agreements in violation of the state's champerty, such as: the assignment of the legal claim, the right to control the litigation and the right to settle the litigation (***Charge Injection Tech., Inc. v. E.I. DuPont de Nemours & Co.***, Del. Super. Ct., 2016). Likewise, the New York Court of Appeals has defined champerty as the purchase of notes, securities or other instruments or claims with the intent and for the primary purpose of bringing a lawsuit. However, the NY court provided the "safe harbour" provision of **Judiciary Law §489(2)**, which exempts the purchase or assignment of notes or other securities from being champertous when they have an aggregate purchase price or bona fide legal obligation to pay, at least $500,000 (***Justinian v. WestLB AG***, NY 2016).

Litigation funding is primarily utilized to support large-scale commercial litigation, specifically complex business and IP disputes. Funding is commonly utilized in contract, trade secrets, international arbitration, antitrust and patent litigation with them helping to defray the high costs of litigating these types of claims while potentially sharing in a portion of the comparatively high awards issued via the courts. Although litigation funding can be used to finance securities claims in the US, the majority of securities claims are funded directly by well-established plaintiffs' law firms with sufficient capital to shoulder the costs of litigation. Litigation funding is also used in bankruptcy litigation.

The US Court of Appeals for the Second Circuit recently affirmed a judgment obtained by the trustee for Magnesium Corp. of America against Ira Rennert and The Renco Group, the holding company of Magnesium Corp. and its founder, following a jury verdict holding Rennert and Renco liable for looting Magnesium Corp. to pay for personal expenses. Gerchen Keller provided $26.2M in financing to the trustee, and within six months, received a $50M share of the $213M judgment recovered.

The US is also seeing a trend in favour of investing in pools of cases, not just a single claim. Pool investing allows the litigation funder to invest capital across several distinct cases a law firm might be handling, which also diversifies the risk to the funder. In exchange, the funder usually obtains a percentage return of those receivables yielded from the pool of matters.

UK

In the UK, the involvement of professional funders has fuelled all the large securities claims with cases brought in the last couple of years against two banks, RBS and Lloyds, which nearly collapsed during the 2008 financial crisis, and Tesco, which had to restate its profits in 2014 due to the use of inappropriate accounting practices. They have provided the backing for the £14B antitrust class action filed against Mastercard under the **Consumer Rights Act 2015** in relation to its interchange fees.

They are also providing capital for claims brought by large publicly listed companies, including the UK's largest telecommunications company, BT.

BT recently signed a deal with Burford Capital. Burford is providing over £30M of funding, for a portfolio of 10 cases, which BT wants to pursue.

They have also financed a significant amount of commercial litigation in both the courts and in arbitration, including ***Arkin v Borchard Lines Ltd [2003]***, a shipping dispute. Their involvement has also been identified in some professional negligence claims.

In ***Thwaytes v. Sotheby's [2015]***, UK fund Harbour backed the unsuccessful plaintiff in a case concerning the disputed provenance of a Caravaggio painting that Sotheby's considered was attributable to another lesser-known artist.

Americas

In Canada, litigation funding is often used to back class actions with funders including private equity firms and public sources, such as the Ontario Class Proceedings Fund. It has had little impact in South America other than in some very large energy and pollution disputes.

A South American claim backed by professional funders was a pollution case against Chevron. In 2011, the plaintiffs obtained a $9.5B judgment against Chevron in Ecuador for alleged contamination resulting from crude oil production. In 2014, the US court for the Southern District of New York ruled that this judgment was unenforceable as it was the product of the fraud and racketeering. This led to all of the funders, including Burford Capital, withdrawing their backing.

Australia

Litigation funding is the principal source of third-party funding in Australia, where it took off. It covered a gap in the market that had arisen as a result of the prohibition on Australian lawyers undertaking litigation on a contingency basis. One of the largest funds, IMF Bentham, has its roots in Sydney. It is used to back most of the large class actions filed in Australia, and is a regular source of finance for commercial litigation and insolvency claims.

