I. Introduction

Alternative litigation finance (“ALF”) refers to the funding of litigation activities by entities other than the parties themselves, their counsel, or other entities with a preexisting contractual relationship with one of the parties, such as an indemnitor or a liability insurer. These transactions are generally between a party to litigation and a funding entity and involve an assignment of an interest in the proceeds from a cause of action. These activities have become increasingly prominent in recent years, leading to significant attention in the legal and popular press, scrutiny by state bar ethics committees, and scholarly commentary. The continuing...
globalization of the market for legal services makes alternative litigation finance available to clients in markets such as the United Kingdom, Australia, Germany and Spain, where it is legally permitted and generally available.

At least some forms of alternative litigation finance are permitted in many U.S. jurisdictions as well, but many lawyers are unfamiliar with the ethical issues presented by these transactions. The American Bar Association Commission on Ethics 20/20 therefore formed a Working Group on Alternative Litigation Finance to study the impact of these emerging transactional structures on the client-lawyer relationship and the professional responsibilities of lawyers. The Working Group was directed to limit its consideration to the duties of lawyers representing clients who are considering or have obtained funding from alternative litigation finance suppliers. It did not consider social policy or normative issues, such as the desirability of this form of financing, or empirical controversies, such as the systemic effects of litigation financing on settlements (except insofar as this has an impact on the ethical obligations of lawyers), or the effect that alternative litigation finance may have on the incidence of litigation generally, or unmeritorious ("frivolous") lawsuits specifically. Nor did the Working Group consider legislative or regulatory responses to perceived problems associated with alternative litigation finance in the consumer sector, such as excessive finance charges or inadequate disclosure. However, to the extent a lawyer is representing a client and advising or negotiating

presented at the conference, see

The members of the Working Group are Philip H. Schaeffer (Co-Chair and Liaison to the Commission from the Standing Committee on Ethics and Professional Responsibility) Jeffrey B. Golden (Co-Chair and Commissioner), the Hon, Kathryn A. Oberly (Commissioner), Herman J. Russomanno (Commissioner), Professor Stephen Gillers (Commissioner), John C. Martin (ABA Section of Litigation), Charles D. Schmerler (ABA Section of International Law), Olav A. Haazen (Boise, Schiller & Flexner, LLP). Professors W. Bradley Wendel and Anthony Sebok serve as Reporter. Ellyn S. Rosen, Commission Counsel, and Ruth A. Woodruff provided counsel to the Working Group.

The Working Group received comments from groups expressing various opinions about the effect of alternative litigation finance on the civil justice system. Critics of ALF predict that it will drive up the filing of lawsuits, without regard to their legal and factual merit, because suppliers will consider only the expected value of the investment, not the substantive merits of the claim. See, e.g., Comments of the Am. Tort Reform Ass'n to the Am. Bar Ass'n Working Group on Alternative Litig. Fin. (Feb. 15, 2011) (on file with author); Comments of the Prod. Liab. Advisory Council to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. (Feb. 15, 2011) (on file with author); Comments of the U.S. Chamber Inst. for Legal Reform to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. (Feb. 15, 2011) (on file with author). Proponents suggest there is some evidence that although the availability of alternative litigation finance is correlated with an increase in claim filing, its suppliers tend to fund strong claims, not frivolous ones. See, e.g. Martin, supra note 4; Moliterno, supra note 4; Molot, supra note 4; Rodak, supra note 4. Scholars also offer various views. For an empirical study, see Daniel L. Chen & David S. Abrams, A Market for Justice: The Effect of Third Party Litigation Funding on Legal Outcomes, Duke Law Sch., Working Paper, 2011), available at http://www.duke.edu/~dlc28/papers/MktJustice.pdf. Other scholars assert that alternative litigation finance better aligns the incentives of attorneys and clients, and also provides a strong signal of claim quality, suggesting that meritorious claims, not weak ones, attract third-party funding. See MAX SCHANZENBACH & DAVID DANA, HOW WOULD THIRD PARTY FINANCING CHANGE THE FACE OF AMERICAN TORT LITIGATION? THE ROLE OF AGENCY COSTS IN THE ATTORNEY-CLIENT RELATIONSHIP (2009), available at http://www.law.northwestern.edu/searlecenter/papers/Schanzenbach_Agency%20Costs.pdf (paper presented at Northwestern Law School public policy roundtable on alternative litigation finance). An evaluation of the competing empirical assertions in these submissions and in the scholarly literature – e.g. that ALF tends to increase the filing of non-meritorious claims – is beyond the mandate and expertise of the Commission on Ethics 20/20, which was not intended to engage in social science research.
with respect to an ALF transaction, the duties considered in this Informational Report are applicable.

The Commission identified numerous issues upon which it sought public comment, and prepared an Issues Paper, which was made available on November 23, 2010. Comments were received until February 15, 2011. In addition, the Commission heard public testimony at the American Bar Association Midyear Meeting in Atlanta, Georgia, on February 11, 2011.

Written submissions were provided by lawyers whose clients had used ALF and entities that provide ALF to the consumer or commercial market, or that, in one case, provide loans to lawyers. In addition, there were submissions from various organizations and groups, including the American Tort Reform Association, the American Insurance Association, the Product Liability Advisory Council, and the United States Chamber of Commerce, and from Alan B. Morrison, Associate Dean for Public Interest & Public Service, George Washington University Law School.

The Commission also heard from witnesses who provided oral statements concerning ALF and answered questions posed to them by the Working Group. They were: Douglas Richmond, AON Global Profession Practice; Harvey Hirschfeld, American Litigation Finance Association (ALFA); John Beisner, Skadden Arps, on behalf of U.S. Chamber Institute for Legal Reform; and Gary Chodes, Oasis Legal Finance.

To obtain further public comments, the Commission released a draft of this Informational Report in September 2011 and received comments through November 22, 2011.

One theme of this Informational Report is that it is difficult to generalize about the ethical issues for lawyers associated with alternative litigation finance across the many differences in transaction terms, market conditions, relative bargaining power of the parties to the transactions, and type of legal services being financed. Regulation that might be appropriate for products in a sector of the market such as relatively unsophisticated one-off individual personal-injury plaintiffs, may be inappropriate in a different segment of the market, as exemplified by investments by hedge funds or high-net-worth individuals in commercial litigation. Moreover, this is a still-evolving industry, and new forms of financing may be developed that raise new concerns. Nevertheless, the Commission believes it will be helpful to the profession to consider some of the types of problems that lawyers may encounter as a result of their own, or their clients’, interaction with alternative litigation finance. This Informational Report is meant as a beginning to the U.S. legal profession’s conversation about ALF through the highlighting of associated ethics issues. The Commission hopes that the Association will continue and broaden this discussion by forming a body comprised of relevant and interested Association entities (e.g., the Litigation Section, Dispute Resolution Section, Section of International Law, and the Standing Committee on Ethics and Professional Responsibility) to study and develop any necessary policy proposals regarding the regulation of ALF.
II. Executive Summary

The general conclusion of this Informational Report is that lawyers must approach transactions involving alternative litigation finance with care, mindful of several core professional obligations. That said, the Informational Report should not be interpreted as suggesting that alternative litigation finance raises novel professional responsibilities, since many of the same issues discussed below may arise whenever a third party has a financial interest in the outcome of the client’s litigation. A lawyer must always exercise independent professional judgment on behalf of a client, and not be influenced by financial or other considerations. Moreover, a lawyer must not permit a third party to interfere with the exercise of independent professional judgment. Numerous specific provisions in the American Bar Association Model Rules of Professional Conduct (“Model Rules”), including conflicts of interest rules and rules governing third-party payments of fees, reinforce the importance of independent professional judgment.

In addition, lawyers must be vigilant to prevent disclosure of information protected by Model Rule 1.6(a), and to use reasonable care to safeguard against waiver of the attorney-client privilege. Any infringement on rights that clients would otherwise have, resulting from the presence of alternative litigation finance, requires the informed consent of the client after full, candid disclosure of all of the associated risks and benefits.

Lawyers who are not experienced in dealing with these funding transactions must become fully informed about the legal risks and benefits of these transactions, in order to provide competent advice to clients. Because this is a new and highly specialized area of finance, it may be necessary for a lawyer to undertake additional study or associate with experienced counsel when advising clients who are entering into these transactions.

III. Overview of Alternative Litigation Finance (ALF)

All litigation, even pro se litigation, requires some degree of monetary funding. Most entity clients, at least on the defendants’ side, pay on an ongoing basis for the work of their lawyers, out of their operating budgets or from existing sources of credit. This is true whether the client itself is paying for litigation expenses or the expenses are paid by its insurer under the contractual obligations of a liability insurance policy. However, certain plaintiffs’ claims, particularly individual personal injury tort claims, are funded by the plaintiff’s lawyer advancing the value of the lawyer’s time, and sometimes also the expenses of litigation to the client. These advances are subsequently repaid out of the proceeds of a judgment or settlement, if the claim is

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8 See MODEL RULE 1.7(a)(2) (representation materially limited by lawyer’s responsibilities to a third party or the lawyer’s own interests); MODEL RULE 1.8(e) (with limited exceptions, lawyers may not provide financial assistance to client); MODEL RULE 1.8(f) (lawyer must not accept compensation for representation from third party without informed consent of client and unless it will not interfere with independent professional judgment); MODEL RULE 1.8(i) (lawyers may not acquire proprietary interest in subject matter of representation); MODEL RULE 5.4(c) (lawyer may not permit fee payor to direct or regulate lawyer’s professional judgment).
successful, pursuant to the terms of the contingency fee agreement entered into between the lawyer and client.

In some cases, however, litigants are unable to finance the cost of legal services from their operating budgets or existing lines of credit, or would prefer to access different sources of capital to finance their lawyers’ bills. This may be the case for both plaintiffs and defendants, generally in large, complex, litigated matters. In addition, some litigants find themselves in urgent need of funds to pay living or medical expenses as they are accrued. Individual plaintiffs in tort actions may find themselves in this predicament. They may not have access to other sources of capital, such as bank loans or credit cards, and may discover that the most valuable asset against which they can obtain capital is a contingent share in an eventual judgment or settlement. Thus, while these transactions are not intended to fund litigation expenses, they are occasioned by an injury that is the subject of ongoing litigation, and the cause of action arising out of the injury is used as security for the funding.

Following the suggestion in Steven Garber’s 2009 RAND paper, this Informational Report has adopted the term “alternative litigation finance” (“ALF”) to describe the universe of contracts that is the subject of the paper. Defined most generally, ALF refers to mechanisms that give a third party (other than the lawyer in the case) a financial stake in the outcome of the case in exchange for money paid to a party in the case. Sometimes the money paid to the party is used to pay litigation expenses, and sometimes the money is used by the party to pay for non-litigation related expenses, such as living expenses (e.g., where the party is an individual involved in a personal injury suit). Individuals or organizations that provide capital used to support litigation-related activities, or to support clients’ ordinary living expenses during the pendency of litigation, are referred to here as ALF suppliers. There is a spectrum of transactions by ALF suppliers that ranges, for example, from sophisticated investments in major cases such as critical patent litigation, with the investors seeking returns akin to venture capital returns, to support of personal injury litigation. Both plaintiffs and defendants can make use of ALF, although as discussed below, the market is segmented to some extent according to the sophistication of clients/borrowers. ALF is presently characterized by spreading the risk of litigation to investors via various methods, including, predominately, nonrecourse or limited recourse financing.

ALF is relatively new in the United States but appears to be evolving as a method of providing financial support to litigants. It often takes the form of nonrecourse financing between

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9 For example, the plaintiff in *Echeverria v. Lindner*, No. 018666/2002, 2005 WL 1083704 (N.Y. Sup. Ct. Mar. 2, 2005), was an undocumented worker injured in a construction-site accident. In order to pay for necessary back surgery, he sold a share of his personal-injury claim to a company called LawCash for $25,000, or borrowed $25,000 from LawCash – whether to construe the transaction as a loan or a sale was one of the issues considered by the court.


two laypersons, secured solely by a claim, but it can also include loans to lawyers in a contingency fee case. Investors, both traditional and nontraditional financers, provide funding either as a lump sum or as periodic payments to a claimant in exchange for a share of the proceeds of the judgment on, or settlement of, the financed claim. The business model requires that the ALF supplier assume the risk that if the claim is unsuccessful, in whole or in part, the ALF supplier may not recover any or a part of the sums so advanced. A variation of ALF may be an investor’s acquisition of a full or partial interest in a claim where the investor becomes one of the parties in interest. Information obtained by the Commission Working Group shows that, at present, investors in ALF are primarily financing the claimant, though defense side financing is also possible. Funding on the defense side obviously does not involve taking a percentage interest in the claim, but often does involve the ALF supplier taking all or a percentage interest in the liability facing the defendant. As discussed below, ALF transactions between large law firms and defendants are generally negotiated individually between the parties, with the method of calculating the supplier’s payment being one of the most important terms in the contract.

A. A Typology of ALF

The ALF market is apparently fairly strongly differentiated. A large number of ALF suppliers serve the consumer sector, marketing to personal-injury plaintiffs, and to other individual clients with relatively small legal claims. Consumer ALF suppliers are distinguishable from settlement factoring companies; the former take a partial assignment in a claim that has not yet been settled or reduced to judgment, while the latter purchases a claim that has been reduced to judgment, typically as a result of a judicially approved settlement. A considerably smaller number of entities fund large, complex commercial litigation. These companies conduct extensive due diligence on individual cases and make sizeable financial investments. Finally, commercial lenders and some specialized ALF companies make loans directly to lawyers, as opposed to purchasing claims or parts of claims from clients.

1. Consumer Legal Funding.

The sector of the ALF industry that has attracted the most attention, in both the popular media and in scholarly commentary, is that which provides money to consumers with pending lawsuits, most often personal-injury claims but including other individual-client causes of action such as employment discrimination and securities fraud, who are generally already represented by counsel. For the purposes of this discussion, it will be assumed that the transaction involves a tort plaintiff represented by a lawyer pursuant to a standard contingency fee agreement. In a typical transaction, the ALF supplier agrees to pay a given amount of money to the plaintiff (say, $25,000) in exchange for a promise by the plaintiff to pay the ALF supplier that amount plus an additional amount (sometimes referred to as a “fee”) specified in the contract in the event of a

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12 See, e.g., Comments of Burford Group to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. 4 (Feb. 15, 2011) (on file with author) (“Burford is willing to finance plaintiffs and defendants with equanimity.”); Comments of Juridica Capital Mgmt. Ltd. to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. 2 (Feb. 17, 2011) (on file with author) (“To date we have been involved mainly in claims by plaintiffs in major commercial litigation but we – and we understand at least one of our peers – are working on products for defendants as well.”).

13 See Barksdale, supra note 4, at 715.
positive outcome in the suit (that is, a judgment or settlement). As Steven Garber’s RAND Report notes, “[t]hese financing fees seem typically to increase with the elapsed time from the provision of the funds to the date on which the consumer pays the supplier, but the contracted fees do not depend on the total recovery in the underlying lawsuit or the amount of the recovery received by the consumer plaintiff.” The transactions are also nonrecourse, meaning that if the plaintiff recovers nothing by way of judgment or settlement, the plaintiff has no obligation to repay the amount to the supplier.

Comments received by the Working Group from entities in the ALF industry indicate that the purpose of these transactions is generally to provide funds for living expenses during the pendency of litigation. Injured plaintiffs are often disabled or at least unable to work at their previous job, and may lack access to conventional sources of capital, such as bank loans and credit cards. They may therefore have a pressing need to make mortgage or rent payments, or to pay medical expenses. On the other hand, some plaintiffs may not have an urgent need for funds, but may instead be interested in monetizing the contingent value of their legal claim.

In some cases lawyers will be involved in the process of negotiating a consumer-sector ALF transaction, but in other cases the client – either prior to or subsequent to the beginning of the representation – will obtain financing without the involvement of the lawyer. Because this Informational Report focuses on the duties of lawyers when representing clients in connection with ALF transactions, analysis relating to consumer protection is beyond its scope. Many ALF suppliers in the consumer sector advertise to generate customers. A person with a cause of action may respond to these advertisements and approach an ALF supplier without the knowledge of a lawyer. In some cases, if the claimant is already represented by counsel, a lawyer may be involved in the process of obtaining financing, in which case the duties discussed in this Informational Report are applicable. Other problems that may arise in connection with consumer ALF transactions, however, such as misleading advertising, inadequate disclosure of financing terms, and excessive financing charges, do not fall within the client-lawyer relationship and are therefore best addressed by legislation or regulation apart from the regulation of the legal

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14 Some ALF suppliers in the consumer sector made their contracts available to the Working Group. See, e.g., Oasis (Nebraska) Form Purchase Agreement. Other information concerning transaction terms and the interaction between ALF suppliers and lawyers was gleaned from judicial decisions and media reports.
15 GARBER, supra note 10, at 9.
16 See, e.g., Comments of Oasis Legal Finance/Alliance for Responsible Consumer Legal Funding to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. (Apr. 5, 2011) (on file with author) (indicating that purpose of consumer-sector ALF is to “enable these consumers to pursue their legal claims without worrying about how they are going to pay for basic living expenses”).
17 See GARBER, supra note 10, at 10.
18 See, e.g., Fausone v. U.S. Claims, Inc., 915 So.2d 626, 627-28 (Fla. Dist. Ct. App. 2005), aff’d, 931 So. 2d 899 (Fla. 2006) (“In fairness to U.S. Claims, it should be emphasized that there is no evidence that it solicited Ms. Fausone. How or why she contacted them is not contained in the record.”).
19 See GARBER, supra note 10, at 12. As Garber notes, running a Google search using terms like “lawsuit cash” or “litigation funding” generates pages of hits, with links to websites with names like LawMax Legal Finance, My Legal Advance, Fast Funds, LawCash, Ca$hCa$h, Legal Advance Funding, Funding Cash, LawLeaf, and Advance Cash and Settlement Funding.
profession.\textsuperscript{20}

2. Investing in Commercial Litigation

A very different segment of the ALF market involves public and private funds that seek to invest in large, complex commercial lawsuits, including contract, intellectual property, and antitrust litigation. Two public companies in this industry, Juridica and Burford, primarily invest in claims owned by large corporate litigants represented by major law firms; their investments are reportedly in the range of $500,000 - $15 million.\textsuperscript{21} Other funds are private and therefore less is known about the nature and scope of their investments.

The terms of agreements between suppliers in this sector and recipients of funding are generally confidential. When these contracts have been publicly disclosed, they appear to be “bespoke” documents negotiated between the recipient of funding and the ALF supplier, as opposed to the standard-form contracts employed in the consumer funding sector.\textsuperscript{22} Many users of ALF in this sector of the market are sophisticated, repeat-player litigants, generally with in-house legal representation. Thus, it is likely that lawyers have been involved in the process of negotiating the terms of the agreement.

