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Lending Strategies

Overview of Relevant Laws and Considerations for Pursuing a Third-Party Litigation Funding Strategy

By Boris Ziser and James E. McGuire, *Schulte Roth & Zabel*

Over the past two decades, third-party litigation funding (*i.e.*, litigation finance, legal finance or alternative litigation financing) has become common in the U.S. legal sector. As individual claimants, commercial claimants and attorneys become increasingly familiar with the practice, capital markets players have taken notice. The result is that an estimated $12.4 billion in assets under management was committed to U.S. litigation financing strategies as of the end of 2021.

The increased popularity of third-party litigation funding can be attributed to several factors, including attractive returns and the uncorrelated nature of the investment. Fund managers should be aware, however, that third-party litigation funding is not a "one-size-fits-all" investment. Instead, it involves bespoke situations with a multitude of different investment opportunities, structures and considerations.

This article provides a primer on third-party litigation funding to both commercial claimants and law firms. Specifically, the article delves into the primary features of each type of litigation funding; the regulatory landscape at both the state and federal level for funders to navigate; and practical considerations for funders to weigh.

For more on another uncorrelated investment type, see our three-part series on contingent dislocation funds and market disruptions: "Appeal, Application and Adoption Before Adverse Events" (Mar. 15, 2022); "Unique Mechanisms That Position Them to Pounce" (Mar. 22, 2022); and "Suitable Fund Participants and Potential Downsides to Avoid" (Mar. 29, 2022).

Introduction

Third-party litigation funding broadly refers to a situation in which a third party, which otherwise has no interest in a dispute between two or more parties, provides one party, a group of parties or their respective counsel with capital to assert rights, seek remedies and prosecute a claim for dam-

ages in connection with a dispute. Litigation funding can apply to judicial decisions, settlement proceedings, arbitration hearings or other types of disputes.

There are various ways that types and structures of third-party litigation funding can be categorized and delineated. One prominent category is consumer litigation funding, which involves individual claimants seeking monetary damages for personal injuries, property damage or other similar disputes. More relevant to the private funds industry, however, is commercial litigation funding, to which an increasing amount of new money has been allocated over the past five years.

Commercial litigation funding describes transactions in which a third-party litigation funder provides funding to either:

1. *Commercial Claimant Litigation Funding*: a claimant to pursue monetary damages and other potential relief (*e.g.*, protection of a trademark or patent) in connection with a commercial claim held by the claimant; or
2. *Law Firm Litigation Funding*: a law firm to pursue claims on behalf of its clients.

Commercial Claimant Litigation Funding

In Commercial Claimant Litigation Funding, the funder enters into the transaction directly with a claimant that holds a claim against one or more possible defendants.

The claim held by the claimant is typically expensive to prosecute, and the claimant either does not have the resources or liquidity to prosecute the claim itself or is hesitant to assume the risk of incurring the expenses necessary to prosecute its claim for the ultimate reward (which could take years to realize, assuming it will be successful at all). Therefore, the proceeds of the funding are often used to pay the claimant's legal fees and expenses. The funder typically agrees to provide capital to the claimant in consideration for a portion of the recoveries if the claim is successful.

The transactions are typically non-recourse, however, meaning that the funder does not receive anything – including its invested capital – if the case does not generate any recovery. Adding to the complexity of underwriting the investment, the funder is not permitted to have control over the litigation. Instead, the decisions must rest with the claimant and its counsel.

Law Firm Litigation Funding

In the other type of commercial litigation funding – Law Firm Litigation Funding – a funder enters into a transaction directly with a law firm that is prosecuting a variety of claims for a variety of claimants on a contingent-fee basis. The funder agrees to fund either the whole law firm or a portion of its case portfolio, with the funding secured by all or a portion of the contingent fees, litigation expense receivables and other amounts payable to the law firm from those cases. Law Firm Litigation Funding transactions are commonly non-recourse to the law firm or its principals absent certain specified events.

See "In Turbulent Markets, Fund Managers Turn to Litigation Funding for Absolute, Uncorrelated Returns" (Jun. 24, 2009).

