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The Wolf of Law Street: The Litigation Finance Industry and the Ethics of Investing in Justice

Plaintiff. Defendant. Put these two words together and you have the quintessential adversarial players featured in common law countries, like the United States. Add a third-party investor into the mix and you have one of the most controversial, yet relatively unknown ethical topics of todays revolutionized legal market. The two-party system is the epitome of American litigation, tracing its origins back to medieval trials by combat. Where even then, third-parties made their way into disputes and influenced the outcomes. In fact, some litigants were allowed champion knights to fight on their behalf. Welcome to the realm of litigation finance where the modern day knight is a high-powered investment firm, equipped with a double-edged sword. One edge of the sword slices through financial barriers that would otherwise preclude a trial on the merits. The other edge of the sword cuts deep into the ethics of the law and threatens the integrity of the courtroom.

Litigation finance is the mechanism through which litigants finance lawsuits through a third-party. These third-party funding entities provide cash advances to litigants in exchange for a percentage share of the judgment or settlement. If the case proceeds to trial and the litigant loses, the third-party receives nothing and loses the money they have invested in the case. In other words, if the litigant loses, he or she owes nothing. Thus, in theory, a litigant's case must have sufficient merit in order to receive third-party funding.

The amount of money that plaintiffs receive through legal financing varies. Normally, the funder lends between ten to twenty percent of the expected recovery, but financing firms allow individuals to request more or less money and have varying payout rates depending on the characteristics of the case at hand. On the surface, legal funding appears to possess the characteristics of an unsecured loan with a traditional lender. However, it is generally considered a form of an asset purchase. The underlying rationale is the inherent contingent nature of such contracts and the risk borne by the lender. Consequently, U.S. litigation finance has been likened to the stock market, where high-powered investors pick and choose attractive lawsuits—or assets—to invest in.

The Ancestors of Litigation Finance

Litigation finance was born out of the Medieval legal doctrines of maintenance, champerty, and barratry. Maintenance involves an arrangement where one party supports another to enable him or her to further their legal claim. Maintenance is third-party intermeddling that is intended primarily for personal gain. Thus, lending money to an individual who would not otherwise be able to afford a lawsuit was not considered maintenance unless the lender intended to gain substantially by obtaining a portion of the recovery. Champerty and barratry are subsets of maintenance. Champerty involves an unrelated party striking a bargain with a litigant to financially support the litigation in return for a share of the proceeds. Barratry entails the encouragement of another to bring or continue a claim. A common "barrator" was defined as "a common mover or stirrer up…or maintainer of suits, quarrels, or parties, either in Courts, or in the country." *See* Lord Neuberger, *From Barretry, Maintenance and Champerty to Litigation Funding,* Harbour Litigation Funding First Annual Lecture, Gray's Inn, May 8, 2013, available at, https://www.supremecourt.uk/docs/speech-130508.pdf *(*citing *The Case of Barratry,* 8 Rep. 36b-37a, 77 ER 528-9) and detailing the history of barratry, maintenance and champerty).

In England, maintenance, champerty, and barratry were used by the powerful as a means of settling scores. Feudal lords and other privileged members of society would often support the legal disputes of others against the supporter's personal or political enemy. Most colonies that imported their laws from England—including many states in the U.S.—passed laws designed to protect litigants from such "officious intermeddling," including exploiting the sale of legal claims to third-parties. Over time however, courts slowly found prohibitions on maintenance, champerty, and barratry unnecessary.

The current civil justice system in the United States acknowledges that access to justice depends upon the broad availability of legal representation for all socioeconomic levels. The public policy for increasing access to the legal system for those that could least afford it overrode the concerns underlying the Medieval doctrines. The modern perspective offers widespread exceptions to these doctrines and recognizes financial position often influences one's access to justice.