3. Loans to Lawyers and Law Firms

Commercial lenders and some specialized ALF suppliers provide loans or lines of credit directly to law firms. These loans are typically secured by assets of the firm, such as furniture and fixtures, the firm’s accounts receivable, or the firm’s contingent interests in ongoing cases.\textsuperscript{23} As two Canadian lawyers noted, regarding the difficulty of funding complex litigation:

\begin{quote}
We suspect it is very difficult for most Canadian counsel to wrap their minds around the concept of financing $2.6 million of disbursements. How many of us can claim an “Uncle Pete” relationship with our bankers that will support a million dollar loan to finance a single case? How many of us can finance the balance of $1.6 million from our “war chest” left over from our successful cases?\textsuperscript{24}
\end{quote}

A similar problem, of finding funds to pay for millions of dollars in disbursements, faces lawyers in the United States as well. Law firms representing plaintiffs and defendants may seek financing to support ongoing expenses of litigation. It may be the case, however, that firms representing plaintiffs are more likely to make use of nontraditional lenders as a source of

\textsuperscript{20} The Commission and its Working Group did not attempt a comprehensive review of existing statutes and regulations concerning ALF, but there are a handful of recently adopted state laws concerning the relationship between ALF providers and citizens in those states. This is a subject that could be addressed by the ABA as part of the broader discussion referenced at page 3 above.

\textsuperscript{21} Id. at 12. See also Lyon, supra note 4, at 574 (reporting that “corporate litigants may now routinely borrow up to $15,000,000, on cases valued at $100,000,000 or more”).

\textsuperscript{22} See, e.g., Parloff, supra note 2 (discussion of the contract between the Ecuadorian plaintiffs and Burford).

\textsuperscript{23} GARBER, supra note 10, at 13.

B. Common-Law Doctrines Historically Affecting ALF

1. Maintenance and Champerty

Maintenance, champerty and barratry are closely related but are not identical. “[P]ut simply, maintenance is helping another prosecute a suit; champerty is maintaining a suit in return for a financial interest in the outcome; and barratry is a continuing practice of maintenance or champerty.”

a. Historical Background.

Champerty is considered a type of maintenance. The historical justification for prohibiting any form of maintenance was that third-party funding of litigation encouraged fraudulent lawsuits. The wealthy and powerful would “buy up claims, and, by means of their exalted and influential positions, overawe the courts, secure unjust and unmerited judgments, and oppress those against whom their anger might be directed.” As one contemporary scholar put it, “[b]arons abused the law to their own ends and . . . bribery, corruption, and intimidation of judges and justices of the peace [was] widespread.” Whether this historical analysis was accurate or not, American courts long ago held that the risk that courts could be easily bribed or corrupted by third parties had disappeared with the advent of then modern reforms.

Furthermore, the modern doctrines of abuse of process, malicious prosecution, and wrongful initiation of litigation deal more directly with the problems that may have originally motivated the common law doctrine of champerty, since they provide victims of third-party interference a remedy when a third party promotes litigation that is based on fraudulent allegations or baseless legal theories. Given that existing ethical and legal obligations of lawyers and their clients are already supposed to insure that litigation be conducted in good faith and non-frivolously, it is unclear why the historical concerns of the common law would justify today placing special burdens on litigation funded by third parties.

25 Garber, supra note 10, at 13.
29 See, e.g., Thallhimer v. Brinckerhoff, 3 Cow. 623 (N.Y. Sup. Ct. 1824) (“In modern times, and since England has enjoyed a pure and firm administration of justice, these evils are little felt, and champerty and maintenance are now seldom mentioned . . . as producing mischief in that country.”).
30 See Sec. Underground Storage, Inc. v. Anderson, 347 F.2d 964, 969 (10th Cir. 1965) (explaining that the common law of champerty has been replaced by modern remedies such as abuse of process, malicious prosecution and wrongful initiation of litigation). Although the common law’s purpose in attacking maintenance and champerty has been analogized to the purpose now served by the tort of malicious prosecution, differences remain, such as the fact that malicious prosecution requires proof of malice or the lack of probable cause, whereas an allegation of maintenance required only proof that the suit supported was groundless. See Weigel Broad. Co. v. Topel, 1985 U.S. Dist. LEXIS 23862 (N.D. Ill. Aug. 19, 1985) at *18.
Limitations on maintenance can come from two sources: common law and statutes. There are currently two states with statutes that follow the early English common law’s approach and prohibit any form of maintenance (even maintenance that is not for profit). Here, for example, is Mississippi’s law:

It shall be unlawful for any person . . . either before or after proceedings commenced: (a) to promise, give, or offer, or to conspire or agree to promise, give, or offer, (b) to receive or accept, or to agree or conspire to receive or accept, (c) to solicit, request, or donate, any money . . . or any other thing of value, or any other assistance as an inducement to any person to commence or to prosecute further, or for the purpose of assisting such person to commence or prosecute further, any proceeding in any court or before any administrative board or other agency.31

This language would, in theory, prohibit one neighbor from gratuitously providing something of value (information, law books, etc.) to another in connection with litigation. American common law restrictions on maintenance, in those states where they were recognized, refused to follow early English common law and were limited to restricting champerty.

In the early Twentieth Century some courts interpreted the principle of maintenance to permit third-party support only under the narrowest of circumstances. In In re Gilman’s Administratrix, 167 N.E. 437 (N.Y. 1929), Judge Cardozo said that “maintenance inspired by charity or benevolence” could be legal but not “maintenance for spite or envy or the promise or hope of gain.”32 Gilman itself involved maintenance by the party’s own lawyer, which may have made it especially obnoxious to Cardozo. This, of course, would be permitted today in every jurisdiction under the practice of the contingency fee, which had, by the mid-1930’s, become generally accepted as industrialization brought more and more claims in need of legal representation.33 It is worth noting that 65 years later the New York Court of Appeals held that an offer by a personal injury litigant to give another party 15% of his net recovery from his lawsuit in exchange for certain personal services could constitute an “enforceable assignment of funds” that created a lien on the proceeds of the lawsuit.34

Other courts in the same period took a broader view of maintenance in cases involving a third party who was not the party’s own lawyer. These courts came to view maintenance between two laypersons as permissible regardless of whether it was done for charity or profit, or

31 MISS. CODE ANN. § 97–9–11 (2009). Illinois’ law sweeps slightly less broadly:
If a person officiously intermeddles in an action that in no way belongs to or concerns that person, by maintaining or assisting either party, with money or otherwise, to prosecute or defend the action, with a view to promote litigation, he or she is guilty of maintenance and upon conviction shall be fined and punished as in cases of common barratry. It is not maintenance for a person to maintain the action of his or her relative or servant, or a poor person out of charity.
720 ILL. COMP. STAT. 5/32–12 (2009). Illinois allows selfless maintenance when the recipient of the support is either one’s family or a person who is poor.
whether the supplier was the client’s lawyer or a stranger.35

b. Contemporary Views.

As the Ninth Circuit Court of Appeals stated in 2011, “[t]he consistent trend across the country is toward limiting, not expanding,” the common law prohibition of champerty.36 In some states, such as Arizona, California, Connecticut, New Jersey, New Hampshire, New Mexico and Texas, the courts have held that the early common law prohibitions on champerty were never adopted from England.37 In other states, such as Colorado, champerty laws, if they had been adopted from England, were later abandoned.38 The Massachusetts Supreme Judicial Court struck down Massachusetts’ champerty laws in 1997. The court stated that “the decline of champerty, maintenance, and barratry as offences [sic] is symptomatic of a fundamental change in society’s view of litigation – from ‘a social ill, which, like other disputes and quarrels, should be minimized,’ to ‘a socially useful way to resolve disputes.”’39 In Florida, the common law prohibition of champerty was discarded by an appellate court, which held in a case involving litigation funding that no claim of champerty exists unless a stranger to a lawsuit “officiously intermeddles” in the suit.40 In New York, the Leon case cited above established that the courts would enforce the partial assignment of the proceeds of a lawsuit resulting from an exchange of the assignment for something of value, such as services (in that case, home health care).41

According to the one recent survey on the topic, 27 out of 51 jurisdictions, including the District of Columbia, permit some form of champerty, subject to the sort of limits described as follows.42 In these jurisdictions champerty is generally permissible as long as the supplier is not:

(1) clearly promoting “frivolous” litigation (e.g. a lawsuit that does vindicate a genuine legal interest of the party bringing the suit);

(2) engaging in “malice champerty”, which is the support of meritorious litigation motivated by an improper motive. (e.g. prima facie tort in NY);

(3) “intermeddling” with the conduct of the litigation (e.g. determining trial strategy or controlling settlement).

Given paucity of modern cases that directly discuss the kind of transactions that comprise

36 Del Webb Cmty., Inc. v. Partington, 652 F.3d 1145, 1156 (9th Cir. 2011).
38 Fastenau v. Engel, 240 P.2d 1173 (Colo. 1952) (“Common-law maintenance and champerty no longer exist in Colorado.”).
40 Officious intermeddling means “offering unnecessary and unwanted advice or services; meddlesome, esp. in a highhanded or overbearing way.” Mere provision of financing to a plaintiff is not enough. Kraft v. Mason, 668 So. 2d 679, 682 (Fla. Dist. Ct. App. 1996).
42 Sebok, supra note 4, at 98-99.
ALF as discussed in this Informational Report, there may be more states in which champerty is tolerated or where, if the issue were raised again in a modern context, a contemporary court would have little reason to preserve the doctrine of maintenance, either as a matter of common law or public policy. Some states have recently reversed the common law prohibition of champerty through legislation. However, other states have reaffirmed these doctrines through the courts, noting “the potential ill effects that a champertous agreement can have on the legal system.”

2. Usury

Usury is the taking of interest at a rate that exceeds the maximum rate provided by law for the particular category of lender involved in the transaction. There is considerable variation from state to state in the interest rates that constitute usury and in the extent to which different rates may be specified for different types of lenders (e.g., banks, insurance companies, merchants, etc.).

Discussions of ALF often refer to the funding provided as a loan. ALF suppliers, on the other hand, assert that they are making an investment or purchasing a share of a claim, not making a loan. Whether these transactions are characterized as a loan or an investment may determine whether state usury provisions apply to the rate of return specified in the contract.

Generally speaking, debt, at least in the context of consumer usury law, involves a transaction in which the borrower has an absolute obligation to repay the sum advanced. Some

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44 Johnson v. Wright, 682 N.W.2d 671, 680 (Minn. Ct. App. 2004); see Wilson v. Harris, 688 So.2d 265, 270 (Ala. Civ. App. 1996), quoting Lott v. Kees, 165 So. 2d 106 (Ala. 1964) (“The doctrine of champerty is directed against speculation in lawsuits and to repress the gambling propensity of buying up doubtful claims.”). In dicta another court speculated that a rate of return disproportionate to the investor’s risk might render the contract voidable for unconscionability. Fausone v. U.S. Claims, Inc., 915 So.2d 626, 630 (Fla. Dist. Ct. App. 2005), aff’d, 931 So.2d 899 (Fla. 2006). On the record before the court, however, no findings were possible concerning the risk of non-recovery.
45 See, e.g., N.Y.C. Bar Ass’n Comm. on Prof’l and Judicial Ethics, Formal Op. 2011-2 (2011) (“This opinion addresses non-recourse litigation loans, i.e. financing repayd by a litigant only in the event he or she settles the case or is awarded a judgment upon completion of the litigation.”).
46 See, e.g., Comments of Augusta Capital, LLC to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. (Feb. 7, 2011) (on file with author) (“The funding that Augusta Capital provides is entirely contingent - the lawyer is not obligated to repay any portion of the funding provided by Augusta Capital - nor to pay any fee to Augusta for the funding - for a particular case unless and until a recovery is made in that particular case.”); Comments of Oasis Legal Finance, LLC to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. (Jan. 18, 2011) (on file with author) (“This product does not fall into a traditional ‘loan product’ category as it is non-recourse.”).
47 See Odell v. Legal Bucks, LLC, 665 S.E.2d 767, 777 (N.C. Ct. App. 2008) (citations omitted) (“[A] transaction in which the borrower’s repayment of the principal is subject to a contingency is not considered a loan because the terms of the transaction do not necessarily require that the borrower repay the sum lent or return a sum equivalent to that which he borrow[ed].”); 1-6 CONSUMER CREDIT LAW MANUAL § 6.08 (2011) (“The second element of a traditional usury case is the debtor’s absolute obligation to repay the principal amount of the money transferred to him or her.”); Cynthia Bulan, A Small Question in the Big Statute: Does Section 402 of Sarbanes-Oxley Prohibit Defense Advancements?, 39 CREIGHTON L. REV. 357, 374-75 (2006) (“A handful of courts have addressed the
courts have relied upon this understanding of the definition of debt to state that ALF is not lending. However, some may argue that notwithstanding the absence of any judicial precedent applicable to ALF, such advances from a supplier are in reality “nonrecourse loans.” Consistent with this perspective, some courts have characterized ALF transactions as loans, potentially triggering state law usury limitations.\footnote{See, e.g., Dopp v. Yari, 927 F. Supp. 814 (D.N.J. 1996); Kraft v. Mason, 668 So. 2d 679 (Fla. Dist. Ct. App. 1996); Nyquist v. Nyquist, 841 P.2d 515 (Mont. 1992); Anglo-Dutch Petroleum Int’l, Inc. v. Haskell, 193 S.W.3d 87, 96 (Tex. Ct. App. 2006).}

In 2010, two of the major national consumer-sector ALF providers sued the Colorado Attorney General to obtain a declaratory judgment holding that their activities are not loans and are not in violation of Colorado’s Uniform Consumer Credit Code. Recently, the trial judge hearing this suit held that under Colorado’s Uniform Consumer Credit Code, debt need not be recourse and therefore consumer ALF transactions made with an “expectation of repayment” may not charge more than the interest rate set by that state’s usury law.

C. Examples of ALF Transactions

The following hypothetical scenarios illustrate some of the ways in which lawyers may be involved when they represent clients receiving funds from ALF suppliers. The hypotheticals also suggest some of the ethical issues confronting lawyers.

Case 1: Plaintiff was injured in a car accident and his injuries have rendered him unable to perform his job involving physical labor at a factory. Plaintiff has many financial obligations, including rent payments and other bills coming due, but is unable to borrow money from traditional lenders or to take out further cash advances on his credit card. Lawyer is a personal injury lawyer representing Plaintiff in the accident litigation. Lawyer believes Plaintiff’s case has a reasonable likelihood of settling for $100,000, but due to a slow state court docket, Lawyer expects it will take 18 months or more to settle the case. Plaintiff tells Lawyer that he has seen late-night television ads run by Supplier offering “cash for lawsuits,” and asks Lawyer whether he should sell a portion of his claim to Supplier. Lawyer is unfamiliar with the terms of the financing contracts entered into between Supplier and its customers. How should Lawyer advise Plaintiff?

\footnote{See, e.g., Lawsuit Financial, LLC v. Curry, 683 N.W.2d 233 (Mich. Ct. App. 2004); Echeverria v. Estate of Lindner, No. 018666/2002, 2005 WL 1083704 (N.Y. Sup. Ct. Mar. 2, 2005). The same ALF contract that was at issue in Echeverria (where the ALF supplier, not being a party, did not have the opportunity to brief the court on New York law), was later declared to be valid and not covered by New York’s usury statutes in a suit for declaratory judgment brought by the ALF supplier. Plaintiff Funding Corporation d/b/a LawCash v. Echeverria, No. 10140/2005 (N.Y. Sup. Ct. 2005). In Ohio, the lower courts in the Rancman case characterized an ALF transaction as a loan, but the Ohio Supreme Court invalidated the contract with the supplier on a different ground, concluding that it violated state law prohibitions on champerty. See Rancman v. Interim Settlement Funding Corp., 789 N.E.2d 217 (Ohio 2003). The Ohio legislature subsequently overruled Rancman and permitted transactions of the sort involved in that case. In North Carolina, the Court of Appeals held that, although the ALF supplier had not provided a loan for the reasons explained supra, it had provided an “advance,” which did fall under North Carolina’s usury statute, even though an advance was not a loan. Odell v. Legal Bucks, LLC, 665 S.E.2d 767, 778 (N.C. Ct. App. 2008).}
Variation: Lawyer has represented personal-injury clients in other cases who have sold portions of their claims to Supplier. Based on this experience Lawyer knows that Supplier does not request to inspect confidential documents, but relies for its due diligence on filed pleadings and other publicly available information. Lawyer also reasonably believes that Supplier clearly discloses the terms of the financing contract with its customers. Based on other agreements Lawyer has seen between Supplier and its customers, Lawyer reasonably believes that Supplier will not require Plaintiff to agree to convey any decision-making authority with respect to the representation to Supplier.

Case 2: Plaintiff enters into a contract with a funding company, Supplier, which advertises extensively with slogans such as “quick cash today!” The contract terms provide that, in exchange for $25,000, Plaintiff agrees to repay Supplier the principal amount of $25,000 plus financing charges computed at a monthly rate of 3.85% of the principal amount, compounded monthly, plus various charges denominated “case review” and “case servicing” fees. The obligation to repay Supplier has priority over Plaintiff receiving any proceeds from a settlement or judgment in the litigation, and Plaintiff and Plaintiff’s lawyer are required to hold any proceeds in trust until the obligation to repay Supplier has been satisfied. In addition, under the agreement Plaintiff permits Supplier to inspect any pleadings, reports, memoranda or other documents relating to the lawsuit, and agrees to waive any duty of confidentiality that would restrict Plaintiff’s lawyer from disclosing this information to Supplier. Plaintiff also agrees to prosecute the lawsuit vigorously and in good faith, and to give Supplier notice of any termination or substitution of counsel. Finally, Plaintiff agrees not to accept any offer of settlement without giving written notice to Supplier and obtaining Supplier’s consent to the settlement.

Plaintiff has retained Lawyer to represent him in a personal-injury lawsuit. After Plaintiff and Lawyer signed a retention agreement, Plaintiff told Lawyer about the contract with Supplier. After reviewing the contract, Lawyer became concerned about her ability to represent Plaintiff effectively. What should Lawyer do now?

Case 3: Plaintiff, an inventor, approaches Lawyer, an intellectual property lawyer, about pursuing a patent infringement action against a large manufacturing company. The matter will be complex and likely take several years to complete, and the prospective defendant is notorious for using delaying tactics to drive up the litigation costs of its adversaries. Lawyer does not have sufficient capital on hand to represent Plaintiff on a contingent fee basis. Lawyer therefore recommends that Plaintiff approach Supplier, a company that buys shares in causes of action asserted in complex commercial disputes. Lawyer has dealt with Supplier in the past in connection with the representation of other clients, but does not receive compensation for referring clients to Supplier.