The cases backed by funders in Australia include a claim against Lloyd's underwriters concerning water damage to business premises. They are also providing support for a class action in New Zealand against insurers which concerns the property damage caused by the Christchurch earthquake in 2011.

Asia

Its use is limited in Asia with many countries having strict rules that prohibit its use, or legal systems which are not seen as independent. It is allowed in the DIFC Courts in Dubai, subject to certain disclosure requirements. Recent legislative changes in Singapore which allow third-party funding for international arbitrations, and the proposed introduction of similar reforms in Hong Kong, should open the door to litigation funding in those jurisdictions.

In ***Al Khorafi v Bank Sarasin [2009]***, a UK fund, Vannin, provided financial support for a successful misselling lawsuit in Dubai brought by three members of a prominent Kuwaiti family against a Swiss bank concerning the sale of $200M of structured financial products.

Europe

Its influence is growing in Northern Europe, with professional funders backing European securities claims, including the shareholder action against VW in Germany, and targeting Scandinavia as a growth area given its less restrictive approach. The caps in most European countries on the amount of adverse costs a plaintiff can be ordered to pay if its claim is unsuccessful, are an attractive factor for funders.

Some funders in Belgium, Germany and the Netherlands are prepared to purchase claims directly from potential plaintiffs to get round existing restrictions. Such cases usually involve anti-trust issues, such as price fixing.

IMF Bentham is looking to fund a potential $110B damages claim against Europe's biggest truck manufacturers following the EU Commission's finding that those manufacturers engaged in price fixing, and colluded in passing onto customers the costs of complying with strict EU emission rules.

There have been few reports of its use elsewhere in Europe, even in countries such as France where it is allowed in certain cases. In Ireland, professional funding is still considered illegal although there is a possibility this may change as the Irish Supreme Court is due to hear a case concerning this issue.

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IMPACT OF LITIGATION FUNDING – US

Cases supported by funders	Terry Bollea (Hulk Hogan), invasion of privacy claim against Gawker Media. SAC Capital Advisors securities class action stemming from insider trading convictions with a $135M settlement pending court approval (***Kaplan v. SAC Capital Advisors*** SDNY, 2015). Breach of fiduciary duty claims by bankruptcy trustee for Magnesium Corp. of America against former owner and investment fund.
Alternatives to litigation funding	While its prevalence is growing, litigation funding is less prolific in the US, as litigation follows the American rule, where each party bears its own cost. Due to this, there is little need for funding to cover any adverse costs risk. In addition, most states in the US allow contingency fees. Contingency fee agreements have to state the method by which the fee is to be determined, including the percentage payable to the lawyer in the event of settlement, trial or appeal, the litigation and other expenses to be deducted from the recovery, and whether such expenses are to be deducted before the contingent fee is calculated. The agreement must notify the client of any expenses for which the client will be liable in any event (***Model Rules of Prof'l Conduct R. 1.5***).
Claims management	In many US states, courts recognize the doctrine of champerty, holding that funders may not take over a claim with the intent and for the primary purpose of bringing a lawsuit (***Justinian v. WestLB AG***, NY, 2016). As such, funders are often prohibited from exercising direct control over the litigation. This limitation is not universal as states such as Arizona, California, Connecticut, New Jersey, New Hampshire, New Mexico and Texas never adopted the champerty doctrine. Some courts that have adopted champerty have applied the following principles in order for funders to avoid violations of the champerty and related doctrines: (i) the agreement does not assign ownership of the legal claim to the funder; (ii) the funder does not have any right to direct or control the litigation; and (iii) the party bringing the claim retains the total and "unfettered" right to settle the litigation at any time and for any amount. See, for example, ***Charge Injection Tech., Inc. v. E.I. DuPont de Nemours & Co***. (Del. Super. Ct., 2016). However, in ***WFIC, LLC v. LaBarre*** (Pa. Sup. Ct., 2016), the litigation funding agreement was champertous and, therefore, void and unenforceable as the funders were unrelated parties who had no legitimate interest in the underlying litigation.
Approval of settlements	The decision to settle a claim belongs solely to the plaintiff. Funders, however, may be able to structure funding agreements to encourage the plaintiffs to consider settlement within a range of values or at certain points during the litigation.
Disclosure of funding	In the majority of US jurisdictions, disclosure of third-party funding is not mandatory, and is addressed on a case by case basis usually via motion practice. For example in ***Kaplan v. S.A.C. Capital Advisors, L.P.*** (SDNY, 2015), the production of funding documents was not required as they were irrelevant to the case. However, in ***Gbarabe v. Chevron Corp.*** (ND Cal, 2016), the court compelled the production of the confidential litigation funding agreement, holding that it was relevant in order to evaluate the adequacy of class counsel as the pleadings indicated it was two attorneys without a formal office or support staff. The US District Court for the Northern District of California is the only jurisdiction that requires the automatic disclosure of third-party funding agreements. However, this only applies to proposed class, collective or representative actions (***N.D. Cal. Standing Order On Contents of Joint Case Management Statement***). Amendments to the Federal Rules of Civil Procedure have been proposed to the Advisory Committee, but are not under formal consideration. The Committee last addressed litigation funding in December 2014, when it stated that the questions raised by third-party financing are important, but have not yet been fully identified.