Today, almost every state in the U.S., including Illinois, permits maintenance, champerty, and barratry and will not void contracts based on these doctrines. The final hurdle for litigation finance entities is the law of usury, which traces back to the Code of Hammurabi in 1750 B.C.E. Usury laws prohibit lending money at an unlawfully high interest rate. Such laws were enacted to protect vulnerable borrowers from predatory or unscrupulous lenders. Today, usury laws are harshly criticized for their paternalism and the hindrance they impose upon people pursuing loans. These same critics feel that usury laws are economically illogical. *See* Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should be Tamed Not Outlawed,* 10 FORDHAM. J. CORP. & FIN. L. 55, 56 (2004); George Steven Swan, *The Economics of Usury and the Litigation Funding Industry: Rancman v. Interim Settlement Funding Corp*., 28 OKLA. CITY. U. L. REV. 753, 765, (2003). Most states, including Illinois, declare litigation financing a form of investment, or a non-recourse loan, rather than a traditional loan. Abts, Mikey. "The Current State of Litigation Finance Legislation: Part 1." *Litigation Finance Journal*. (June 2, 2017), available at https://litigationfinancejournal.com/current-state-litigation-finance-legislation/. Therefore, litigation finance companies are generally exempt from complying with statutory limits on interest rates and need not worry about usury laws.

The Code of the United Kingdom

Litigation finance is a relatively young phenomenon in the United States —emerging just 20 some years ago—but third-party funding is no new concept. Prohibitions on maintenance and champerty were abolished in England and Wales in 1967, welcoming "litigation funding" into the United Kingdom's legal system. In order to police the litigation funding market, an agency of the U.K.'s Ministry of Justice, the Civil Justice Council, published a Code of Conduct for Litigation Funders in 2011. The Association of Litigation Funders (ALF) is the regulatory body responsible for ensuring compliance with the Code of Conduct (the Code). The Code sets out the standards of best practice and behavior for litigation funders.

The Code also provides transparency to claimants and their solicitors. *Code of Conduct*, Association of Litigation Funders, available at http://associationoflitigationfunders.com/code-of-conduct/. It requires litigation funders to complete a screening process and provide satisfactory answers to certain key questions before entering into relationships with claimants. *Id.* Under the Code, litigation funders are required to give assurances to claimants that, along with other things, the litigation funder will not try to take control of the litigation. *Id.* The Code requires the litigation funder to have the money to pay the costs of the funded litigation, and prevents the funder from terminating the agreement, absent a materially adverse development. *Id.*

Funders must also maintain adequate financial resources at all times in order to meet their obligation to fund all of the disputes they have agreed to fund. *Id.* The Code also requires that funders cover aggregate funding liabilities under all of their funding agreements for a minimum of 36 months. *Id.* The Code even requires funders to "behave reasonably" at all times. *Id.* The main function of the Code is to keep the role of the funders, the litigants, and their lawyers, separate. *Id.*

The Current Market

The United States legal system has yet to implement any sort of governing system like the U.K.'s Code of Conduct. Accordingly, the legal framework of litigation financing in the U.S. has been dubbed the "Wild West" due to a lack of regulation and uniformity. In 2012, the American Bar Association released an informational report to the House of Delegates, regarding litigation finance that warned of the ethical complications at stake. Despite significant criticism from the popular press, state bar ethics committees, and scholarly commentary, the U.S. litigation finance industry remains unfettered.

Furthermore, the United States has a litigious epidemic on its hands and many critics feel the litigation finance industry only adds fuel to the fire. Across the country, there are an average of fifteen million civil cases filed annually, with the total cost of such lawsuits being well over 250 billion dollars per year. *See* Christopher Danzig, *Infographic of the Day: American Litigiousness Statistics That Will Make You Angry.* Above The Law—We The Plaintiffs. http://abovethelaw.com/2012/07/infographic-of-the-day-american-litigiousness-statistics-that-will-make-you-angry/ (detailed Infographic outlining the statistical issues involved in U.S. litigation). According to a study of litigation financing firms, most of the companies are members of a trade group called the American Legal Finance Association (ALFA). *See* Steven Garber, *Alternative Litigation Financing in the United States, Issues, Knowns, and Unknowns*, RAND (2010) available at, http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf

One of the largest players in the U.S. litigation financing business is Burford Capital, with its headquarters in Chicago. The company's financial report indicates incredible upward growth in a very short period of time. For the 2013 fiscal year, Burford Capital reported an astounding 89 percent increase in profits from the year prior, for a total $18 million. For the 2014 fiscal year, Burford Capital reported a "modest" increase in revenue upwards of 40 percent, tallying $82 million. In 2015, up to $103 million, in 2016, $163 million, and in 2017, expected revenue totaling a mammoth $233 million. *See* Roy Strom, *Numbers Never Lie—Or do they?*

ChicagoLawyer (February 1, 2015) available at http://www.chicagolawyermagazine.com/Archives/2015/02/Litigation-Funding-Business.aspx (detailing the lucrative litigation finance industry and lack of transparency).