In the course of negotiating the agreement between Plaintiff and Supplier, numerous issues have arisen. Supplier has insisted that its claim have priority in the proceeds of any judgment or settlement recovered, so that Plaintiff does not receive anything until Supplier is paid in full. That is, Supplier would get paid after Lawyer, but before Plaintiff. Supplier also seeks unrestricted access to all documents in Lawyer’s possession, including those that may be
protected by the attorney-client privilege or work product doctrine. Supplier asks Lawyer to agree not to withdraw or associate with co-counsel without the express written consent of Supplier. Finally, Supplier proposed a contract term requiring Plaintiff to seek Supplier’s agreement before accepting any offer of settlement.

How should Lawyer proceed in the negotiations with Supplier on behalf of Plaintiff?

Case 4: Lawyer is a personal-injury attorney specializing in class action and non-class aggregate litigation. Product liability lawsuits have recently been filed against a pharmaceutical company, asserting that the manufacturer knew but failed to warn of dangerous side effects of a prescription drug. Lawyer believes it would be possible to attract numerous clients with potential claims against the manufacturer, but is concerned that the litigation will be lengthy, vigorously contested by the manufacturer, and therefore expensive. Lawyer does not have sufficient capital on hand in her firm’s account to finance the case herself, with the aim of recouping the expenses through a contingency fee obtained after a judgment or settlement. Lawyer therefore approaches a commercial lender about establishing a line of credit to be used for the purpose of financing the case. The lender agrees to make a loan, secured by Lawyer’s office fixtures and accounts receivable. The interest rate is at fair market value for this type of loan. Lawyer subsequently is retained by hundreds of clients in a non-class aggregate lawsuit against the manufacturer. The clients agree to pay Lawyer one-third of the amount of any judgment or settlement received, plus expenses advanced by Lawyer on their behalf, and sign a contingent fee agreement that complies with Model Rule 1.5(c) except that it does not mention the possibility of borrowing funds and passing along interest expenses. After recovery is obtained for the clients, may Lawyer charge the clients a pro rata share of the borrowing costs Lawyer incurred to finance the litigation?

IV. Professional Responsibility Issues

A. Independent Professional Judgment and Conflicts of Interest

The conflicts of interest provisions in the ABA Model Rules of Professional Conduct, principally Model Rules 1.7 through 1.11, protect clients from having to assume the risk that their interests will be harmed because of the lawyer’s relationship with another client, a former client, or a third party, or the lawyer’s own financial or other interests. Protected interests of clients include the confidentiality of information shared with their lawyers, the reasonable expectation of loyalty of counsel, and the interest in receiving candid, unbiased advice. Conflicts rules regulate prophylactically, prohibiting lawyers from representing clients while subject to a conflict of interest, without obtaining the informed consent of their clients (where permitted). In a sense the conflicts rules provide a second layer of protection, beyond rules directly regulating conduct such as the disclosure of confidential information (Model Rule 1.6) or the exercise of independent professional judgment and the provision of candid legal advice (Model Rule 2.1).

1. Conflicts of Interest
The involvement of ALF has the potential to create conflicts of interest if the lawyer participates directly in or benefits financially from the ALF transaction, as opposed to simply advising the client in connection with the transaction.

Numerous provisions in the Model Rules of Professional Conduct regulate the conflicts of interest that may be created or exacerbated by the presence of ALF. In addition to the general material-limitation conflicts rule (Model Rule 1.7(a)(2)), and the regulation of business transactions with clients (Model Rule 1.8(a)), two non-waivable conflicts rules prohibit a lawyer from providing financial assistance to a client (Model Rule 1.8(e)) and acquiring a proprietary interest in the client’s cause of action (Model Rule 1.8(i)). Although it is not denominated a conflicts rule, the principles governing withdrawal from representation require that a client be free to terminate the representation without restriction. An agreement between an ALF supplier and a client, permitting the ALF supplier to have veto power over the selection of counsel, may limit the client’s right to terminate counsel in a manner that is inconsistent with Model Rule 1.16(a). Finally, a separate rule governs the provision of evaluations to someone other than the client.50

The analysis of conflicts of interest here assumes that a client-lawyer relationship exists only between the lawyer and the client seeking the services of an ALF supplier. If the lawyer also has a professional relationship with the ALF supplier, then a conventional concurrent conflict of interest arises, which must be analyzed under the principles of Model Rule 1.7. A professional relationship with the supplier may arise by express contract or by implication from the conduct of the parties.51 For example, in Leon v. Martinez, 638 N.E.2d 511 (N.Y. 1994), the New York Court of Appeals held that the allegations in the supplier’s complaint were sufficient to support a cause of action for legal malpractice against the lawyer who had been representing the plaintiff in personal-injury litigation. In particular, the lawyer had performed legal services for the supplier in the past, suggesting it was permissible to infer that the lawyer had intended to represent both the plaintiff and the supplier in the funding transaction.

a. Material Limitation Conflicts: Model Rule 1.7(a)(2)

A conflict of interest under Model Rule 1.7(a)(2) may arise if a lawyer has a relationship with an ALF supplier that creates a financial interest for the lawyer that may interfere with his or her obligation to provide impartial, unbiased advise to the client. For example, an attorney may have an agreement with an ALF supplier that it will pay the lawyer a referral fee for clients who use the supplier’s services. Attorneys are prohibited from paying others for referrals of clients, Model Rule 7.2(b), but there is no explicit prohibition in the Model Rules on receiving referral fees. Nevertheless, the acceptance of referral fees very likely constitutes a material limitation on the representation of the client, resulting from a personal interest of the lawyer.52 Under Model Rule 1.7(a)(2), therefore, the lawyer would be required to obtain the informed consent of the client to the referral-fee arrangement. Even in the absence of an explicit agreement to refer

50 See MODEL RULE 2.3.
52 In some jurisdictions ethics opinions state that these fees are prohibited outright, presumably because the risk that they will interfere with the lawyer’s independent professional judgment is too great. See infra note 91.
clients, a lawyer with a long-term history of working with a particular ALF supplier may have an interest in keeping the supplier content, which would create a conflict under Rule 1.7(a)(2).

A more subtle material limitation conflict could arise from the lawyer’s involvement in negotiating a contract with an ALF supplier. In Case 3, above, the lawyer representing the inventor is negotiating with the funding company, but the terms of the agreement may have an impact on the lawyer’s own interests. In the case of a contract negotiation over the structure of a financing arrangement, the conflict arises because the lawyer may have incentives to act in ways that are not in the client’s best interests. A conflict of interest exists if any interest of the lawyer:

would materially impair the lawyer’s ability to consider alternative courses of action that otherwise would be available to a client, to discuss all relevant aspects of the subject matter of the representation with the client, or otherwise to provide effective representation to the client.53

Case 3 is but one instance of a conflict of interest that can arise regardless of whether or not ALF is present. A lawyer working under a contingent fee may share with a third party who lends money to the client an interest that the litigation be resolved sooner than the client’s objectively determined interests might dictate. A lawyer may be able to disregard these incentives, give the client impartial advice, and provide competent representation, and the Model Rules are designed to make it possible for a lawyer to fulfill her professional obligations in the face of such incentives. Nevertheless, the client is entitled to know about the risks presented by the lawyer’s financial and other incentives created by the contract, and to have an opportunity to provide or decline informed consent. The risks include the possibility that some term of the agreement may adversely affect the client’s financial interests relative to those of the lawyer. For example, the ABA Standing Committee on Ethics and Professional Responsibility has concluded that an attorney may acquire an ownership interest in the stock of a corporate client, but that the client must give informed consent to the investment and the transaction must satisfy the requirements of Model Rule 1.8(a).54 The concern in these stock-for-fees transactions is that the lawyer might structure the transaction in some way that is unfair to the client. Thus, in a situation like Case 3, the lawyer must ensure that the client is adequately informed of the risk that the agreement negotiated between the lawyer and the ALF supplier may favor the lawyer’s financial interest over that of the client.

As a result, the lawyer must obtain the client’s informed consent, confirmed in writing, to the conflict presented by the lawyer’s role in the funding contract. Informed consent means the client’s agreement “after the lawyer has communicated adequate information and explanation about the material risks and reasonably available alternatives to the proposed course of conduct.”55 Thus, the lawyer in Case 3 would be required to explain to the client the ways in which the contract terms proposed by the ALF supplier could adversely affect the client’s interests. For example, the schedule of payments from the proceeds of the lawsuit may be

53 RESTATEMENT § 125 cmt. c.
55 MODEL RULE 1.0(e).
structured in a way that favors the lawyer’s interests over the interests of the client. There may be a good reason to do this – for example, it may be a way for the client to obtain the services of his or her choice of counsel – but the risks and benefits of this option must be explained fully to the client. The lawyer should also discuss reasonably available alternatives to the suggested contract terms, and suggest available alternatives to ALF funding, if they would be in the client’s best interests.

Simply paying a portion of the proceeds of a judgment or settlement to an ALF supplier holding a valid lien does not create a conflict of interest. A lawyer is required to deliver to a client or third party any funds in which the client or third party has an interest. The Leon case confirms that a lawyer does not violate the obligation of undivided loyalty to a client when paying funds to a third party that the third party is entitled to receive under a valid agreement. In a different case, however, the client might object to the lawyer disbursing the funds. In that instance, the lawyer’s obligation is stated in Model Rule 1.15(e), which requires the lawyer to hold the disputed funds separately until the dispute is resolved. There may a conflict of interest under Model Rule 1.7(a)(2) if the lawyer’s financial interest in obtaining a share of the disputed funds materially limits the lawyer’s ability to advocate effectively for the client’s rightful share of the funds; in that case, full disclosure to and informed consent by the affected client would be required.

b. Business Transactions with Clients: Model Rule 1.8(a)

A lawyer may enter into a business transaction with a client, or knowingly acquire “an ownership, possessory, security or other pecuniary interest adverse to a client” only after giving the client clearly understandable written disclosure of the terms of the transaction, along with written advice to consult independent legal counsel and a reasonable opportunity to do so, and obtaining the client’s informed consent to the terms of the transaction and the lawyers role in it, in a writing signed by the client. In addition, the terms of the transaction must be substantively fair and reasonable to the client.

Many ALF transactions are negotiated between the client and the supplier, with no involvement of the lawyer. Some transactions, however, are like the hypothetical described in Case 3, where the lawyer represents the client in negotiations with the ALF supplier, and where the terms of the agreement may affect the rights the lawyer and client have, vis-à-vis one another,

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57 MODEL RULE 1.15(d).
58 See Leon v. Martinez, 638 N.E.2d at 514.
59 Even a requirement that the lawyer hold funds for payment to the supplier, in effect putting the lawyer in the role of escrow agent, may create a conflict of interest under Model Rule 1.7(a)(2). At common law the duty of an escrow agent is to serve as a neutral fiduciary with respect to all of the parties to the escrow. An attorney, on the other hand, may be permitted to assert non-frivolous arguments on behalf of a client that the client is entitled to disputed funds in an escrow. These differential obligations may give rise to a conflict between the attorney’s role as escrow agent and as a zealous advocate for the client’s interests. See, e.g., Splash Design, Inc. v. Lee, 103 Wash. App. 1036, 2000 WL 1772519 (Wash. Ct. App. Dec. 4, 2000).
60 See, e.g., Fausone v. U.S. Claims, Inc., 915 So. 2d 626, 629 n.4 (Fla. Dist. Ct. App. 2005) (attorney followed the procedure outline in Rule 1.15 and deposited the funds with the court until the dispute was resolved).
61 See MODEL RULE 1.8(a).
in the proceeds of any recovery. Such a case likely involves the lawyer acquiring a “pecuniary interest adverse to a client,” triggering the requirements of Model Rule 1.8(a). In Case 3, in addition to satisfying the requirement of obtaining informed consent to the material limitation conflict (Model Rule 1.7(a)(2)), the lawyer must ensure compliance with Model Rule 1.8(a), by:

- Ensuring that the contract terms negotiated by the lawyer, respecting the interests of the lawyer, the client, and the ALF supplier, are substantively fair and reasonable from the client’s point of view.
- Fully disclosing the terms of the transaction and transmitting them in writing, in terms that can be reasonably understood by the client.
- Advising the client in writing of the desirability of seeking independent legal advice, and providing a reasonable opportunity for the client to obtain separate representation in the transaction.
- Obtaining the client’s informed consent, in writing, to both the substantive terms of the transaction and the lawyer’s role in it (i.e. that the lawyer is also an interested party, as well as acting as the client’s representative).

As discussed below (Section IV.C.2), some state bar ethics opinions have suggested that the requirements of Model Rule 1.8(a) are applicable when a lawyer obtains a loan from a commercial lender and seeks to recoup the interest expenses from clients.

c. Financial Assistance to Clients – Model Rule 1.8(e)

Model Rule 1.8(e) provides as follows:

A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

(1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and

(2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.63

The policy underlying the Rule is set out in Comment [10]: “Lawyers may not subsidize lawsuits or administrative proceedings brought on behalf of their clients, including making or guaranteeing loans to their clients for living expenses, because to do so would encourage clients to pursue lawsuits that might not otherwise be brought and because such assistance gives lawyers

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62 See MODEL RULE 1.8 cmt. [3] (lawyer must comply with Model Rule 1.7 as well as Model Rule 1.8(a) when the lawyer’s financial interest in the transaction “poses a significant risk that the lawyer’s representation of the client will be materially limited by the lawyer’s financial interest in the transaction”).

too great a financial stake in the litigation.” The Comment distinguishes prohibited financial assistance from lending court costs and litigation expenses, “because these advances are virtually indistinguishable from contingent fees and help ensure access to the courts.”

The primary focus of this Informational Report is the duties of lawyers when dealing with ALF suppliers who are independent of the lawyer. When lawyers themselves become the suppliers, except through the established mechanism of contingency fee financing, this Rule may be implicated. If the Rule applies, there is no provision for waiver with the informed consent of the client. Depending on the structure of the transaction, a lawyer may also acquire an interest in the client’s cause of action, which is prohibited by a separate rule, Model Rule 1.8(i).

d. Acquisition of an Interest in the Client’s Cause of Action – Model Rule 1.8(i)

Model Rule 1.8(i) provides as follows:

A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

(1) acquire a lien authorized by law to secure the lawyer's fee or expenses; and

(2) contract with a client for a reasonable contingent fee in a civil case.

The rationale for this Rule is explained in Comment [16]. The Rule is intended primarily to reinforce the lawyer’s capacity to exercise independent judgment in the representation of the client, which might be impaired if the lawyer has too great a personal interest in the representation. The Comment also notes that if the lawyer has a proprietary interest in the cause of action, the client will have a difficult time discharging the lawyer if the client is dissatisfied. The client’s right to terminate the professional relationship is almost absolute (Model Rule 1.16(a)(3)), subject only to the requirement of obtaining court permission in litigated matters (Model Rule 1.16(c)).

Even in states that have abolished the common law prohibition on champert, lawyers may not engage in champertous transactions with their clients in violation of Model Rule 1.8(i). Although this Rule is grouped with other conflicts of interest rules that may be waived upon the informed consent of the client, there is no provision in Model Rule 1.8(i) for informed consent. Thus, the Rule stands as an absolute prohibition on lawyers acquiring a proprietary interest in their clients’ causes of action.

Both the prohibition on acquiring an interest in the client’s cause of action, Model Rule 1.8(i), and the prohibition on providing financial assistance to clients, Model Rule 1.8(e), if applied literally would call into question the propriety of contingency fee financing. Both Rules

64 Lawyers have occasionally been permitted to assert claims for retaliatory discharge. See RESTATEMENT § 32 cmt. b & Reporter’s Note.
therefore contain a kind of carve-out or saving clause for contingency fees.\(^6^5\) Comments to Model Rule 1.8 acknowledge the similarity between prohibited transactions and contingent fees.\(^6^6\) As Comment [16] notes, the prohibitions in these Rules are rooted in the common law of champerty and maintenance. Because these doctrines evolved to take account of the development of contingent-fee financing, the provisions of state rules of professional conduct preserved the distinction between prohibited assistance or acquisition of an interest in the client’s cause of action, on the one hand, and permitted contingent-fee financing on the other. In substance, however, the permitted and prohibited transactions are similar—a non-party provides financial assistance to a party, or acquires an interest in the party’s cause of action. Nevertheless, contingent fees are permitted, subject to the disclosure requirements of Model Rule 1.5(c).

e. Withdrawal and Substitution of Counsel

Funding agreements may purport to restrict the client’s right to terminate a lawyer or to retain substitute counsel. For example, a Michigan state bar ethics opinion refers to a contract with an unnamed ALF supplier under which a tort plaintiff agrees not to terminate an existing client-lawyer relationship or substitute a different lawyer without the express written consent of the ALF supplier.\(^6^7\) As between lawyer and client, the client retains the right to terminate the client-lawyer relationship at any time, with no requirement of showing good cause, subject only to the requirement of obtaining court approval if the lawyer has entered an appearance for the client in pending litigation.\(^6^8\) Under principles of agency law applicable to the client-lawyer relationship, a client and lawyer cannot validly agree to a contract term that prohibits the client from discharging the lawyer.\(^6^9\) Courts frequently state that the client’s right to discharge a lawyer is virtually absolute.\(^7^0\) Provisions in retention agreements between lawyers and clients purporting to limit the right of clients to discharge lawyers have been set aside as interfering with what should be the client’s unrestricted right to terminate the relationship at any time.\(^7^1\) Thus, the provision described in the Michigan opinion, in the contract between the supplier and the plaintiff, may be deemed void as a matter of public policy. In a different case, the balance of policy considerations may be different and the recipient of funding may be permitted to validly agree to limitations on rights he or she would otherwise possess. For example, while a lawyer is not permitted to restrict the client’s right to discharge counsel, the client’s contract with the supplier may restrict this right. The validity of such a provision is a matter of state law and public policy and is beyond the scope of this Informational Report.