Regulatory Landscape

There is no national, comprehensive framework in place that is specifically designed to regulate third-party litigation funding. That has led to an impression held by certain observers that the industry is largely unregulated or susceptible to abuse. That could not be further from the truth, however.

In addition to state and federal lending laws that are generally applicable to credit transactions, third-party litigation funding is subject to:

- disclosure requirements in certain states and jurisdictions;
- common law doctrines in certain states; and
- the professional and ethical rules that apply to the attorneys involved in the transactions.

Common Law Standards

English common law has historically been wary of the potential risks to the legal system – *e.g.*, from frivolous litigation and vindictive/punitive legal actions – of non-interested parties providing funding to claimants and practitioners. That uneasiness can be traced back to medieval England, where feudal lords and members of the aristocracy commonly used the legal system to damage their rivals by soliciting and funding meritless claims against them.

The doctrines of maintenance, champerty and barratry evolved as an attempt to curtail those risks. According to Victoria Shannon Sahani, professor of law at the Arizona State University Sandra Day O'Connor College of Law, "Maintenance is about people who are not party to a legal case providing funding for that case, and champerty is maintenance for a profit." In that vein, barratry is a common law doctrine criminalizing the institution of repeated/persistent legal claims for purposes of profit or harassment and the encouragement thereof, or, as described by the U.S. Supreme Court, "barratry is a continuing practice of maintenance or champerty."

Although many states in the U.S. have either elected to not adopt those doctrines or have abandoned them, some states continue to enforce champerty and maintenance and all states enforce some form of barratry.

State Disciplinary Rules

Each state also has disciplinary rules that apply to the attorneys who are licensed to practice law in that state. Importantly, lawyers appearing in a case may be licensed in another state under a practice called "pro hac vice," but they must agree to act in accordance with and be subject to the disci-

plinary rules of that applicable state. That agreement subjects the lawyer to the disciplinary rules of the jurisdiction in which the adjudicating tribunal sits.

As disciplinary rules apply to lawyers and not funders, one might ask whether funders should care. To state the obvious, any threat to the prosecution of a funded case, whether funded directly or via the law firm, is a threat to the funder's investment. Specifically, violation of state professional and ethical standards can result in a law firm or its attorneys:

- being unable to practice law;
- being unable to receive legal fees; and/or
- diminishing the reputation/goodwill of the law firm, which could cause clients to seek alternative counsel or lead to other negative consequences.

Model Rules of Professional Conduct

Although professional and ethical standards vary among states, the vast majority are based on the Model Rules of Professional Conduct (MRPC) published by the American Bar Association. Although all of the professional and ethical standards are important, the following are some of the key rules of the MRPC – or variations thereof that exist in any applicable state – that are relevant to third-party litigation funding transactions.

Rule 1.5

Rule 1.5 of the MRPC relates to the reasonableness of attorneys' fees, how an attorneys' fees should be split among the various attorneys representing a claimant and the information that must be provided to a client in respect thereof. The law firm is relying on its attorneys' fees to repay its indebtedness to the funder – and, of course, the funder is relying on the fees to be paid – so any violation of Rule 1.5 may jeopardize the law firm's ability to fully recover its fees and thus jeopardize the funder's investment.

Rule 1.6

Rule 1.6 of the MRPC relates to the confidentiality obligation of attorneys for information received from a claimant or another source that relates to or arises in the attorney's representation of the claimant.

Essentially, in the absence of the client's informed consent (as defined in Rule 1.0(e)), the lawyer must keep information relating to the representation of clients confidential. Although funders generally require information from law firms to value the cases and track their progress, that information is often general and aggregated so as to not violate the attorney-client privilege or similar doctrines. For any other information about a claimant's case that is required by a funder, the law firm must obtain the claimant's consent to sharing that information.

See “Making the Most of a Contractual Advice-of-Counsel Defense” (Apr. 12, 2022); and “Preserving Privilege in Audits and Internal Investigations” (Oct. 13, 2020).