Handling cases supported by funders	Evaluating the viability of attacking the funding directly via a jurisdiction's recognition or codification of the common law doctrines of champerty and maintenance. Discovery requests related to funding and challenges to adequacy of class counsel, when funding is in place. Early settlement offers. Although a funder cannot force a decision regarding settlement, its presence should not be discounted when determining both the amount and timing of a possible settlement offer.
Defendant's costs recovery	Under the American Rule, parties are not entitled to recover costs incurred during litigation unless specifically provided for by statute or contract.
Funders' costs recovery	A funder's only avenue of recovery is through a successful claim by a plaintiff. Many litigation funding agreements in the US provide for the funders to be the "first money" out with regard to a settlement or judgment amount.
Implications for Insurers	The increased use of third-party funding may extend the lifecycle of litigation, which may lead to increased exposure for insurers defending those matters, including higher settlement costs. The funder's financial interest in funded cases, may lead to an increase in settlement demands. Insurers may be able to analyze settlement terms involving third-party funding to determine if the amount payable to the third-party funder falls under the policy's definition of "Loss." As litigation funders grow in size, they may be the subject of various professional liability claims, as well as claims associated with disputes regarding the enforcement of the litigation funding agreements with their clients.
Use by Insurers	There is presently no bar on insurers accessing litigation funding. It is a potential option for commercial disputes and subrogation claims.
Possible future developments	US courts may begin to more uniformly address disclosure issues surrounding third-party funders. Presently, most courts address such issues on a case-by-case basis, with only a small minority of jurisdictions employing a standardized statutory scheme. As third-party funding becomes more prevalent, more jurisdictions, including under potential revisions to the Federal Rules of Civil Procedure, may establish statutory provisions mandating the disclosure of third-party funding. There may be an increase in adversary proceedings brought by bankruptcy trustees in the US, which may not have been pursued as vigorously without access to the alternative capital sources provided by funders.

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IMPACT OF LITIGATION FUNDING – UK