2. Interference with Lawyers’ Professional Judgment

\(^6^5\) See Model Rule 1.8(e)(1); Model Rule 1.8(i)(2).
\(^6^6\) See Model Rule 1.8 cmts. [10], [16].
\(^6^8\) Model Rule 1.16(a)(3), 1.16(c); Restatement § 32(1).
\(^6^9\) See Restatement § 31 cmt. d.
\(^7^0\) See, e.g., Balla v. Gambro, Inc., 584 N.E.2d 104 (Ill. 1991) (citing the client’s near-absolute right to terminate counsel as the principal reason for not recognizing a cause of action for retaliatory discharge).
\(^7^1\) See Restatement § 32 cmt. b & Reporter’s Note.
The presence of ALF has the potential to interfere with the lawyer’s exercise of candid, objective, independent judgment on behalf of the client. Arguably the Rules safeguarding a lawyer’s independence can be seen as reinforcing the prohibition on representing a client in circumstances in which there is a significant risk that a personal interest of the lawyer will materially limit the lawyer’s representation of the client. Protecting professional independence is a significant rationale underlying the conflict of interest Rules. Because the Model Rules treat independence in a number of separate Rules, however, it is important to consider how ALF may affect the lawyer’s professional independence, and how these Rules are implicated in ALF transactions.

ALF suppliers are businesses, operated with the goal of maximizing return on investments. The investments are in legal claims, acquired in whole or in part. The interests of a supplier in any given transaction, therefore, will be to maximize the expected value of a legal claim. In order to protect their investments and to maximize the expected value of claims, suppliers may seek to exercise some measure of control over the litigation, including the identity of lawyers pursuing the claims, litigation strategy to be employed, and whether to accept a settlement offer or refuse it and continue to trial. The efforts of suppliers to maximize the return on their investment may create incentives and effects that differ from what would be expected in a similar case in which ALF funding was not present.

ALF suppliers may also seek the right to advise on, or even veto, decisions made by lawyers during the course of litigation. In one Florida case, for example, the supplier had the right “to approve the filing of the lawsuit; controlled the selection of the plaintiffs’ attorneys; recruited fact and expert witnesses; received, reviewed and approved counsel’s bills; and had the ability to veto any settlement agreements.” The court deemed this control sufficiently extensive to warrant treating the supplier as a “party” for the purposes of a fee-shifting statute. Case 2 presents a hypothetical scenario of a client entering into a contract with an ALF supplier that obligates the client to do various things, such as permitting the supplier to inspect pleadings, waiving confidentiality, and giving the supplier a say in the hiring and firing of counsel and the decision whether to settle. While cast in extreme terms, this hypothetical raises the important and general problem of whether certain professional duties owed by lawyers to clients are non-delegable. For example, as between the lawyer and client, the client retains the authority to decide whether to settle a civil lawsuit. But does it follow that the client cannot agree by

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72 See MODEL RULE 2.1.
73 See MODEL RULE 1.7(a)(2).
74 See, e.g., MODEL RULE 1.7 cmt. [8].
75 See, e.g., Weaver, Bennett & Bland, P.A. v. Speedy Bucks, Inc., 162 F. Supp. 2d 449, 451 (W.D.N.C. 2001) (alleging that a supplier keeping tabs on its investment caused a plaintiff to reject a reasonable settlement offer).
77 It does not necessarily follow that the supplier would be deemed a “client” for other purposes, such as the application of concurrent or successive client conflicts rules. There is an extensive body of law, beyond the scope of this Informational Report, governing the formation of the attorney-client relationship. See generally RESTATEMENT § 14 & Reporter’s Note; GEOFFREY C. HAZARD, JR., ET AL., THE LAW AND ETHICS OF LAWYERING ch. 6 (5th ed. 2010), (“Who Is the Client?”).
78 MODEL RULE 1.2(a).
contract with a third party ALF supplier to cede these rights to the ALF supplier? The fiduciary nature of the client-lawyer relationship is the reason for the unenforceability of a client-lawyer contract provision interfering with certain client rights, such as the right to make decisions respecting settlement. In an arm’s-length transaction, however, these fiduciary considerations are absent. There would seem to be no reason, as a matter of contract law, to regard these contractual provisions as unenforceable, absent some facts establishing a defense such as duress or unconscionability.

Regardless of whether the provisions delegating decision-making authority to the ALF supplier would be enforceable as a matter of contract law, they may create such a limitation on an attorney’s professional judgment that a reasonable lawyer might conclude that it is impossible to provide competent representation to that client. A lawyer and client may agree among themselves to limit the scope of the lawyer’s duties, but these limitations must be reasonable under the circumstances (and the client must give informed consent to the limitation).79 A contract between a would-be client and an ALF supplier may create such onerous duties on the part of the client that a lawyer would be unable to represent the client, even in a limited-scope representation. For example, a provision in a contract may permit the supplier to refuse further funding if the lawyer makes decisions in the course of the representation with which the supplier has a fundamental disagreement. The lawyer, on the other hand, has an obligation to act with reasonable competence and diligence in the representation of the client, and may reasonably believe that the funder’s second-guessing of decisions made in the representation of the client is an unreasonable interference with the lawyer’s professional judgment.

While it is outside the scope of this Informational Report, it should be noted briefly that state common law doctrines of champerty and maintenance may bear on the degree of control an ALF supplier is permitted to exercise over the representation.80 Even in states permitting an ALF supplier to obtain an interest in a party’s cause of action, retention by the supplier of control over the decision-making of the party and its counsel, via a contractual provision between the supplier and the party, may be deemed unlawful as champerty or maintenance.81

On the other hand, some ALF suppliers disclaim any control over the decision-making of lawyers, stating that they are in an entirely passive role.82 Indeed, some reported cases note that

79 Model Rule 1.2(c).
80 See Sebok, supra note 4, at 109-12.
81 See, e.g., Am. Optical Co. v. Curtiss, 56 F.R.D. 26, 29–32 (S.D.N.Y. 1971) (agreement limiting litigant’s control over whether to sue violated Fed. R. Civ. P. 17(a) requirement of suit brought by real party in interest); Kraft v. Mason, 668 So. 2d 679, 682 (Fla. Dist. Ct. App. 1996) (“officious intermeddling” is an element of champerty); Huber v. Johnson, 70 N.W. 806, 808 (Minn. 1897) (voiding contract that required plaintiff to pay funder a penalty if plaintiff sued without funder’s consent).
82 See, e.g., Comments of Burford Group, LLC to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. 5 (Feb. 15, 2011) (on file with author) (“Burford does not hire or fire the lawyers, direct strategy or make settlement decisions. Burford is a purely passive provider of non-recourse financing to a corporate party.”); Comments of Juridica Capital Mgmt. Ltd. to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. 6 (Feb. 17, 2011) (on file with author) (“We do not seek to control any of the decisions regarding the conduct of any litigation that we finance, nor are we aware of any other supplier in this market segment who does.”).
the ALF supplier exercised no control over the lawyer’s representation of the client.83

Investments by ALF suppliers may be used for a variety of purposes, but when they are used to pay litigation expenses, an attorney must ensure that the funding arrangement does not compromise the lawyer’s independent professional judgment (Model Rule 5.4(c)). Of course, interference with professional judgment is not a risk unique to ALF, but arises whenever a lawyer feels pressure to favor the interest of a non-client, regardless of whether the non-client has provided funds to pay the client’s legal expenses or have some other material interest in the outcome of the client’s litigation.

a. Referring Clients to ALF Suppliers

Numerous state ethics opinions have considered the issue of whether a lawyer may provide information to clients about the availability of ALF, or refer clients to ALF suppliers. The majority of these opinions conclude that it is permissible to inform clients about funding companies,84 or to refer clients to ALF suppliers.85 If it is legal for a client to enter into the transaction, there would appear to be no reason to prohibit lawyers from informing clients of their existence. A more difficult question is whether lawyers should evaluate the terms of the transaction for their fairness or to advise the client whether to accept the funding. As with any subject on which a lawyer offers an opinion, a lawyer should ensure his or her competence to evaluate the ALF transaction.86 At a minimum the lawyer should become familiar with the terms of the transaction and explain its risks and benefits to the client in terms the client can understand.87 Competent representation and reasonable communication may also require the lawyer to compare the proposed transaction with other available means of obtaining funding, and possibly to recommend alternatives. If the lawyer is not competent to evaluate the risks and benefits of the transaction, the lawyer should refer the client to a competent advisor.

Many of the state bar ethics opinions permitting referrals to ALF suppliers include qualifications, reflecting other ethical obligations owed by lawyers to their clients. Typical limitations include: Lawyers may not disclose confidential information to an ALF supplier

86 See MODEL RULE 1.1.
87 See MODEL RULE 1.4.
without the client’s informed consent; lawyers should warn clients about the risk of waiver of the attorney-client privilege (often as part of obtaining informed consent to disclose confidential information); lawyers may not have an ownership interest in the ALF supplier to which the client is referred; lawyers may not receive referral fees or otherwise benefit financially as a result of referring the client to the ALF supplier. Some opinions include the proviso that the lawyer must be satisfied that the funding arrangement is in the client’s best interests, which implicates the concerns, discussed in Section IV.D, below, about the lawyer’s competence to make this assessment. Many opinions admonish lawyers in general terms to avoid any interference with their professional judgment as a result of involvement in the ALF transaction. A South Carolina opinion even requires the lawyer to inform the ALF supplier in writing that the client, not the funding company, retains the right to control all aspects of the litigation.

The prevalence of these qualifications in state bar ethics opinions shows that the interference with independent professional judgment is one of the principal perceived risks associated with ALF. The opinions also suggest, however, that this risk can be managed, by full disclosure to the client, compliance with the obligation to obtain the client’s informed consent to any potential interference with a client’s interests (such as confidentiality), and also awareness on the part of the lawyer of risky contract provisions.

Case 1, above, does not appear at the outset to involve any potential interference with the lawyer’s professional judgment. The client has asked his lawyer whether it is advisable to sell a portion of his tort claim to an ALF supplier. In the variation on Case 1, the lawyer has acquired expertise in this area and is likely competent to advise the client on the risks and benefits of the ALF transaction. If the lawyer did not have this experience and could not evaluate the potential risks and benefits, the lawyer may honestly answer “I don’t know” or, in the alternative, the lawyer might do sufficient research to be in a position to render competent legal advice to the client. In either case, the ethical obligation here is primarily one of rendering competent legal

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95 See MODEL RULE 1.1. See also the discussion below, Section IV.D., on the lawyer’s duty of competence in advising on ALF transactions.
advice. The mere referral of the client to an ALF supplier does not implicate the lawyer’s independent professional judgment.

b. Effect on Settlement

i. Express Contract Provisions

A client may agree, in a contract with an ALF supplier, to seek the consent of the ALF supplier before entering into any settlement of the client’s cause of action. The Working Group reviewed numerous contracts submitted by ALF suppliers that expressly disclaim any control by the supplier over the settlement decision. Nevertheless, reported cases reveal instances in which ALF suppliers have attempted to influence the decision whether or not to settle a claim.

An agreement to obtain the consent of the ALF supplier to any settlement may interfere with the ability of the attorney to exercise independent professional judgment in the representation of the client. Although the decision to settle is ultimately one for the client, Model Rule 1.2(a), attorneys have a duty to provide competent advice regarding settlement, evaluating the offer from the standpoint of the client’s best interests in light of the terms of the offer and the risk of proceeding with the litigation. The attorney’s advice should be based solely on what is best for the client, without regard to extraneous considerations such as the lawyer’s interests or the interests of third parties. On the other hand, considerations of freedom of contract suggest that clients should be permitted to delegate some authority over the handling of their cases to third parties, in exchange for some valuable consideration.

As a matter of agency law, the authority to settle a claim initially belongs to the client, but the client may delegate revocable settlement authority to the lawyer. In principle there would appear to be no reason why the client could not delegate revocable settlement authority to

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96 For example, Oasis Legal Funding submitted its standard Nebraska purchase contract, which in a prominent disclosure states:

PURCHASER OASIS LEGAL FINANCE, LLC, AS THE COMPANY AGREES THAT IT SHALL HAVE NO RIGHT TO AND WILL NOT MAKE ANY DECISIONS WITH RESPECT TO THE CONDUCT OF THE UNDERLYING LEGAL CLAIM OR ANY SETTLEMENT OR RESOLUTION THEREOF AND THAT THE RIGHT TO MAKE THOSE DECISIONS REMAINS SOLELY WITH YOU AND YOUR ATTORNEY IN THE CIVIL ACTION OR CLAIM.

Oasis Form Purchase Agreement, at 7.

97 See, e.g., Abu-Ghazaleh v. Chaul, 36 So. 3d 691, 694 (Fla. Dist. Ct. App. 2009) (deeming ALF supplier a “party” liable for opposing party’s attorney’s fees where, inter alia, supplier had the right to approve any settlement entered into by the recipient of funds).

98 Although there is a split of authority, many courts hold lawyers to the general standard of reasonable care under the circumstances when advising a client whether or not to accept an offer of settlement. See, e.g., Ziegelheim v. Apollo, 607 A.2d 1298 (N.J. 1992). The relevant “circumstances” include the inherent uncertainty involved in these decisions, but an attorney should provide the client with an informed judgment concerning the factors that go into making a decision whether to settle or proceed to trial. See generally RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 31:42 (2009).

99 See RESTATEMENT § 22(1), (3) & cmt. c.
other agents. Under general agency law principles, any delegation of authority can be revoked by the principal. The more difficult question is whether a user of ALF financing may contractually agree to make an irrevocable authorization to the ALF supplier to approve or reject a settlement offer. Contractual limitations on the client’s authority to accept or reject settlement offers have been invalidated where the contract is between the lawyer and client. As discussed in Section IV.A.2, above, as a matter of contract law a client may be able to enter into an enforceable provision in a contract with an ALF supplier, giving the supplier the right to accept or reject a proposed settlement. It is a significant open question whether that contractual delegation is such a significant limitation on the lawyer’s representation of the client – because it interferes with the lawyer’s exercise of independent professional judgment – that the lawyer must withdraw from the representation of a client who has agreed to such a contract provision.

ii. Implicit Interference and the Parties’ Incentives

Apart from an express contractual grant to an ALF supplier of the right to approve a settlement offer, the terms of an ALF transaction may affect the calculus of plaintiffs considering whether to settle a claim. A plaintiff may be reluctant to accept what would otherwise be a reasonable settlement offer because of a contractual obligation to repay a supplier a substantial portion of the proceeds of the settlement. For example, in the Rancman case, the Ohio Supreme Court was worried about the effect on settlement of the supplier’s right to receive the first $16,800 of settlement proceeds, in exchange for having previously provided the plaintiff with $6,000. The court noted that, assuming the plaintiff was also obligated to pay her attorney a 30% contingency fee, she would be indifferent between a settlement offer of $24,000 and nothing at all, because if she received nothing she would be permitted to keep the $6,000 advanced by the supplier. Thus, the plaintiff would have an absolute disincentive to settle for anything less than $24,000. (Compounding the disincentive is the fact that the nonrecourse nature of ALF means that there is no downside for the plaintiff in going to trial, because settling for less than the amount owed to the ALF supplier yields the plaintiff nothing, while losing at trial means owing nothing to the ALF supplier, so the plaintiff still receives nothing.) On the assumption that $24,000 would otherwise be a reasonable settlement offer, the presence of ALF seems to have an adverse impact on the salutary goal of terminating litigation by settlement.

Ironically, depending on the specifics of a funding agreement, ALF may also over-incentivize settlements if plaintiffs who are recipients of ALF funding are concerned about the escalating obligation to repay. While some ALF contracts tie the amount owed to the amount of the judgment or settlement, other agreements set the repayment amount with reference to the

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101 See RESTATEMENT § 22 & Reporter’s Note.
102 See MODEL RULE 1.2(c) (only reasonable limitations on scope of representation are permissible); MODEL RULE 1.16(a)(1) (withdrawal required where representation would result in violation of the rules of professional conduct).
104 Id. at 220.
105 See also Weaver, Bennett & Bland, P.A. v. Speedy Bucks, Inc., 162 F. Supp. 2d 449 (W.D.N.C. 2001) (plaintiff refused settlement offer of $1,000,000 because repayment obligations to suppliers made it a losing proposition to settle for anything less than $1,200,000).
time elapsed since the funding was made. A plaintiff may therefore have an incentive to accept an early but low settlement, rather than going to trial or waiting for a better settlement offer, because the plaintiff’s net recovery after repaying the supplier would be higher in the early stages of litigation.

The ethical issue for lawyers is how such disincentives on the part of their clients affect their exercise of independent professional judgment. Not all situations that are unpleasant ex post are the result of decisions that were unreasonable ex ante. Assuming the client had been fully informed of all the material terms of the ALF transaction and that the client had sought legal advice before entering into the transaction, a reasonable attorney appropriately exercising independent judgment might have advised the client in the above example to accept the $6,000 in funding in exchange for an obligation to repay the first $16,800 out of settlement proceeds. If the client were short of cash and facing an emergency such as eviction or the urgent need for a medical procedure, the client’s short-term need for funds may have been a more important consideration than the ex post disincentive to accept what would otherwise be a reasonable settlement offer. Perhaps the client’s receipt of short-term funds enabled the client to persist in the litigation and receive a better settlement offer than would have been available if the client were forced to settle prematurely. Similarly, a client who agreed to an early settlement offer because it maximized the client’s net recovery may have acted reasonably, given the client’s presumed desire to receive payment up front in exchange for some of the value of the cause of action.

A lawyer’s duty is to provide competent advice to the client considering an offer of settlement. The lawyer should consider what is best for the client, all things considered. If, in the lawyer’s judgment, the client would be better off rejecting a settlement offer and going to trial, then the lawyer should inform the client of this judgment, although the authority to accept or reject the settlement offer remains with the client. One of the factors relevant to the client’s decision might be the obligation to pay the fee charged by the ALF supplier. Other factors unrelated to the merits of the lawsuit may be present as well, such as the client’s risk tolerance, discount rate, need for funds, and preferences regarding a public trial. The presence of ALF is not different in kind from the other factors that are part of virtually any decision to settle; thus, they do not present distinctive ethical issues, beyond the duty of competence and the client’s authority to make settlement decisions. All fee arrangements create conflicts of interest to some extent. For example, an early settlement may result in the lawyer obtaining a higher effective hourly rate, as compared with pursuing the case through trial. These conflicts do not rise to the level of a material limitation, requiring disclosure and informed consent under Model Rule 1.7(a), without some financial interest of the lawyer above and beyond the pervasive interest in obtaining compensation. If the lawyer does have some kind of extraordinary interest beyond the

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108 See MODEL RULE 1.2(a).
109 See RESTATEMENT § 35 cmt. b.
110 See HAZARD, supra note 77, at 798-801 (discussion of the implicit conflicts of interest created by differences in effective hourly contingency fee rates).
fee, such as a financial investment in the ALF supplier, the lawyer must also comply with the requirements of Model Rules 1.7 (conflicts created by lawyer’s financial interest) and 1.8(a) (business transactions with clients).

c. Fee Sharing: Model Rule 5.4(a)

With certain enumerated exceptions, none of which are relevant here, a lawyer may not share legal fees with a nonlawyer. This prohibition is intended to protect the lawyer’s professional independence of judgment.