Rule 1.15

Rule 1.15 of the MRPC sets forth attorneys’ duties as to client funds and third-party funds, and it requires those funds to be maintained in trust for the recipient thereof and segregated from the law firm’s other funds in a manner that renders them easily identified and properly safeguarded. Collection systems for third-party litigation funding transactions should be designed to comply with Rule 1.15 while also providing for sufficient safeguards against risks to the funder (*e.g.*, inadvertent diversion of funds and outright fraud).

Rule 2.1

Rule 2.1 of the MRPC requires attorneys to exercise independent professional judgment and render candid advice when representing a client. Similarly, Rule 5.4(c) prohibits a lawyer from taking direction from a third party that pays the attorney to render legal fees to a client.

Funders should not attempt to have – and litigation funding agreements typically prohibit the Funder from having – control over decisions relating to a case or client. That extends to matters such as legal arguments, procedural decisions, settlement decisions, whether to appeal a judgment, whether to cease representation of a client and the like.

Rule 5.4

Among other things, Rule 5.4 of the MRPC prohibits attorneys from sharing legal fees with non-attorneys except in certain situations and is intended to prohibit “express traditional limitations on fee sharing.” The rule itself is vague and, if read to its most extreme, would prevent a law firm from being able to conduct its day-to-day operations, as any service or product purchased by a law firm must necessarily be with the fees it generates as income. Therefore, a review of the applicable case law in a state is necessary to determine how the courts have interpreted the rule in the past.

Although the jurisprudence surrounding the rule varies between states, Rule 5.4 is generally meant to bar arrangements in which an attorney agrees to pay a percentage of the fees it receives for a case or set of cases as consideration for services provided by a non-attorney. Structures of litigation funding transactions can be viewed as running along a continuum of risk, with one end being high and the other low. Often the law of the applicable jurisdiction will dictate the most prudent path.

State Disclosure Requirements

Some states and courts place additional disclosure requirements on the law firms and claimants that receive third-party litigation funding. Although disclosure of the underlying documentation

and transaction terms is generally not required, the existence of the financing arrangement must be disclosed.

Funders should be aware, however, that certain states and courts require more fulsome disclosure. For example, effective June 21, 2021, the U.S. District Court for the District of New Jersey requires claimants that have obtained third-party litigation funding to disclose the scope of the funder's rights to approve of litigation decisions or settlement decisions, as well as a brief description of the funder's financial interest in the litigation. Also, all of the judges in the U.S. District Court for the Northern District of California issued a standing order (effective November 1, 2018) requiring any person or entity that is funding the prosecution of any class action claim or counterclaim to be disclosed to the court by the relevant litigants.

More recently, Chief District Judge Colm Connolly of the U.S. District Court for the District of Delaware issued a standing order applicable to all cases assigned to him requiring any party to a case that is receiving litigation funding from a non-party to disclose to the court:

- the funder's identity, address and place of formation;
- whether the funder's approval is necessary for litigation or settlement decisions in the action and, if so, the nature of the terms and conditions relating to such approval; and
- a brief description of the nature of the financial interest of the funder.

As third-party litigation funding becomes more prominent, it is likely that more states and regulatory bodies will enact, and more courts will order, similar rules and regulations requiring more fulsome disclosures.

Revised State Standards for Legal Fees

The professional and ethical standards vary by state, and over the past two years Arizona and Utah have revised their disciplinary rules to allow the sharing of legal fees with non-attorneys and to allow non-attorneys to own interests in law firms.

Effective January 1, 2021, the Arizona Supreme Court revised the state's professional and ethical standards to allow for non-attorneys to share attorneys' fees with lawyers. The revisions also enable Arizona law firms to apply for a license to become registered as an alternative business structure (ABS), which allows non-attorneys to own equity interests in such law firms. The ABS rules provide safeguards to protect clients' interests, including requiring any law firm with non-attorney equity holders to have an Arizona attorney appointed as its compliance officer and prohibiting any non-attorney equity holder from exercising any influence or control over its cases.

Similarly, effective August 14, 2020, the Utah Supreme Court revised its Rule 5.4 so that non-attorneys can own equity and exercise management authority in Utah law firms in certain circumstances through a pilot program (often referred to as the "regulatory sandbox") administered by the Office of Legal Services Innovation.