Cases supported by funders	RBS and Tesco securities claims, Mastercard antitrust litigation, Brexit case, Sotheby's Caravaggio dispute and a portfolio of BT claims.
Alternatives to litigation funding	Damages-based agreements whereby a plaintiff pays its lawyers a percentage of the damages recovered in a claim (capped at 50 percent) and contingency agreements whereby a plaintiff pays its lawyers an uplift on their fees upon a successful conclusion. For both damages-based agreements and contingency agreements, no fees are payable if a claim is defeated. As such agreements don't cover a defendant's costs, they are usually taken out with 'after-the-event' insurance policies that pay out where claims are not successful.
Claims management	Funders are not allowed to take full control as this is still seen in English law as a breach of the rule against maintenance and champerty, which is not permitted. If a funding agreement is found to breach this rule, the consequences are that the agreement is void and unenforceable as a matter of public policy. Funders, therefore, typically seek to exercise indirect control often through directing plaintiffs to use law firms they have a good relationship with, and their involvement in the settlement process.
Approval of settlements	The terms of the funding agreements give funders a significant amount of influence. The agreements used by most major funds, provide that plaintiffs are not able to agree settlements without their consent unless a supportive opinion is obtained from an independent QC.
Disclosure of funding	Plaintiffs are not obliged to disclose the source of their funding. Where there are doubts as to their ability to pay a defendant's costs if their lawsuits are unsuccessful, security for costs applications can smoke them out, as the courts can order the disclosure of the identity of the funders (***Wall v RBS [2016]*** and ***RBS Rights Issue Litigation [2017]***). The courts, however, will not order the production of funding agreements (***Reeves v Sprecher [2007]***).
Handling cases supported by funders	Engaging strongly on the merits of a case at an early stage. Given the importance funders place on written evidence, challenging it may cause them concerns, particularly if unseen material adverse to a plaintiff's case can be produced. Early settlement offers. Funders are likelier to sign off on lower settlements at an early stage before substantial costs have been incurred. Considering raising coverage-related issues, such as policy limits and the potential application of conduct exclusions, where appropriate and agreed with the insured.
Defendants' costs recovery	Defendants and their insurers can recover defence costs from funders. The percentage of costs awarded is usually higher as the courts often order funders to pay a defendant's costs on an indemnity basis, which typically enables defendants to recover over 80 percent of their costs, as in ***Excalibur v Texas Keystone [2016]***.
Funders' costs recovery	In court proceedings, funders can only recover their litigation funding fees from the plaintiffs if the claims are successful. The costs recoverable from defendants are limited by the ***Civil Procedure Rules*** to the plaintiffs' own legal fees (***CPR 44.1***). The ***Arbitration Act 1996*** gives arbitrators the power to order defendants to pay the plaintiffs' litigation funding fees, as part of the plaintiffs' legal or other costs (***Section 59(1)(c)***). Such awards are only made in exceptional cases where a defendant's conduct is egregious, such as in ***Norscot v Essar [2016]***.

Implications for Insurers	The increased role of funders is likely to increase the costs of defending claims as plaintiffs are in a better financial position to run their cases through to trial. It will add complexity to the settlement process as more parties have a financial interest in case outcomes. This is likely to affect the claims handling process, including the setting of reserves. Litigation funders will need to obtain their own insurance to provide cover for shareholder disputes, claims arising out of the provision of their services and lawsuits regarding the enforcement of the litigation funding agreements with their customers. There may be arguments as to whether a policy would cover a plaintiff's litigation funding fee that an insured is ordered to pay. This could depend on how "Loss" is defined in the policy wording.
Use by Insurers	There is no bar on insurers using litigation funding. It is a potential option for commercial disputes and subrogation claims.
Possible future developments	Use of litigation funding is likely to grow as companies become more aware of it. Companies may consider using their litigation assets as collateral for financing. It is conceivable they may look at entering into arrangements with funders whereby they are paid to take over the costs and liabilities of defending claims, if such arrangements provide accounting or tax benefits. A more frequently tapped resource in coverage disputes. The ***Enterprise Act 2016***, which allows policyholders to seek damages for the late or non-payment of valid insurance claims for policies entered into on or after 4 May 2017, may make financing such actions a more appealing proposition for funders. Opt-out class actions which are currently limited to anti-trust lawsuits, could be extended to other types of claims, such as securities actions and product liability cases. This would be consistent with the US and other jurisdictions. As such actions are expensive, it is likely funders would provide the backing for many of them. It is possible the ***Civil Procedure Rules*** could be altered to allow plaintiffs to recover litigation funding fees from defendants in court actions. This would probably be restricted to a limited category of claims.

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