A few state ethics opinions have addressed the fee-sharing rule in connection with ALF transactions. These opinions state that a lawyer may not agree to give an ALF supplier a share of or a security interest in the fee the lawyer expects to receive under a contingency fee agreement with the client. Some cases, however, have reached the opposite conclusion. In *Core Funding Group v. McDonald*, No. L-05-1291, 2006 WL 832833 (Ohio Ct. App. Mar. 31, 2006), the Ohio Court of Appeals stated that it is not inappropriate for a lender to take a security interest in an attorney’s accounts receivable, to the extent permitted by commercial law. This is an ordinary secured transaction and does not violate the prohibition on sharing fees with a nonlawyer, the court concluded. Following these principles, no prohibited fee splitting would be involved if the lawyer repays interest on a loan taken out by the lawyer to fund the litigation.

d. Third-party Payment of Fees: Model Rules 1.8(f) and 5.4(c)

Two provisions of the Model Rules seek to limit the influence of third-party payors of attorneys’ fees. Model Rule 1.8(f) prohibits lawyers from accepting compensation from a third party for the representation of a client unless the client gives informed consent, there is no interference with the lawyer’s exercise of independent professional judgment, and confidential information is protected as required by Model Rule 1.6. Model Rule 5.4(c) reinforces the protection of independent professional judgment by directing lawyers not to “permit a person who . . . pays the lawyer to render legal services for another to direct or regulate the lawyer’s professional judgment in rendering such services.” These rules overlap with, and reinforce, the lawyer’s general obligation stated in Model Rule 2.1 to “exercise independent professional judgment and render candid advice.” As noted previously, in connection with the decision to settle, many ALF suppliers disclaim any effort to regulate the decision-making of lawyers. Even without this disclaimer by the suppliers, however, Model Rules 1.8(f), 2.1, and 5.4(c) require lawyers to, in effect, insist that suppliers not attempt to regulate the professional judgment of lawyers. If the supplier attempts to interfere with the lawyer’s professional judgment, a lawyer would have no choice but to withdraw from the representation.

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111 MODEL RULE 5.4(a).
112 MODEL RULE 5.4, cmt. [1].
114 See MODEL RULE 1.16(a)(1) (withdrawal mandatory where representation would result in violation of the rules of professional conduct).
These Rules do not apply to purely passive investments. Model Rule 1.8(f) is not applicable to ALF transactions that do not involve the payment of “compensation for representing a client.” If a tort plaintiff, for example, receives $10,000 in exchange for a promise to repay the supplier out of the proceeds of a judgment or settlement, the lawyer is not receiving compensation from the supplier. Similarly, Model Rule 5.4(c) applies only to attempts to direct the lawyer’s exercise of judgment by “a person who . . . pays the lawyer.” The same hypothetical supplier who obtains an assignment of a share of a tort plaintiff’s claim for $10,000 is not paying the lawyer. Nevertheless, the lawyer always has a duty under Model Rule 2.1 to ensure that the lawyer is exercising independent professional judgment solely for the benefit of the client.

B. Confidentiality, Privilege, and Work Product

As part of their underwriting process, ALF suppliers often require the lawyer to release information or to provide a litigation assessment referencing such information. That information is manifestly relevant to the decision of the ALF supplier. Such disclosures also clearly involve potential waivers of confidentiality and privilege that require the client’s consent. A lawyer must exercise reasonable care to preserve the confidentiality of information protected by Model Rule 1.6, and to safeguard against inadvertently waiving the protection of the attorney-client privilege and the work product doctrine.

In public comments, many ALF suppliers stated that they do not seek access to information covered by the attorney-client privilege. On the other hand, some agreements between ALF suppliers and clients have provided for the supplier to have a right to inspect all documents, including those covered by the attorney-client privilege.

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115 See, e.g., Fausone v. U.S. Claims, Inc., 915 So. 2d 626, 628 (Fla. Dist. Ct. App. 2005), aff’d, 931 So.2d 899 (Fla. 2006) (“[tort plaintiff’s] attorneys also provided [the supplier] with information about her claim to assist [the supplier] in deciding whether to advance her funds”). See also Emanuel, supra note 1, at 8 (quoting application and disclosure form provided by LawCash, a consumer ALF supplier, which informs the claimant’s lawyer: “We might ask you to provide medical reports, emergency room reports, accident reports, expert testimony, insurance information, information about the current status of the litigation, and any other details that would help us to make our decision.”). Some of the information sought here may be covered by the attorney-client privilege (e.g. “current status of the litigation” if it revealed confidential attorney-client communications); other information might be protected by the work product doctrine (e.g. expert reports). All of it would be subject to the duty of confidentiality in Model Rule 1.6(a).

116 See MODEL RULE 1.6, cmts. [16]–[17].

117 See, e.g., Comments of Juridica Capital Mgmt. Ltd. to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. 2 (Feb. 17, 2011) (on file with author) (“Our experience is that ALF funders generally do not need access to privileged or confidential information in order to make financing decisions. We perform our due diligence by relying primarily on publicly-filed pleadings and memoranda and other non-privileged materials. We do not seek attorney-client privileged information.”); Comments of Oasis Legal Finance/Alliance for Responsible Consumer Legal Funding to the Am. Bar Ass’n Working Group on Alternative Litig. Fin. 4 (Apr. 5, 2011) (on file with author) (“By and large, consumer legal funding companies have no need to request privileged information from attorneys regarding their clients.”).

118 See, e.g., Mich. State Bar Standing Comm. on Prof’l Ethics, Advisory Op. RI-321 (2000) (discussing an agreement between a civil tort plaintiff and an unnamed ALF supplier in which the supplier is “entitled to inspect all records, including all privileged attorney-client records, relating to the collateral”) (internal quotation marks omitted).
Lawyers considering disclosure of information to ALF suppliers must be aware of three distinct but overlapping legal doctrines: The duty of confidentiality (as provided for by the Model Rules and agency law), the evidentiary attorney-client privilege, and the work-product doctrine (with its common law origin and codification in the rules of civil procedure). Questions of the scope of duty, client consent, and particularly waiver of protection vary subtly among these confidentiality-related doctrines.

1. Duty of Confidentiality: Model Rule 1.6

A lawyer must not disclose “information relating to the representation of a client” without the client’s informed consent, unless the disclosure is impliedly authorized in order to carry out the representation. The scope of the duty of confidentiality is significantly broader than the attorney-client privilege (see below), which protects only communications made in confidence between attorney and client, for the purpose of obtaining legal assistance. The duty of confidentiality imposes duties on lawyers to safeguard information (Model Rule 1.6 cmt. [16]), but it does not create an evidentiary privilege that may be asserted in response to an official demand for information, such as a subpoena or a question at trial or in a deposition. However, competent representation does require an attorney to exercise reasonable care to ensure that the attorney-client privilege and work product protection are not inadvertently

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119 Model Rule 1.6(a).

120 There is considerable jurisdictional variation with respect to the definition of confidential information. For example, the District of Columbia and New York retain the Model Code’s distinction between confidences (communications protected by the attorney-client privilege) and other information to which the duty of confidentiality is applicable. The definition of non-privileged protected information is narrower than the expansive Model Rule 1.6 term, “information relating to the representation.” “Secrets” in the D.C. rules include “other information gained in the professional relationship that the client has requested be held inviolate, or the disclosure of which would be embarrassing, or would be likely to be detrimental, to the client.” D.C. Rules of Prof’l Conduct R. 1.6(b). New York similarly defines protected confidential information as follows:

“Confidential information” consists of information gained during or relating to the representation of a client, whatever its source, that is (a) protected by the attorney-client privilege, (b) likely to be embarrassing or detrimental to the client if disclosed, or (c) information that the client has requested be kept confidential. “Confidential information” does not ordinarily include (i) a lawyer’s legal knowledge or legal research or (ii) information that is generally known in the local community or in the trade, field or profession to which the information relates.

N.Y. Rules of Prof’l Conduct R. 1.6(a). Finally, California Business and Professions Code § 6068(e) (incorporated by reference into proposed California Rule 1.6(a)) requires lawyers to protect the confidences and secrets of clients. The scope of protected information has been defined as “information gained by virtue of the representation of a client, whatever its source, that (a) is protected by the lawyer-client privilege, (b) is likely to be embarrassing or detrimental to the client if disclosed, or (c) the client has requested be kept confidential.” See proposed Cal. Rules of Prof’l Conduct R. 1.6 cmt. [3].

Some disclosures of information relating to representation, which would be prohibited under Model Rule 1.6(a), would not violate the duty of confidentiality in jurisdictions such as New York, D.C., or California, which preserve the Model Code’s narrower definition of protected information.
Thus, lawyers representing clients in connection with ALF transactions must exercise reasonable care to ensure that confidential client information is protected.

A client may give informed consent to the disclosure of confidential information. As noted in connection with conflicts of interest, informed consent means the client’s agreement “after the lawyer has communicated adequate information and explanation about the material risks and reasonably available alternatives to the proposed course of conduct.”

One of the risks of disclosing confidential information to an ALF supplier is that the disclosure will cause a waiver of the attorney-client privilege or (less likely) the protection of the work product doctrine. The following section discusses the law governing the assertion and waiver of the attorney-client privilege. Because there is considerable uncertainty with respect to some aspects of this law, such as the applicability of the common-interest exception to the principle that voluntary disclosure waives the privilege, a client’s informed consent to share confidential information with an ALF supplier must be predicated upon full disclosure of the risk of a loss of privilege.

In Case 2, the client has come to the lawyer subject to a pre-existing contractual obligation to share all relevant information with an ALF supplier and to waive any applicable duty of confidentiality. The client may or may not appreciate the significance of these contract terms. Thus, an attorney should explain the risks associated with sharing confidential information with the ALF supplier and should obtain the client’s informed consent to the attorney providing this information to the supplier.

2. Attorney-Client Privilege

The attorney-client privilege is an evidentiary doctrine with deep roots in the common law. It protects confidential communications from discovery by opposing parties in litigation. Because it is a matter for case-by-case development, there is considerable variation in the specific contours of the privilege, both in terms of prerequisites for coverage and waiver doctrines. This Informational Report will discuss privilege and waiver in general terms, but attorneys must be mindful of differences among jurisdictions, and also of the fact-specific nature of many privilege and waiver cases. It is also important to emphasize that the attorney-client privilege is an aspect of state and federal evidence law, and develops independently of the duty of confidentiality recognized in state and federal rules of professional conduct.

a. Scope

The attorney-client privilege covers communications made between privileged persons, in confidence, for the purpose of obtaining or providing legal assistance for the client. “Privileged persons” include the attorney, the client, and agents of the lawyer who facilitate the

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121 Cf. RESTATEMENT § 79 cmt. h (no waiver if the client or lawyer took reasonable precautions to safeguard against inadvertent disclosure).
122 MODEL RULE 1.6(a).
123 MODEL RULE 1.0(e).
124 RESTATEMENT § 68.
representation. Experts retained by the lawyer to facilitate the representation, such as accountants and economists, may be considered privileged persons if they facilitate the client-lawyer communication – in effect acting as translators of technical material.126

The definition of privileged persons is related to the issues considered below, regarding the common interest doctrine, which functions as an exception to the rule of waiver by voluntary disclosure. For example, the disclosure by an attorney of privileged communications to a liability insurer, pursuant to a cooperation clause in an insurance policy, may not waive the privilege with respect to third parties. The conclusion of non-waiver may be based upon the premise that the insurer is also a privileged person, along with the attorney and client.127 Alternatively, it may be based upon the premise that the client and the insurer are either jointly represented clients128 or have a common interest129 in the litigated matter.130

b. Waiver by Voluntary Disclosure

Disclosure of privileged communications to anyone other than another privileged person waives the privilege and the communication is subject to discovery.131 Because the privilege protects confidential communications between attorney and client, conduct by either party that is inconsistent with the ongoing confidentiality of the communication destroys the rationale for the privilege. Courts generally take a strict approach to privilege waivers, finding that any voluntary disclosure of private communications will waive the privilege. Some courts have recognized a doctrine of “limited waiver,” permitting disclosure to some parties (generally government agencies) without waiving the privilege with respect to other parties (such as private litigants).132 The considerable majority of courts, however, do not recognize limited waiver; thus, any disclosure of confidential communications will waive the privilege that otherwise would have

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125  RESTATEMENT § 70.
126  See, e.g., U.S. v. Kovel, 296 F.2d 918 (2d Cir. 1961).
127  See RESTATEMENT § 70 cmt. f & Reporter’s Note.
128  See RESTATEMENT § 75.
129  See RESTATEMENT § 76.
131  See generally id. § 9:28.
132  See, e.g., Diversified Indus. v. Meredith, 572 F.2d 596 (8th Cir. 1978). As is often the case with respect to the attorney-client privilege, courts use terminology inconsistently. In re Columbia/HCA Healthcare Corp. Billing Practices Litig., 293 F.3d 289 (6th Cir. 2002) uses the term “selective waiver” to refer to the attempt by a party to share confidential communications with the government but continue to assert the privilege to thwart discovery of the communications by a private litigant. A leading treatise on the attorney-client privilege, however, uses the term “selective waiver” to refer to disclosure of one part of a privilege communication, while seeking to assert the privilege as to the remainder of the communication. See RICE, supra note 130, § 9:80. This kind of partial subsequent disclosure is related to the idea of “subject matter” waivers – i.e. that the partial disclosure of a communication waives the privilege with respect to all communications on the same subject matter. See RESTATEMENT § 79 cmt. f. This Informational Report adopts the term “limited waiver,” see RICE, supra note 130, § 9:88, to refer to what the Columbia/HCA court calls “selective waiver,” which is the context in which waiver issues would arise in connection with ALF transactions.
protected the communications from discovery. This is the case even if the selective or limited disclosure is made subject to a confidentiality agreement.

Thus, under privilege law in most jurisdictions, sharing of privileged communications with an ALF supplier is a voluntary disclosure that may effect a waiver of the attorney-client privilege. A court reaching the contrary conclusion of non-waiver may reason that the supplier is another privileged party, along with the attorney and client, or that the supplier and the client have a common interest in the litigated matter.

c. Common Interest Exception

The common interest exception is not, strictly speaking, an expansion of the attorney-client privilege. Rather it is a rule of non-waiver that stands as an exception to the general principle that disclosure of privileged communications to a non-privileged party waives the privilege. The common interest exception is closely related to the privilege for jointly represented co-parties, with the difference being that parties may have a common interest even if they are not represented by the same lawyer. Courts and lawyers sometimes use the term “joint defense” privilege to refer to these situations, but the common interest doctrine is not limited to defendants, to formal parties to litigation, or to litigated matters. The most important predicate for the application of this doctrine is that the multiple parties have a common interest in the matter and agree to share confidential information concerning the matter.

There is a significant unresolved question of whether disclosure of privileged communications to an ALF supplier waives the privilege – that is, whether the ALF supplier and the client have interests sufficiently in common to fall within the rule of non-waiver. One case has held that materials protected under the attorney-client privilege provided to an ALF firm do not fall within the common interest exception. The court stressed that, for the common-interest doctrine to apply, there must be a commonality of legal, not merely business interests. It suggested that the test to be applied is whether the disclosures would not have been made, but for the sake of securing or providing legal representation. Because the party seeking discovery failed to satisfy this burden, the district court concluded that the magistrate judge’s order to produce the documents claimed to be privileged was not clearly erroneous.

Another case is sometimes cited for the proposition that materials may be provided to investors without waiver, because the disclosure falls within the common-interest exception.
It is important to note, however, that this case involved disclosure of documents protected by the work product doctrine. As discussed below, the work product doctrine is subject to a different waiver standard, as compared with the attorney-client privilege. The privilege may be lost through the public disclosure of confidential communications. Protection of the work product doctrine, by contrast, is lost only where the disclosure increases the likelihood that the adversary will come into possession of the documents. The district court in *Mondis Tech. v. LG Electronics* concluded that the disclosure to prospective investors of documents reflecting the plaintiff’s litigation strategy and licensing plan “did not substantially increase the likelihood that the adversary would come into possession of the materials.” This reasoning does not invoke the idea of a commonality of interests between the plaintiff and the investors, and therefore this case should not be relied upon in support of a conclusion of non-waiver of the attorney-client privilege.

### 3. Work Product Doctrine

The work product doctrine has common law origins, but it has been codified in the Federal Rules of Civil Procedure and most state rules of procedure. The purpose of the work product doctrine is to protect the thoughts, mental impressions, and strategies of lawyers from being discovered by opposing parties in litigation. As Justice Jackson put it in his concurring opinion in the *Hickman* case, “discovery was hardly intended to enable a learned profession to perform its functions on wits borrowed from the adversary.” This well-known quote also shows that the work product doctrine is justified with reference to the functioning of the adversary system of litigation, not privacy concerns generally. Thus, work product protection is narrower in scope than either the attorney-client privilege or the duty of confidentiality. It extends to:

> documents and tangible things otherwise discoverable . . . prepared in anticipation of litigation or for trial by or for another party or by or for that other party’s representative (including the other party’s attorney, consultant, surety, indemnitor, insurer, or agent)...[145]

“Ordinary” work product, which is to say material other than an attorney’s mental impressions, theories, and opinions, may be discovered upon a showing of substantial need and an inability by the party to obtain the equivalent by other means. “Opinion” work product, on the other hand, is hardly ever discoverable.

Because work product protection focuses on the privacy of the lawyer’s strategies and mental impressions, and is also tightly linked with the process of litigation, the analysis of waiver of work product protection differs somewhat from the rules governing waiver of the attorney-client privilege. Generally only disclosures that substantially increase the likelihood of

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141 *Id.* at *3.
143 See, e.g., FED. R. CIV. P. 26(b)(3).
144 *Hickman v. Taylor*, 329 U.S. at 516 (Jackson, J., concurring) (internal alterations omitted).
145 FED. R. CIV. P. 26(b)(3).
documents falling into the hands of an adversary in litigation are deemed to waive the protection of the work product doctrine.146 As discussed above, in connection with the common-interest rule of non-waiver of the attorney-client privilege, the district court in Mondis Tech. v. LG Electronics concluded that a party could share documents prepared by a lawyer, containing information about legal strategy, with investors without waiving the work product protection that applied to the documents. The reason for not finding waiver in this case was that the presentation to investors did not substantially increase the likelihood that the documents would come into possession of the plaintiff’s adversary in litigation.