In addition to other conditions set forth in Utah's Rule 5.4, attorneys in a regulatory sandbox entity are permitted to provide legal services in any context only if "there is at all times no interference with the lawyer's (1) independence of professional judgment; (2) duty of loyalty to the client; [or] (3) protection of client confidences," provided that such attorney shall:

> (1) before accepting a representation, provide written notice to a prospective client that one or more nonlawyers holds a financial interest in the organization in which the lawyer practices or that one or more nonlawyers exercises managerial authority over the lawyer; and (2) set forth in writing to a client the financial and managerial structure of the organization in which the lawyer practices.

Unlike the Arizona framework, the Utah rules are currently scheduled to sunset on August 31, 2027, which date may be extended, or the rules may be made permanent.

Practical Concerns for Third-Party Litigation Funders

Commercial Claimant Litigation Funding

In a Commercial Claimant Litigation Funding transaction, the funder effectively invests in:

- the quality of the claim being asserted by the claimant;
- the quality of the lawyers handling the case; and
- the ability of the defendant(s) to pay any resulting judgment, settlement or other recovery.

As decisions about prosecuting a case must remain with the claimant and the attorney handling the case, it is critical for funders to underwrite the counsel in addition to the underlying case. Also, each case type has different risks, different milestones and other nuances that make these investments particularly bespoke. In light of that, funders should understand the unique aspects of the particular case type they're funding and the jurisdiction(s) in which the case(s) will be adjudicated.

In addition, funders should be prepared to not receive any return on their investments for an extended amount of time, given that repayment occurs from the proceeds of any judgment, settlement or other award that could take years to realize. Therefore, the funder must be comfortable extending capital without a definitive repayment date on the horizon. In addition, the funder should have a contingency plan in place for a situation where it fully extends its committed capital but the claim is still being adjudicated and additional funds are required to maintain the case.

Law Firm Litigation Funding

In a Law Firm Litigation Funding transaction, the funder effectively invests in the principals of the law firm, as well as the firm's actual or expected case portfolio.

The funder will have no control, and should not attempt to have any control, over the decisions of the law firm and its principals related to their clients and cases. It is reasonable and common, however, for the funder to have some level of input into the law firm's general operations, such as its operating expenses. Given that the firm's viability is critical to the success of the investment, limitations on risks that can threaten the enterprise (*e.g.*, excessive debt) are important. Needless to say, that also substantially benefits the law firm's clients because their interests are aligned with the funder and the law firm.

For more on selecting legal counsel in a traditional context, see our three-part series: "How Fund Managers Can Control Legal Costs and Negotiate Outside Counsel Fees" (Mar. 10, 2020); "Ways to Approach the Process of – and Key Criteria to Consider When – Selecting Outside Legal Counsel" (Mar. 17, 2020); and "Advice for Allocating Legal Tasks Between In-House Attorneys, Outside Counsel, Consultants and Other Vendors" (Mar. 24, 2020).

Law Firm Litigation Funding is most commonly a non-recourse transaction because law firms do not have many available resources over which remedies could be exercised (even the office equipment is often leased). Therefore, it is imperative for funders to take all steps reasonably necessary to protect the case portfolio of the law firm, as well as to collect the expected attorneys' fees and other amounts payable to the law firm in connection therewith. The level of control over the principals of the law firm varies, and protections against case diversion, misapplication of funds and other risks that are unique to litigation funding investments will be important.

Further, funders must recognize that not all law firms are the same. Small law firms provide a different set of concerns and risks to the funder than large law firms. Also, large law firms that have an international footprint provide a different set of concerns and risks than large law firms that only operate domestically.

Conclusion

Third-party litigation funding opens doors that were previously closed to plaintiffs and attorneys, while providing capital providers an investment that is uncorrelated with the market and potentially lucrative. Transactions can be structured to satisfy a wide variety of risk appetites and investment size preferences. The risks inherent in third-party litigation funding can be mitigated and properly managed, however, with proper underwriting; diligent review of applicable laws and regulations; and a well-structured transaction.

Boris Ziser is a partner and James E. McGuire is an associate in the finance and derivatives practice and the litigation funding practice in the New York office of Schulte Roth & Zabel LLP.

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