The most fascinating, and surely one of the most controversial developments in the litigation finance industry is the arrival of a company called LexShares. The company seeks to revolutionize the market with a cutting edge online platform. *Invest In Justice*, LexShares, available at https://www.lexshares.com/. The company website gives investors access to a new class of assets: potentially lucrative commercial lawsuits. *Id*. The venture has been described as a crowdfunding platform meant to level the playing field for plaintiffs suing better-funded defendants. *Id*. The portal posts case details for up to 60 days, allowing accredited investors to make indirect investments in the case for a minimum of $2,500. *Id*. LexShares' goal is to deliver investors annualized returns of fifty percent or more. Companies like LexShares present some of the most formidable challenges to courtroom integrity and legal ethics. *Id*.

At present, the litigation finance industry is notoriously opaque. Whether because the industry is relatively young in the United States or because the investment firms strategically intend so, there is very little information available to the public. The vast majority of litigation finance firms are not listed in any sort of public forum. The bulk of firms that are discoverable through online research do not disclose their financial records or business plans. Virtually no firms unveil their agreement procedures or forms, except through court documentation.

Practical Implications for the Defense Bar

Ethical Dilemma

Although much less common than typical plaintiff funding, litigation financing is available to defense firms. Defense-side funding is generally available only for commercial litigation (as opposed to personal injury). Generally speaking, a defense firm submits their claim to a litigation finance firm. If the firm agrees to take the case, they assign an expected loss or damages amount. Any amount received below the expected damages is the value generated by the litigation finance firm, which obtains a portion of that value. This of course creates several issues, as it is almost impossible to accurately, effectively, and objectively measure expected losses from a defense perspective especially when the litigation finance firm must be allocated a profit margin.

Defense attorneys who take part in third-party financing must be mindful of their ethics and understand their individual role. Lawyers owe their clients a duty of loyalty, but the current scheme of U.S. litigation finance may place lawyers' responsibilities in a bind. Litigation finance contracts can create confusion concerning which party actually owns and controls the lawsuit. A litigation finance company seeking information about a party's case, may obtain information from the attorney that violates confidentiality rules and forfeits the attorney-client privilege. A key role of the lawyer in litigation financing situations is to ethically negotiate the funding arrangements. Many times the lawyer introduces the client to the financier and then proceeds to negotiate the funding agreement. However, a serious problem arises if there is a business referral arrangement in place between the lawyer and financier. The interests of the lawyer and the financier could potentially trump the interest of the client. A deeper problem is that both the lawyer and financier are involved in the case to make money. As such, their interests may not align with the client's.

Furthermore, the funding agreement between financier and client may state that the financier must approve any settlement agreement. The attorney's primary ethical responsibility is to negotiate the best deal for the client, even if it is not the best deal for the financier. The best deal for the client might include terms that are non-monetary and thus carry no financial benefit for the financier. Some funding agreements even go as far as explicitly stating that the financier can unilaterally remove and replace legal counsel if they are "unhappy" with the legal representation. This places added pressure on the attorney to keep the financier happy in order to preserve his or her job, irrespective of whether such measures conflict with the client's interests. Additionally, if a third-party funder withdraws and a case collapses, there is currently no protection for an attorney against a resulting malpractice suit. The third-party funder is able to withdraw without recourse and the attorney is left responsible to the client.

Illinois Rules of Professional Conduct Operate as Informal Regulations

Of course, even without regulatory framework in Illinois, numerous provisions in the Illinois Rules of Professional Conduct reinforce the importance of independent professional judgment from attorneys handling third-party financing. Conflicts of interest rules, confidentiality rules, and rules governing third-party payments of fees all provide steady guidance for attorney conduct. In accordance with Illinois Rule of Professional Conduct 5.4(a), a lawyer may not share legal fees with a non-lawyer. Illinois Rules of Professional Conduct, Ill. S. Ct. R. art. VIII (2010) (IRPC) Rule 5.4(a). This prohibition is intended to protect the lawyer's professional independence of judgment. Likewise, Rule 1.8 prohibits lawyers from accepting compensation from a third-party for the representation of a client unless: (1) the client gives informed consent, (2) there is no interference with the lawyer's exercise of independent professional judgment, and (3) confidential information is protected as required by Rule 1.6. IRPC 1.8 and 1.6.