4. Third-Party Evaluations

Lawyers are frequently requested to provide opinion letters to various third parties, attesting to their clients’ compliance with legal requirements. For example, lenders often seek assurances that they will have a valid security interest in property the client is using as collateral for a loan.147 Lawyers are permitted to provide an evaluation to a third party of a matter affecting the lawyer’s client, as long as doing so is compatible with other aspects of the client-lawyer relationship.148 If there is a significant risk that the client’s interests will be affected materially and adversely by providing the evaluation, the lawyer must first obtain the client’s informed consent.149 If there is no significant risk to the client, the lawyer is impliedly authorized (by the client’s direction to provide the third-party evaluation) to disclose information that would otherwise be protected by the duty of confidentiality.150

An ALF supplier may seek information about a client’s case as part of the funding process.151 As discussed below, there may be a significant risk that any information disclosed to an ALF supplier will no longer be covered by the attorney-client privilege. Thus, the client’s informed consent is required before disclosure is permitted. In order to obtain informed consent, the lawyer must explain the risk of waiver of the privilege, advise the client whether the benefits of disclosure outweigh this risk, and advise the client of reasonably available alternatives.152

C. Fees

1. Reasonableness: Model Rule 1.5(a)

A lawyer may not charge an unreasonable fee, or an unreasonable amount for expenses arising out of the representation.153 The reasonableness of fees and expenses is evaluated using

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146 See 8 CHARLES A. WRIGHT, ET AL., FEDERAL PRACTICE AND PROCEDURE § 2024.
147 See, e.g., Greycas, Inc. v. Proud, 826 F.2d 1560 (7th Cir. 1987) (legal malpractice case).
148 MODEL RULE 2.3(a).
149 MODEL RULE 2.3(b).
150 MODEL RULE 2.3 cmt. [5].
151 See, e.g., Emanuel, supra note 1, at 8 (quoting application and disclosure form provided by LawCash, a consumer ALF supplier, which informs the claimants lawyer that “[w]e might ask you to provide . . . information about the current status of the litigation, and any other details that would help us to make our decision”).
152 See MODEL RULE 1.0(e).
153 MODEL RULE 1.5(a). The ABA Committee on Ethics and Professional Responsibility has concluded that the reasonableness standard applies to both fees and expenses. See ABA Comm. on Ethics and Prof’l Responsibility,
an eight-factor test, but judicial decisions tend to focus on two factors: (1) Did the client make a free and informed decision to enter into the contract with the lawyer, and (2) does the contract provide for a fee within the range commonly charged by other lawyers in similar circumstances? Any fees for representing a client, including contingency fees and, as discussed below, financing charges passed through by the lawyer to the client as a result of the lawyer obtaining funding for the representation, must satisfy the reasonableness standard of Rule 1.5(a). Concern has also occasionally been expressed that lawyers’ involvement as principals in ALF transactions may be a way of covertly increasing the lawyers’ contingency fees. There are many other restrictions on lawyers participating personally in ALF transactions, including the prohibitions in Model Rule 1.8 on providing financial assistance to a client and on acquiring a proprietary interest in the client’s cause of action. If the structure of a funding transaction were in compliance with these rules, however, a lawyer’s total compensation for providing legal services would still need to meet the reasonableness requirement of Rule 1.5(a).

2. Passing Borrowing Costs to Clients

Law firms representing clients on a contingency fee basis typically advance the cost of professional services provided to firm lawyers and support staff, as well as out-of-pocket expenses such as filing fees, expert witnesses, and court reporters. In some cases, the projected cost of a protracted lawsuit exceeds the firm’s ability to finance these expenditures out of its ordinary operating budget. In these circumstances, firms have sought loans or lines of credit from commercial lenders. In some cases lawyers have also sought to pass along the interest charges to the client as an expense, as opposed to absorbing these borrowing costs as part of the firm’s overhead that would be reflected in the fee for services portion of the recovery owed to the firm.

It is generally permissible to pass along the cost of disbursements made by lawyers on behalf of clients in connection with representation in a matter. “[T]he actual amount of disbursements to persons outside the office for hired consultants, printers’ bills, out-of-town travel, long-distance telephone charges, and the like ordinarily are charges in addition to the lawyer’s fee.” However, it is improper for a lawyer to add a surcharge to these disbursements, or to charge the client for general overhead expenses. Numerous state ethics opinions have considered this question and concluded that it is permissible to pass on to the client interest charges on funds borrowed in order to finance the costs and expenses of litigation, provided the lawyer fully discloses the terms of the loan and the interest rate is reasonable. The Kentucky

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Formal Op. 93-379 (1993), at 7 (“we believe that the reasonableness standard explicitly applicable to fees under Rule 1.5(a) should be applicable to [disbursements and expenses] as well”).

154 See MODEL RULE 1.5(a)(1)-(8),

155 See RESTATEMENT § 34 cmt. e.


157 See RESTATEMENT § 38 cmt. e.

opinion adds the requirement that the transaction be treated as a business transaction between the lawyer and client, subject to all of the requirements of Rule 1.8(a). Although not citing Rule 1.8(a), the Maine opinion imposes similar requirements – full disclosure of the terms of the transaction and the informed consent of the client, and fairness to the client of the substantive terms of the transaction. In no event may the lawyer surcharge the client by charging more than the amount of interest actually paid to the lender.

In Case 4, the lawyer incurred substantial borrowing costs to finance the litigation on behalf of the plaintiffs. Ethics opinions in several states indicate that the lawyer may permissibly charge these costs to the plaintiffs, assuming two requirements are satisfied. First, the total fee must be reasonable, under the standards of Rule 1.5(a). Second, because the lawyer represented the plaintiffs on a contingent fee basis, the lawyer was required to clearly disclose, in a writing signed by the client, whether the client would be liable for interest expenses, whether these expenses would be deducted from the recovery, and whether this deduction would occur before or after the lawyer’s fee was calculated. The hypothetical states that the lawyer did not clearly disclose in the retainer agreement that the lawyer may incur interest expenses and subsequently pass them along to the client. Thus, the lawyer may lose the entitlement to charge these expenses to the client, due to non-compliance with the disclosure requirements of Rule 1.5(c). If clear, understandable written disclosure had been made, however, there is no reason in principle why these expenses could not be charged to the clients. Fact issues may of course arise concerning the adequacy of the disclosure.

D. Competence and Communication: Advising in Connection with ALF Transactions

A lawyer must communicate with a client regarding matters material to the representation. A client who wishes to enter into a funding transaction with an ALF supplier incurs financial risks that must be adequately explained by a lawyer representing the client in connection with that transaction.

A party to litigation, whether a plaintiff or defendant, may have entered into or considered entering into an ALF transaction without the knowledge of that party’s lawyer. The lawyer may subsequently be called upon to advise the client about the implications of the transaction or contemplated transaction. Case 1 presents an example of a client asking the lawyer for advice concerning whether to sell a portion of his personal-injury claim to an ALF supplier. Lawyers must provide competent representation, using the “legal knowledge, skill, thoroughness and preparation reasonably necessary to the representation.” If the lawyer is unfamiliar with transactions of this nature, he or she must either acquire the appropriate knowledge through reasonable study and preparation, associate with an experienced lawyer, or


159 See MODEL RULE 1.5(c).
160 MODEL RULE 1.4.
161 MODEL RULE 1.1.
162 Although a lawyer may be able to satisfy the duty of competence through study and preparation, it may not be reasonable to bill the client for the time spent acquiring this new expertise. See MODEL RULE 1.5(a); see also In re
refer the client to another lawyer with established competence.\textsuperscript{163} The variation on Case 1 is intended not only to show that a lawyer may have acquired the relevant expertise through experience with similar transactions, but also the kinds of issues a lawyer should be aware of when advising a client. The extent of control sought by the supplier, whether the supplier seeks access to confidential information, and the material terms of the financing transaction are all relevant to the advice the lawyer should give the client.

Case 2 illustrates some of the risks that unsophisticated users of ALF products face. One problem for the lawyer representing this plaintiff, however, is that the agreement was entered into without legal counsel, prior to the plaintiff’s retention of the lawyer. If a reasonable lawyer would conclude that the terms of the financing are substantively unfair and unreasonable from the plaintiff’s point of view, the lawyer may advise the client to attempt to renegotiate the transaction. On the other hand, a reasonable lawyer may conclude that the transaction was not unfair from the plaintiff’s point of view, given the difficulty the plaintiff would otherwise have in obtaining funds and the riskiness of this investment, from the point of view of the ALF supplier.

In both Case 1 and Case 2, competent advising requires, at a minimum, that a lawyer be aware of potential risks to the client associated with ALF transactions, such as the possibility of waiver of the attorney-client privilege. Other risks may be present depending on the terms of the transaction. For example, a client who sells a portion of a cause of action in exchange for periodic investments by an ALF supplier may be exposed to the risk of the subsequent insolvency of the supplier.

V. Conclusion

The market for alternative litigation finance involves suppliers and customers who demand this form of financing. Because of this demand, and because of the complexity of regulation in various jurisdictions, the specific form of ALF transactions will undoubtedly continue to evolve. The Commission on Ethics 20/20 has accordingly set out to define general principles of professional responsibility that are applicable to lawyers representing clients who are involved in ALF funding. Lawyers must adhere to principles of professional independence, candor, competence, undivided loyalty, and confidentiality when representing clients in connection with ALF transactions. In the event that the lawyer’s involvement in the funding process significantly limits the lawyer’s capacity to carry out these professional obligations, the lawyer must fully disclose the nature of this limitation, explain the risks and benefits of the proposed course of action, and obtain the client’s informed consent.

Respectfully Submitted,

ABA Commission on Ethics 20/20

\textsuperscript{163} See Model Rule 1.1 cmts. [1], [2], [4].
The Association of Litigation Funders of England and Wales

Code of Conduct for Litigation Funders

November
2011
The code

1. This code (the Code) sets out standards of practice and behaviour to be observed by Funders who are Members of The Association of Litigation Funders of England & Wales.

2. A Funder has access to funds immediately within its control or acts as the exclusive investment advisor to an investment fund which has access to funds immediately within its control, such funds being invested pursuant to a Litigation Funding Agreement (LFA) to enable a Litigant to meet the costs of resolving disputes by litigation or arbitration (including pre-action costs) in return for the Funder:

   (a) receiving a share of the proceeds if the claim is successful (as defined in the LFA); and

   (b) not seeking any payment from the Litigant in excess of the amount of the proceeds of the dispute that is being funded, unless the Litigant is in material breach of the provisions of the LFA.

3. A Funder shall be deemed to have adopted the Code in respect of funding the resolution of disputes within England and Wales.

4. The promotional literature of a Funder must be clear and not misleading.

5. A Funder will observe the confidentiality of all information and documentation relating to the dispute to the extent that the law permits, and subject to the terms of any Confidentiality or Non-Disclosure Agreement agreed between the Funder and the Litigant.

6. A Litigation Funding Agreement is a contractually binding agreement entered into between a Funder and a Litigant relating to the resolution of disputes within England and Wales.

7. A Funder will:

   (a) take reasonable steps to ensure that the Litigant shall have received independent advice on the terms of the LFA, which obligation shall be satisfied if the Litigant confirms in writing to the Funder that the Litigant has taken advice from the solicitor instructed in the dispute;

   (b) not take any steps that cause or are likely to cause the Litigant's solicitor or barrister to act in breach of their professional duties;

   (c) not seek to influence the Litigant's solicitor or barrister to cede control or conduct of the dispute to the Funder;

   (d) maintain at all times adequate financial resources to meet its obligations to fund all of the disputes that it has agreed to fund, and in particular will maintain the capacity:

       (i) to pay all debts when they become due and payable; and

       (ii) to cover aggregate funding liabilities under all of its LFAs for a minimum period of 36 months.

8. The LFA shall state whether (and if so to what extent) the Funder is liable to the Litigant to:

   (a) meet any liability for adverse costs;

   (b) pay any premium (including insurance premium tax) to obtain costs insurance;
(c) provide security for costs;
(d) meet any other financial liability.

9. The LFA shall state whether (and if so how) the Funder may:

(a) provide input to the Litigant’s decisions in relation to settlements;

(b) terminate the LFA in the event that the Funder:

(i) reasonably ceases to be satisfied about the merits of the dispute;

(ii) reasonably believes that the dispute is no longer commercially viable; or

(iii) reasonably believes that there has been a material breach of the LFA by the Litigant.

10. The LFA shall not establish a discretionary right for a Funder to terminate a LFA in the absence of the circumstances described in clause 9(b).

11. If the LFA does give the Funder any of the rights described in clause 9 the LFA shall provide that:

(a) if the Funder terminates the LFA, the Funder shall remain liable for all funding obligations accrued to the date of termination unless the termination is due to a material breach under clause 9(b)(iii);

(b) if there is a dispute between the Funder and the Litigant about settlement or about termination of the LFA, a binding opinion shall be obtained from a Queen’s Counsel who shall be instructed jointly or nominated by the Chairman of the Bar Council.

This code is to be read in conjunction with the Articles and Rules of the Association of Litigation Funders of England & Wales, which are available for inspection at: http://www.judiciary.gov.uk/about-the-judiciary/advisory-bodies/cjc
ICCA-QMUL TASK FORCE ON TPF IN INTERNATIONAL ARBITRATION
SUBCOMMITTEE ON SECURITY FOR COSTS AND COSTS

DRAFT REPORT

1 November 2015

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INTRODUCTION

The Costs Subcommittee of the ICCA-Queen Mary Task Force on Third-Party Funding was established to address a range of policy and practical issues concerning costs that arise with the participation of third-party funders, including the effect of third-party funders on the decisions of arbitrators on cost allocation and security for costs applications. The purpose of this draft Report on Costs is to provide guidelines in respect of the impact of TPF on allocation of costs and security for costs applications.

Member of the Costs Subcommittee are: Professor Stavros Brekoulakis (Chair), Mr Audley Sheppard, QC, Ms Susan Dunn, Mr Mick Smith and Mr Jonas von Goler.

EXECUTIVE SUMMARY

The draft Report first examines issues on awarding of costs, and then issues on security for costs applications. Unless a tribunal establishes the likelihood that costs will be awarded, it cannot make a decision on a security for costs application.

As regards allocation of costs, the report has reviewed a number of arbitration laws, arbitration rules and arbitral awards on allocation of costs to conclude to the following observations and recommendations:

1. When a party is funded by a third party funder it typically assumes an obligation to reimburse the funder for the costs advanced, in case of successful recovery. This should be sufficient for tribunals to accept that a funded party has incurred costs.

2. The fact that a party’s costs have been funded should generally not be regarded as a relevant factor in determining whether or not costs are to be allocated based on the outcome of the case.

3. It is not appropriate for tribunals to award funding costs (such as a conditional fee, ATE-premium, or litigation funder’s return), as they are not procedural costs incurred for the purpose of an arbitration.

4. In principle, a tribunal will lack jurisdiction to issue a costs order against a third-party funder.

As regards security for costs, the report has reviewed a number of arbitration laws, arbitration rules and arbitral awards on security for costs to conclude to the following observations and recommendations:

1. Arbitral tribunals should ascertain the financial situation of the claimant starting from general financial records, such as annual accounts and statutory returns. A third-party funding agreement may be considered as an indication of the funded party’s financial situation along with other financial records, however on its own it is no necessary indication that a claimant is impecunious.

2. It is not for this committee to lay down a test for awarding security for costs. However, if the test in commercial arbitration is that the applicant must show material change of circumstances that were commercially unforeseeable (consent perspective), then
procuring external funding of legal costs should not usually be proof that circumstances have materially changed in a way that is commercially unforeseeable.

3. It is not for this committee to lay down a test for awarding security for costs. However, if the test in investment arbitration is that the applicant must show that there are extreme circumstances that warrant a security for costs order, then mere recourse to third-party funding by a claimant that has become impeccunious cannot readily be characterized as carrying an element of abuse, and cannot of itself be taken as a reason for tribunals to award security for costs.

4. When reviewing third-party funding agreements for the purpose of assessing security for costs applications, tribunals should pay particular attention to clauses on termination rights and clauses on funders’ liability for adverse costs.

5. Arbitral tribunals should consider indicating to the requesting party that, should the defence fail, it will be held liable for the costs reasonably incurred by the funded party in posting security.
AWARDING OF COSTS

When awarding costs at the end of the proceedings, an arbitral tribunal has to address a number of issues. First, it must determine whether costs will be awarded. Second, if costs will be awarded, how they should be allocated. Third, where costs are allocated based on the outcome of the case, the tribunal must determine which of the prevailing party’s costs are recoverable (type and amount of recoverable costs). An arbitral tribunal’s decisions on these issues will be framed by the applicable arbitral laws and rules [A]. A number of arbitral tribunals (and state courts) have already dealt with the awarding of costs in the presence of a third-party funder. These decisions shall be looked at [B] before presenting the recommendations of the sub-committee on how Tribunals should award costs in claims funded by third-party funders [C].

The Report addresses the following issues:

1. Should a funded party that has prevailed in the arbitration be able to recover party costs at all where these costs have been funded by a third party?
2. Where costs are allocated based on the outcome of the case and the funded party prevails, what type of costs can it recover from the opponent?
3. Where costs are allocated based on the outcome of the case and the non-funded party prevails, could an arbitral tribunal render a costs order directly against a third-party funder?

[A] Arbitral Laws and Rules

[I] Arbitral Laws

English arbitration law contains comparatively detailed provisions on costs allocation. Section 61 English Arbitration Act 1996 provides that:

(1) The tribunal may make an award allocating the costs of the arbitration as between the parties, subject to any agreement of the parties.

(2) Unless the parties otherwise agree, the tribunal shall award costs on the general principle that costs should follow the event except where it appears to the tribunal that in the circumstances this is not appropriate in relation to the whole or part of the costs.

As regards the amount of recoverable costs, Section 63 English Arbitration Act 1996 states:

(3) The tribunal may determine by award the recoverable costs of the arbitration on such basis as it thinks fit.

If it does so, it shall specify—

(a) the basis on which it has acted, and
(b) the items of recoverable costs and the amount referable to each.
(4) If the tribunal does not determine the recoverable costs of the arbitration, any party to the arbitral proceedings may apply to the court (upon notice to the other parties) which may—

(a) determine the recoverable costs of the arbitration on such basis as it thinks fit, or

(b) order that they shall be determined by such means and upon such terms as it may specify.

(5) Unless the tribunal or the court determines otherwise—

(a) the recoverable costs of the arbitration shall be determined on the basis that there shall be allowed a reasonable amount in respect of all costs reasonably incurred, and

(b) any doubt as to whether costs were reasonably incurred or were reasonable in amount shall be resolved in favour of the paying party.

Default rules on costs shifting can also be found in the arbitration laws of Hong Kong, Germany, Spain, Brazil and Portugal. While the arbitration laws of UNCITRAL Model Law, France, Switzerland, and the United States are silent on the issue of costs allocation, it is clear that tribunals sitting in these jurisdictions have the power to render awards on costs.