In regard to the second prong of Rule 1.8, Rule 2.1 further directs a lawyer to "exercise *independent* professional judgment and render candid advice" (emphasis added). IRPC 2.1. If a third-party funder interferes with the lawyer's independent professional judgment, the lawyer must withdraw from the representation. In the event that the lawyer's involvement limits the lawyer's capacity to carry out his or her professional duties, the lawyer must fully disclose the nature of the limitation, explain the risks and benefits of the proposed course of action, and obtain the client's informed consent. Lawyers involved with defense based third-party funding must be vigilant and use reasonable care at all junctions in the case.

Defending Against Third-Party Funded Plaintiffs

On the other hand, in defending against third-party funded plaintiffs, the primary objective from the defense bar has been added transparency—full disclosure of the funding arrangement. In fact, the President of the U.S. Chamber Institute for Legal Reform wrote a letter on behalf of state and local chambers and defense bar groups, noting: "Absent a robust disclosure requirement, plaintiffs will continue to utilize [third-party litigation financing]—in some situations, illegally—undetected and unchecked." Fruend, John. "In David vs. Goliath, Which One is Litigation Finance, *Litigation Finance Journal*, (October 10, 2017), available at https:// litigationfinancejournal.com/david-vs-goliath-one-litigation-finance/ (citing Chamber Institute of Legal Reform Letter). Consequently, some members of the defense bar have proposed amending Federal Rule of Civil Procedure 26, and locally, Illinois Supreme Court Rule 213, to require automatic disclosure of any third-party financing agreements in discovery. *Id*.

Although no proposed amendments have been enacted in Illinois, there are encouraging signs of progress elsewhere. In 2017, the U.S. District Court for the Northern District of California added disclosure requirements to its standing order for judges. *Id*. Trade industry articles from Texas also indicate the U.S. District Court of the Eastern District of Texas is considering a similar practice.

Conclusion

Treating Lady Justice like the Stock Market is a disquieting notion in and of itself and implores the inquiry: How much is justice actually worth? Should we allow the complexities of outside economics to influence the merits of legal disputes? Is the justice system of the United States merely a "pig in a white dress"—a business model built around the inevitability of societal differences? This is a topic for another day. For now, and for better or for worse, litigation finance is a growing facet of the United States legal system and the defense bar must act accordingly. With no concrete regulations like the UK's Code of Conduct, there is a plethora of potential ethical violations for lawyers. Whether defending against a third-party funded plaintiff or representing a third-party funded defendant, lawyers must be evermore cognizant of their duties and responsibilities to their clients.

About the Author

Mitchell A. Capp is an associate attorney at *HeplerBroom LLC* in Chicago. He focuses his practice on matters involving complex commercial and corporate litigation including construction law, corporate and business, medical malpractice, and intellectual property law. He earned his B.A. from Michigan State University and earned his J.D., *cum laude*, from The John Marshall Law School. While in law school, Mr. Capp served as the Production Editor of *The John Marshall Law Review*. He also competed on the Saul Lefkowitz Trademark Moot Court team as a council member. Mr. Capp has interned at the United States Attorney's Office for the Northern District of Illinois and held externships at both the Circuit Court of Cook County and The United States District Court for the Northern District of Illinois. He is an active member of the Illinois Association of Defense Trial Counsel, the Italian American Labor Council, and the Sports Lawyers Association.

About the IDC

The Illinois Association Defense Trial Counsel (IDC) is the premier association of attorneys in Illinois who devote a substantial portion their practice to the representation of business, corporate, insurance, professional and other individual defendants in civil litigation. For more information on the IDC, visit us on the web at www.iadtc.org or contact us at PO Box 588, Rochester, IL 62563-0588, 217-498-2649, 800-232-0169, idc@iadtc.org.