Many widely used arbitral rules contain a presumption that costs should follow the event, or should be allocated based on the degree of success, unless particular circumstances call for a different approach. Other rules simply provide for wide arbitrator discretion.

As regards the type and amount of recoverable party costs, Article 40(2)(e) UNCITRAL Rules is representative, limiting recoverable costs to ‘[t]he legal and other costs incurred by the parties in relation to the arbitration to the extent that the arbitral tribunal determines that the amount of such costs is reasonable’. Similar formulations can be found, for instance, in the ICC Rules, the LCIA Rules, and the CIETAC Rules.

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1 Hong Kong Arbitration Ordinance 2011, s. 72(4) (written offer to settle as a particularly relevant factor), German Code of Civil Procedure, s. 1057(1) (outcome of the case as a particularly relevant factor), Spain, Art. 37 of Law 60/2003, Portugal Art.42 of Law 63/2011 and Brazil Art.27 of Law 13.129 of 26 May 2015.
2 UNCITRAL Rules, Art. 42 (‘costs of the arbitration shall in principle be borne by the unsuccessful party’); LCIA Rules, Art. 28(4) (‘costs should reflect the parties’ relative success and failure in the award or arbitration or under different issues, except where it appears to the Arbitral Tribunal that in the circumstances the application of such a general principle would be inappropriate under the Arbitration Agreement or otherwise’); DIS Rules, s. 35(2) (‘[i]n principle, the unsuccessful party shall bear the costs of the arbitral proceedings’, but the tribunal may order each party to bear its own costs or apportion the costs between the parties, in particular, where each party is partly successful and partly unsuccessful); WIPO Rules, Art. 74.
3 ICSID Convention, Art. 61(2) (‘the Tribunal shall, except as the parties otherwise agree, assess the expenses incurred by the parties in connection with the proceedings, and shall decide how and by whom those expenses, the fees and expenses of the members of the Tribunal and the charges for the use of the facilities of the Centre shall be paid’); SIAC Rules, Art. 31(1) (‘unless the parties have agreed otherwise, the Tribunal shall determine in the award the apportionment of the costs of the arbitration among the parties’); ICC Rules, Art. 37(3) (‘[i]n making decisions as to costs, the arbitral tribunal may take into account such circumstances as it considers relevant, including the extent to which each party has conducted the arbitration in an expeditious and cost-effective manner’).
4 ICC Rules, Art. 37(1) (‘reasonable legal and other costs incurred by the parties for the arbitration’).

Since the procedural matrix established by the arbitration law and rules typically allow tribunals wide discretion as regards costs allocation, it is not always easy to predict how an arbitral tribunal will ultimately approach the issue in a given case. The award of substantial costs based on the case’s outcome – notably of legal costs based on counsel’s hourly fees – constitutes an approach that is especially prevalent in the United Kingdom and affiliate jurisdictions. Nevertheless, it is one that appears to be increasingly applied in international arbitration as well, not least since, as discussed above, many widely used arbitral rules provide that the prevailing party is presumptively entitled to its costs, while authorizing the tribunal to adopt a different standard if appropriate in the particular case.

[B] Costs Decisions in Third-Party Funding Scenarios

This section looks at the nascent body of (arbitral) case law dealing with the awarding of costs in the context of third-party funding.


In Joannis Kardassopoulos & Ron Fuchs v. Georgia, (Fortier (P), Orego Vicuna, Lowe) the investors were successful in an arbitration funded by German company Allianz Litigation Funding for a claim against Georgia for compensation for the unlawful termination of a concession to build and maintain a pipeline. Claimants requested that they be awarded costs of proceedings including legal costs, arguing that there is a trend of outcome-based recovery in investment-treaty arbitration. Respondent argued, inter alia, that claimants’ legal costs were excessive and they could have been borne in part by a third-party investor and therefore not properly recoverable. The Tribunal held that:

The Tribunal knows of no principle why any such third party financing arrangement should be taken into consideration in determining the amount of recovery by the Claimants of their costs.

This passage has been adopted by the ICSID annulment committees in RSM v. Grenada and ATA v. Jordan.


In Siag and Vecchi v. Egypt the claimants’ law firm (King & Spalding) had acted on a contingency fee basis. Despite this, the claimants requested recovery of a specified amount of

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5 LCIA Rules, s. 28(3) (‘legal or other expenses incurred by a party ... The Arbitral Tribunal shall decide the amount of such Legal Costs on such reasonable basis as it thinks appropriate’).
6 CIETAC Rules, Art. 50(2) (winnower entitled to ‘the expenses reasonably incurred by it in pursuing the case’).
7 Kardassopoulos and Fuchs v. The Republic of Georgia, ICSID Case Nos. ARB/05/18 and ARB/07/15, Award of 3 March 2010.
8 Ibid., para. 691.
9 RSM Production Corporation v. Grenada, ICSID Case No. ARB/05/14 (Annulment Proceeding), Order of the Committee Discontinuing the Proceeding and Decision on Costs of 28 April 2011, para. 68.
11 Siag and Vecchi v. The Arab Republic of Egypt, ICSID Case No. ARB/05/15, Award of 1 June 2009.
normal (hourly) fees, without the corresponding invoices or other details. The tribunal accepted this. Orrego Vicuna dissented, albeit not on the issue of substantiation of costs, but more generally on the allocation of costs:

In respect of the costs of this arbitration I believe that a more adequate approach would be to require each party to pay one half of such costs, particularly taking into account the fact that the Claimant agreed to pay attorney’s fees only on a successful recovery. While there is nothing unusual in such arrangement, it entails the acceptance of the Claimant of a degree of risk that should not entirely be shifted to the Respondent, particularly in view of the amounts involved.¹²

[3] Quasar de Valores v. Russia

In Quasar de Valores v. Russia the tribunal denied the prevailing Spanish portfolio investors in Yukos recovery of their costs because the funder (Menatep, ex-majority shareholder in Yukos) had funded the entirely costs of the proceedings and had no contractual right vis-à-vis the claimants for reimbursement of these costs. The tribunal explained that:

The usual arguments about the recoverability of costs where a party’s representation in a case has been financed by a third party are inapposite here, because such third-party financing is typically part of a legally enforceable bargain under which the prevailing party in the arbitration has given up something in return for that support. Here, it is conceded that there is no legal duty on the part of the Claimants to hand over any recovery on account of costs to Menatep.¹³

[4] ICC Case No. 7006

By contrast to Quasar de Valores v. Russia, an ICC tribunal noted (obiter) that the legal costs of a respondent that had been paid by a third party (insurer) would have been recoverable had the respondent succeeded:

I believe that they are [recoverable], at least from the point that Defendants rather than the [indemnifier], mandated counsel to represent them in the arbitration. By so doing, they incurred the primary obligation to pay such counsel’s fees and expenses-one not negated by the fact that someone else, through prior arrangement, paid them on their behalf. The counterpart to this determination is that Defendants would be obliged to reimburse their indemnifier any costs they recovered from the arbitration.¹⁴

[5] Case Law From the UK and the US holding Funders Liable for Costs

As regards the question whether a third-party funder may be ordered to pay adverse costs should the funded claim fail, there is case law from the UK¹⁵ and the US¹⁶ to the effect that

¹⁵ Excalibur Ventures LLC v. Texas Keystone Inc. & Ors v. Psari Holdings Limited & Ors, English High Court (Queen’s Bench, Commercial Court), Order of 23 October 2014, Case No. 2010 Folio 1517, [2014] EWHC
costs can be awarded against third-party funders if they have obtained a sufficient degree of economic interest and control in relation to the claim. It is doubtful whether these cases, stemming from litigation proceedings, can readily be transferred to consensual arbitration proceedings; this will be addressed further below.

[6] Recoverability of Funding Costs in the UK and the US

In the United Kingdom, conditional fees and the premium for additional after-the-event insurance were declared recoverable under the British Courts and Legal Services Act as amended by the Access to Justice Act 1999. This has changed with the Legal Aid, Sentencing and Punishment of Offenders Act 2012, which abolished the recoverability of after-the-event insurance premiums and conditional fees for agreements entered into after 1 April 2013. In the United States, the Supreme Court has clarified that in case of contingency fees, only reasonable hourly fees (lodestar-method) are recoverable. 17

[C] Key Observations and Suggestions of the Sub-Committee

This section proceeds from the assumption that the tribunal is generally willing to allocate costs based on the outcome of the case. It also assumes that the amount of legal fees claimed by the prevailing party is reasonable.

[1] Should a funded party that has prevailed in the arbitration be able to recover party costs at all where these costs have been funded by a third party?

[a] Amount of costs: did a funded party 'incur' costs?

Although the answer to this question will depend on the billing structures adopted by third party funders for each case, when a party is funded by a third party funder it typically assumes an obligation to reimburse the funder for the costs advanced. This should be sufficient for tribunals to accept that a funded party has incurred costs.

More specifically, the usual practice where a funder is involved, is that the invoices by lawyers are issued in the funded party’s name and become payable by the funder as a result of the funding agreement. The funded party’s lawyers would usually send the invoice to the funder (along with a monthly report). If the funded party and funder are satisfied that the invoice is consistent with the pre-agreed budget then the funder will pay the invoice directly to the lawyer. The fact that there is a funder involved does not change the funded party’s primary liability to discharge the bill. The funded party incurs the obligation to reimburse the funder for the costs so advanced in case of successful recovery (plus a return to the funder as per the funding agreement). For these reasons, the fact that the funder pays the bills can

3436, paras 4, 161; Arkin v. Borchard Lines Ltd. & Ors, English Court of Appeal, Judgement of 16 May 2005, [2005] EWCAT Civ. 655 ("[w]here … the non-party not merely funds the proceedings but substantially also controls or at any rate is to benefit from them, justice will ordinarily require that, if the proceedings fail, he will pay the successful party’s costs").

6 Abu-Ghazaleh v. Chau, Florida Third District Court of Appeal, Decision of 2 December 2009, Nos. 3D07-3128, 3D07-3130, 36 So. 3d 691.

17 City of Burlington v. Dague, Supreme Court of the United States, Judgement of 24 April 1992, 505 U.S. 557 (addressing costs recovery under federal fee shifting statutes).
hardly give the opposing party a ‘free pass’ on not having to repay any costs if it ultimately fails to defend the claim against it.

[b] Allocation of costs: should a tribunal deviate from otherwise applicable outcome-based methods of costs allocation in case the prevailing party’s costs have been funded?

The fact that a party’s costs have been funded should generally not be regarded as a relevant factor in determining whether or not costs are to be allocated based on the outcome of the case. These costs are still costs that the funded party will have to repay to the funder if it is successful in the claim. The result of not doing this is that the funded party would be left uncompensated for the costs it has incurred which it would have recovered had it not been funded.

[2] Where costs are allocated based on the outcome of the case and the funded party prevails, which costs can it recover from the opponent? Only its normal legal costs? Normal legal costs plus additional funding costs contingent on success?

It is not appropriate for tribunals to award funding costs (such as a conditional fee, ATE-premium, or litigation funder’s return), as they are not procedural costs incurred for the purpose of an arbitration. The success portion payable to a third-party funder results from a trade-off between the funded party and the funder, where the funder assumes the cost and risk of financing the proceedings and receives a reward if the case is won. This agreement is not linked to the arbitration proceedings as such. The reasonable legal fees incurred by a funded party should remain recoverable.

Funding costs may be claimed as damages where permitted by the applicable substantive law. It is unclear whether such funding costs would meet the relevant tests for causation and foreseeability.

[3] Where costs are allocated based on the outcome of the case and the non-funded party prevails, could an arbitral tribunal render a costs order directly against a third-party funder?

In principle, a tribunal will lack jurisdiction to issue a costs order against a third-party funder. The third-party funder is not typically party to the arbitration agreement, and has no involvement in the underlying dispute between the two parties in an arbitration. While funders may be involved in the proceedings, this cannot readily be interpreted as consent to arbitrate. The sub-committee is not aware of any arbitral award ordering a third-party funder to pay adverse costs.

However, in the English Excalibur case, the third-party funders of the unsuccessful claimant were joined to the proceedings and ordered to pay the defendants’ costs.\(^\text{18}\) In the United Kingdom, the court’s power to make costs orders flows from section 51(1) and (3) of the Supreme Court Act 1981 (now known as Senior Courts Act), which provides that ‘[s]ubject to the provisions of this or any other enactment and to rules of court, the costs of and incidental

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to all proceedings … shall be in the discretion of the court … The court shall have full power to determine by whom and to what extent the costs are to be paid’. Such type of discretionary powers for ordering costs is very different from the consensual basis of arbitration. It therefore appears difficult to draw an analogy to the situation in international arbitration.
SECURITY FOR COSTS

An arbitral tribunal seized with a security for costs request must balance the claimant’s interest in having access to justice and the respondent’s interest in being able to recover its costs in case of success. Should an arbitral tribunal take into account the fact that a claimant has obtained third-party funding in deciding whether to grant security for costs? If so, how?

An important threshold issue is whether an arbitral tribunal will allocate costs to the losing party (or whether each party will bear its own costs). The more likely it is that the tribunal will allocate costs to the losing party, the more likely it will consider granting the respondent security for its — potentially recoverable — costs. Awarding of costs and third-party funding has been addressed in the preceding section. Assuming that an arbitral tribunal will shift costs to the losing party, the question arises how third-party funding affects whether or not security for costs may be granted. A tribunal’s power to order security for costs is shaped by the applicable arbitral laws and rules [A]. Since these laws and rules do not provide specific guidance on when to grant security, it is helpful to review the practice of arbitral tribunals in investment arbitration and commercial arbitration [B]. Finally, this section identifies the key issues and criteria regarding security for costs, and presents the views of the sub-committee on the significance of third-party funding for evaluating security for costs requests [C].

As regards security for costs, the report distinguishes between commercial and investment arbitration and addresses the following issues:

1. What is the relevance of a third-party funding agreement in ascertaining whether the claimant is impecunious?

2. Should tribunals take into account third-party funding arrangements when assessing applications for security for costs?

3. Should the party seeking security for costs be held liable for the claimant’s cost of posting security if the defence fails?

[A] Arbitral Laws and Rules

As regards an arbitral tribunal’s power to order security for costs, three situations can broadly be identified. No problems should arise where the parties have expressly conferred to the tribunal the power to order security for costs, or have agreed to arbitrate under an arbitration law that expressly allows arbitrators to order security for costs,\(^\text{19}\) or have chosen arbitral rules containing such provisions\(^\text{20}\). The situation is less clear where the applicable arbitration law or arbitration rules only contain a general clause for interim measures.\(^\text{21}\) Recently, an ICSID tribunal noted that one of the reasons why the general clause on interim measures contained in Article 47 ICSID Convention should cover security for costs is that, when the ICSID

\(^{19}\) See, e.g., English Arbitration Act 1996, s. 38(3); Hong Kong Arbitration Ordinance 2011, s. 56(1)(a).

\(^{20}\) See, e.g., LCIA Rules, Art. 25(2); HKIAC Rules, Art. 24; CEPANI Rules, Art. 27(1); SIAC Rules, Art. 24(k).

\(^{21}\) See, e.g., French Code of Civil Procedure (as reformed in 2011), Art. 1468; Swiss Private International Law Act, Art. 183(1); German Code of Civil Procedure, s. 1041(1); ICC Rules, Art. 28(1); ICDDR Rules, Art. 21(1).
Convention was drafted in 1965, 'issues such as third party funding and thus the shifting of the financial risk away from the claiming party were not as frequent, if at all, as they are today'.\(^{22}\) In the third situation, neither express provisions nor a general clause on interim measures exists that could serve as a basis for the tribunal's power to order security for costs. In that case, it can still be argued that the tribunal's power to order security for costs is anchored in its inherent power to preserve the integrity of the proceedings.\(^{23}\)


While the above arbitral laws and rules allow tribunals to order security payment, they do not lay down the circumstances or conditions upon which tribunals may order security for costs. As a result, arbitrators typically enjoy discretion in this regard. While no uniform test has developed, review of the practice of arbitral tribunals allows us to make a number of guidelines which may inform tribunals when deciding to award security for costs. It should be noted though that the purpose of this report is not to recommend a test for a security for costs award, but to examine the relevance of the Third Party Funding in security for costs applications.

In the practice of arbitral tribunals, a key aspect is usually the financial situation of the party against which security payment is requested. There must be sufficient evidence to assume that the current financial circumstances of the claimant are such that it will not be able to pay the respondent's costs at the end of the proceedings.\(^{24}\) Generally speaking, the burden of proof lies on the party seeking security.\(^{23}\)

[I] Commercial Arbitration

In international commercial arbitration, when assessing the financial situation of the claimant tribunals should take into account that the parties have agreed at some point to submit disputes arising between them to arbitration. For this reason, it may not suffice that the funded claimant is likely not to be able to pay a potential adverse costs award. Rather, a tribunal will usually need to consider whether the financial situation of the claimant has materially and unforeseeably changed since the conclusion of the arbitration agreement.\(^{26}\) A respondent which knew (or ought to have known) that the claimant is impecunious when agreeing to arbitrate disputes with that claimant should not be able to obtain security for its costs.

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\(^{22}\) RSM Production Corporation v. Saint Lucia, ICSID Case No. ARB/12/10, Decision on Saint Lucia's Request for Security for Costs of 13 August 2014, para. 55. Whether the explanation offered by the Tribunal in this case is accurate or supported by the history of drafting the ICSID Convention is questionable, and the question of the propriety and jurisdiction to order a State to post security for costs is much more complex.\(^{25}\)

\(^{23}\) Craig, Park & Paulsson, International Chamber of Commerce Arbitration, 467 (who report that even when the ICC Rules did not yet contain a general clause for granting interim measures, 'ICC tribunals had found that they had the power to grant security for costs as part of their inherent powers in connection with the conduct of arbitral proceedings') (with further references); Commerce Group Corp. & San Sebastian Gold Mines, Inc. v the Republic of El Salvador, ICSID Case No. ARB/09/17 (Annulment Proceeding), Decision on El Salvador's Application for Security for Costs of 20 September 2012, para. 45.

\(^{24}\) See, e.g., Chartered Institute of Arbitrators, Practice Guideline 11: Guideline on Security for Costs, para. 3.2.

\(^{25}\) Waincymer, Procedure and Evidence in International Arbitration, 653-654.

possibility that the credit standing of a business partner changes over time is part of normal commercial risk. Therefore, due to the consensual nature of international commercial arbitration, there is less justification generally for granting security for costs when compared with litigation.

In its order dated 3 August 2012, an ICC tribunal (Charles Poncet, Louis Degos, Stephen Bond) examined in great detail a security for costs request against a claimant that had entered into a litigation funding agreement. The terms of the funding agreement were on the record because claimant had previously transferred the agreement to the respondent, without indicating any reasons for this. The tribunal undertook a detailed survey of the criteria applicable to security for costs requests in international arbitration. In its view, the decisive question was whether the litigation funding agreement ‘constitutes a fundamental change of circumstances which would justify granting security for costs’. It ultimately affirmed this question, the key reasons being the following:

- The claimant was a holding company based in Cyprus that was unlikely to be able to pay adverse costs;
- The funding agreement did not cover adverse costs;
- The tribunal interpreted the funder’s termination rights under the funding agreement to the effect that the funder was ‘empowered to terminate the Agreement at any time, entirely at its discretion’.

The tribunal put emphasis on the fact that the funder could ‘walk out at any time’, thereby increasing the respondent’s risk of walking away empty handed.

[2] *Investment Arbitration*

Tribunals in ICSID arbitration have occasionally required evidence of *exceptional circumstances* before security can be ordered, such as abusive conduct or some evidence of bad faith on the claimant side. Unlike the case in commercial arbitration, the respondent State here, at least in treaty-based and legislation-based investment arbitration (albeit not for contract-based investment arbitration), has not signed an arbitration agreement with a particular claimant. However, the respondent is often alleged of having unlawfully expropriated the claimant, thereby causing claimant’s impecuniosity. For this reason, access

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to justice for claimants can be an even more delicate issue in investment arbitration disputes. This may explain why investment tribunals are usually very cautious when it comes to requiring investors to post security in order for the claim to proceed.

In *RSM Production Corporation v. Saint Lucia*, an ICSID tribunal – for the first time ever – ordered a claimant to post security for costs. In line with previous ICSID cases, the tribunal required a showing of exceptional circumstances. The Tribunal held that:

> Those circumstances are, in summary, the proven history where Claimant did not comply with cost orders and awards due to its inability or unwillingness, the fact that it admittedly does not have sufficient financial resources itself and the (also admitted) fact that it is funded by an unknown third party which, as the Tribunal sees reasons to believe, might not warrant compliance with a possible costs award rendered in favor of Respondent.

While the tribunal was of the opinion that the “Claimant’s consistent procedural history in other ICSID and non-ICSID proceedings provide compelling grounds for granting Respondent’s request”, there was no evidence in the record as to the identity of the funder, the funding agreement, and whether or not the funder was contractually responsible for adverse costs.

Gavan Griffith, the respondent appointed arbitrator, published an assenting opinion in which he lays down the reasons that in his view justify the security order. In contrast to the chairman (Siegfried Elsing), who based the order mainly on the claimant’s proven history of not honouring costs awards, Griffith stressed the funding aspect. He suggested that:

> once it appears that there is third party funding of an investor’s claims, the onus is cast on the claimant to disclose all relevant factors and to make a case why security for costs orders should not be made… An example of contrary circumstances might be to establish that the funded claimant has independent capacity to meet costs orders.

In assessing the implications of this case, it appears important to avoid confusing the security order with the respondent appointed arbitrator’s assenting reasons, which are not part of this order. The objective behind the order was to secure the respondent’s right of recovering its legal costs against a claimant that had admitted it would not be able to pay, and – this is the decisive point – had a proven history of defaulting on costs orders. The tribunal viewed the claimant’s past conduct as sufficient evidence of bad faith. It additionally pointed out that third-party funding could not alleviate the concerns that the claimant will again default on payment, as the funder’s responsibility for adverse costs was uncertain. Unlike what is sometimes alleged, nothing in the decision supports the idea of ordering security payment whenever third party funding is present. On 8 April 2015, the tribunal at the respondent’s

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33 *RSM Production Corporation v. Saint Lucia*, ICSID Case No. ARB/12/10, Assenting Reasons of Gavan Griffith of 12 August 2014, paras 18, 16.
request stayed the proceedings and granted Saint Lucia leave to apply for final dismissal of the claims should the claimant fail to put up the security within six months.  

In the most recent decision on the issue, the arbitrators in EuroGas Inc. and Belmont Resources Inc. v. Slovak Republic distinguished the case before them from RSM Production Corporation v. Saint Lucia and denied the respondent’s security request, holding that:

As regularly held by ICSID arbitral tribunals, security for costs may only be granted in exceptional circumstances, “for example where abuse or serious misconduct has been evidenced.” It is true that in RSM v Saint Lucia, an ICSID tribunal ordered security for costs. However, the underlying facts in that arbitration were rather exceptional since the claimant was not only impecunious and funded by a third party, but also had a proven history of not complying with cost orders. As underlined by the arbitral tribunal, these circumstances were considered cumulatively. Yet, no such exceptional circumstances have been evidenced in the instant case. The Claimants have not defaulted on their payment obligations in the present proceedings or in other arbitration proceedings. The Tribunal is of the view that financial difficulties and third-party funding – which has become a common practice – do not necessarily constitute per se exceptional circumstances justifying that the Respondent be granted an order of security for costs.  

While the tribunal in RSM Production Corporation v. Saint Lucia had become aware of the claimant’s funding because the claimant had admitted this during the advance on costs stage, the respondent in Muhammet Çap & Şehil İnşaat Endüstri ve Ticaret Ltd. Sti. v. Turkmenistan requested the claimants to disclose whether they have entered into third-party funding agreements, and if so, to disclose the terms of these agreements. The respondent put forward three main arguments, namely that there might be a conflict of interest between an arbitrator in the panel and a third-party funder, that it considered a security for costs application because of its concern that an undisclosed third-party funder may walk away from the case in the event of an adverse costs ruling, and that it currently encounters difficulties in collecting a costs award against another Turkish claimant. The tribunal granted the disclosure request. At this point, there is no published decision on a (potential) security for costs application by the respondent. The case nevertheless shows that security for costs applications are one factor that may lead tribunals to order disclosure of third-party funding.

[C] Key Observations and Recommendations of the Sub-Committee

[1] What is the relevance of a third-party funding agreement in ascertaining whether the claimant is impecunious?

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34 RSM Production Corporation v. Saint Lucia, ICSID Case No. ARB/12/10, Decision on Saint Lucia’s Request for Suspension or Discontinuation of Proceedings of 8 April 2015, para. 68.
35 EuroGas Inc and Belmont Resources Inc v. Slovak Republic, ICSID Case No ARB/14/14, Procedural Order No 3 of 23 June 2015, paras 119-123 (internal references omitted).
The Sub-Committee recommends that arbitral tribunals ascertain the financial situation of the claimant starting from general financial records, such as annual accounts and statutory returns. A third-party funding agreement may be considered as an indication of the funded party’s financial situation along with other financial records, however on its own it is no necessary indication that a claimant is impecunious. Third-party funding is increasingly used by large, solvent, companies as a way to offset risk. The mere presence of a third-party funder is therefore not, in itself, sufficient reason to grant security for costs. As such, the presence of a funder should not shift the burden of proof as to whether the requirements for security for costs are fulfilled.

[2] Should tribunals take into account third-party funding arrangements when assessing applications for security for costs?

Third-party funding should be one factor for the tribunals to take into account in both Commercial (a) and Investment Arbitration (b). But, following disclosure of the funding agreement (where disclosure is warranted in the first place), tribunals will need to carefully review the terms of the funding agreement (c).

[a] Security for Costs Applications in International Commercial Arbitration

It is not for this committee to lay down a test for awarding security for costs. However, if the test in commercial arbitration is that the applicant must show material change of circumstances that were commercially unforeseeable (consent perspective), then procuring external funding of legal costs should not usually be proof that circumstances have materially changed in a way that is commercially unforeseeable. However, where a third party funder has agreed to be liable for adverse costs, and then opts to discontinue funding, this may be a relevant consideration suggesting material and unforeseeable change of circumstances. It is suggested that third-party funders or funded parties should notify the defendant, if funding is discontinued, particularly in circumstances where the defendant has previously knowingly proceeded on the basis that the funder would meet the adverse costs.

Even where recourse to funding is not considered unforeseeable, a tribunal might want to take into account broader fairness considerations and ask whether it would be unfair for the requesting party to proceed without security in light of all circumstances, including the funding agreement.

[b] Security for costs application in Investment Arbitration

It is not for this committee to lay down a test for awarding security for costs. However, if the test in investment arbitration is that the applicant must show that there are extreme circumstances that warrant a security for costs order, then such extreme circumstances may involve an element of abuse or bad faith. That might be the case, for example, in situations where the claimant company was deliberately created as a mere procedural shell to collect money if the case is won, and frustrate the respondent’s costs claim if the case is lost. By contrast, mere recourse to third-party funding by a claimant that has become impecunious cannot readily be characterized as carrying an element of abuse, and cannot of itself be taken as a reason for tribunals to award security for costs.
[c] Which terms of a funding agreement may become relevant?

**Termination rights**

The circumstances in which the funder is entitled to terminate their funding and their liability for adverse costs in circumstances where they do terminate are relevant and should be taken into account by tribunals when deciding security for costs applications.

Most professional funders have very clear termination provisions which spell out, in circumstances where they have agreed to be liable for adverse costs, when they are liable for such costs, which typically is for the duration of their funding. Where a funder is a member of the Association of Litigation Funders of England and Wales (ALF), its funding agreements must comply with the ALF Code of Conduct for Litigation Funders (ALF Code, January 2014). Article 13.2 ALF Code requires that, in case of a dispute over termination, ‘a binding opinion shall be obtained from a Queen’s Counsel who shall be instructed jointly or nominated by the Chairman of the Bar Council’. Only if the Queen’s Counsel agrees with the funder that it is lawful to terminate, will the Termination Notice be valid. Funders operating in other jurisdictions have internal codes that set out their practice in respect of whether and under which circumstances they can terminate funding.

**Arrangements that the funder is not liable for adverse costs**

Where a funded party steps forward and shows that a solvent funder is contractually liable for a potential adverse costs award, this will usually render unnecessary an order for security for costs. Where a funder has agreed with the funded party to be liable for adverse costs, the capital adequacy of that funder to meet an adverse costs award, whether in its own right or by virtue of an ATE policy, is clearly relevant in assessing whether adequate security has been provided. **It is therefore important for arbitrators to be aware of and take account of arrangements between the funder and the funded party that the former is not liable for adverse costs.**

**Further terms**

Other TPF terms may come into play when Tribunals consider whether to award an order for security for costs, for example terms setting limits for the amount of funding,

[Other terms to suggest?]

[3] Should the party seeking security for costs be held liable for the claimant’s cost of posting security if the defence fails?

The sub-committee considers that an arbitral tribunal should consider indicating to the requesting party that, should the defence fail, it will be held liable for the costs reasonably incurred by the funded party in posting security. It should be for the funded party to substantiate the amount of costs it reasonably incurred in posting security.
in International Arbitration
Third-Party Funding

ICC Institute of World Business Law
Dossiers
general significance for the legal profession

Introduction and overview

Third-party funding

in investor-state arbitration

carloyn b. lam and eckhart r. helbeck

chapter 9
The International Chamber of Commerce has announced that it is releasing a report on the state of funding for third-party financing. The report aims to address the challenges faced by companies in accessing funding for projects, particularly in emerging markets. The report highlights the importance of third-party financing in providing the necessary capital to support projects that are critical to economic development.

The report notes that third-party financing has become increasingly important in recent years, particularly in regions where traditional sources of funding are limited. However, it also acknowledges the challenges that companies face in accessing third-party financing, including regulatory obstacles and the need for reliable credit information.

The report recommends several measures to address these challenges, including the development of clearer and more consistent regulatory frameworks, the provision of technical assistance to companies, and the creation of new financing mechanisms.

Investors are urged to consider the benefits of third-party financing, particularly in emerging markets, where it can provide a valuable source of capital. The report concludes that third-party financing has a crucial role to play in supporting sustainable development and economic growth.
In the context of the CICD, there are specific procedures that need to be followed to ensure proper implementation. These procedures are designed to prevent data loss and ensure the integrity of the system. The procedures include: 

1. **Preparation of the Environment**: Before deploying any changes to the system, a thorough environment check is conducted to ensure that all necessary resources are available.
2. **Data Backups**: Regular backups of all critical data are performed to ensure that in case of any issues, data can be restored to the previous state.
3. **Testing and Validation**: Comprehensive testing is conducted to verify that the changes have been implemented correctly and do not introduce any issues.
4. **Deployment**: Once testing is complete, the changes are deployed to the production environment in a controlled manner.
5. **Monitoring and Maintenance**: After deployment, the system is monitored for any issues, and regular maintenance is performed to ensure optimal performance.

It is crucial that these procedures are followed diligently to prevent any potential issues that could arise from improper implementation. By adhering to these guidelines, organizations can ensure the smooth operation of their systems and minimize the risk of data loss or other adverse outcomes.
Involving the Funder

Implications for costs decision

The International Chamber of Commerce (ICC) has been advocating for a revamped approach to the resolution of ICC disputes. The recent development in technology has opened new avenues for parties to resolve disputes more efficiently and cost-effectively. The ICC has introduced the Online Arbitration Protocol (OAP), which allows parties to conduct online arbitrations, thereby reducing the costs associated with traditional arbitration. The OAP also offers confidentiality and flexibility, making it an attractive option for parties looking to resolve disputes in a cost-effective manner.

The OAP is designed to be user-friendly and accessible, allowing parties to easily navigate the process. The protocol is also designed to be adaptable, allowing parties to tailor the proceedings to their specific needs. The ICC has also introduced a cost-saving feature, which allows parties to choose the level of fees they are willing to pay, making the process more affordable.

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THIRD-PARTY FUNDING IN INTERNATIONAL ARBITRATION

LAMM AND SCHWARTZ, R.

CAROLYN L. LAMM AND EDWARD R. HELLBACK

Discovery

Unique discovery issues may arise in a case financed by a third-party funder. For example, a funder may demand access to confidential information that is protected under legal privilege. The court may need to consider whether the funder has a right to inspect documents or to depose witnesses. The funder may also have a right to receive copies of documents that are in the possession of the parties or the tribunal. The court may need to balance the interests of the parties and the funder in order to ensure that the discovery process does not unduly burden the parties or the court.

Interim measures against third-party funders

In some jurisdictions, interim measures may be available against third-party funders. These measures may include prohibiting the funder from pursuing certain activities, such as seeking additional funding, or from taking certain actions, such as collecting debts. The court may also order the funder to pay a bond or post a guarantee to ensure that the funder complies with the interim measures.

Issues of confidentiality

Confidential information is often a key issue in international arbitration. The parties may have obligations to protect the confidentiality of certain information, such as trade secrets or proprietary information. Third-party funders may also have interests in protecting the confidentiality of information that they have received from the parties. The court may need to consider whether the funder has a right to access confidential information and whether the funder has taken steps to protect the confidentiality of the information.

Advocacy

Third-party funders may provide funding for advocacy in international arbitration. The funder may provide financial support for the expenses of the lawyer in the arbitration, such as travel and living expenses. The funder may also provide financial support for the preparation of the case, such as the cost of expert witnesses or the cost of gathering evidence.

Secrecy

Third-party funders may have a need for secrecy in order to protect their interests. The funder may not want the parties to know about the extent of the funder's involvement in the arbitration. The court may need to consider whether the funder has a right to maintain secrecy and whether the funder has taken adequate steps to protect the confidentiality of the information.
ty of a jurisdictional interest must be established for jurisdictional purposes is the date of the parties’ consent to ICSID arbitration. ICSID Convention, art. 25(2) (b). In most ICSID arbitrations, in which jurisdiction is based on an unilateral offer of consent contained in a treaty or in host state legislation, this will be the date on which the investor perfected the parties’ consent by filing the request for arbitration. Schreuer, Christoph, et al., The ICSID Convention: A Commentary (2nd ed. 2009) pp. 203, 212.


37 The Loewn Group, Inc. and Raymond Loewen v. United States of America, ICSID case no. ARB(AF)/98/3, Award, 26 June 2003, para. 220.

38 Id., at para. 237.

39 Id., at paras. 225-226.

40 Id., at paras. 237, 240.


44 See generally van Boom, supra note 11, at p. 49 (citing Molot, Jonathan, 'Litigation Finance: A Market Solution to a Procedural Problem', Georgetown Law Journal 99 (2010), pp. 65 at pp. 70-73 to discuss litigation risk aversion as a motive for settlement transactions and thus argue how it seems plausible that, in litigation, third-party financing may increase leverage for the claimant and incentives for the defendant - provided that the defendant is aware of the third-party funder's involvement, which conveys confidence in the quality of the claimant's claim).

45 See infra text accompanying note 124.


47 Abaclat et al. v. Argentine Republic, ICSID case no. ARB/07/5, Decision on Jurisdiction and Admissibility, 4 August 2011, para. 541.
Third-Party Funding in International Arbitration: The ICCA Queen-Mary Task Force

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Third-Party Funding in International Arbitration: 
The ICCA Queen-Mary Task Force 
By William W. Park† & Catherine A. Rogers‡

I. Introduction

Third-party funding raises a host of ethical and procedural issues for international arbitration, perhaps most notably in connection with arbitrator comportment. It would be a brave arbitrator indeed who ignored the potential conflicts raised by his service as consultant to an institution bankrolling a claimant in a case sub judice before the arbitrator. Given the funder’s stake in the award, and possible involvement in selection of the arbitral tribunal, similar concerns arise when colleagues in the arbitrator’s law firm serve as counsel or adviser to a funder, or when an arbitrator is called to rule on cost allocation or security in a context where the funder’s participation becomes relevant.

As third-party funding has become an increasingly global phenomenon in national courts, the institutions which provide such financial backing to litigation include not only specialized firms, but also insurance companies, investment banks, and hedge funds, collectively capitalized well into the billions. In recent years, funders have taken a particularized interest in international arbitration. Funders report that upwards of ten percent of their investments are in international arbitration disputes, both commercial and investor-state arbitration.

The need for sustained study of these concerns prompted establishment of a Task Force on Third-Party Funding in International Arbitration, convened by the International Council for Commercial Arbitration (ICCA) along with Queen Mary College at the University of London. As discussed below, the Task Force will assess both real and perceived concerns that the relatively new practice raises, as well as what might be done, and why.

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1 For a survey of this growth and the reasons why, see Chapter 5 in CATHERINE A. ROGERS, ETHICS IN INTERNATIONAL ARBITRATION (Oxford University Press 2014).
2 Kantor, supra note 5, at 69 (reporting Credit Suisse describes 10% of its portfolio in international arbitration, and similar investments by Juridica and Burford Capital Limited).
International arbitration attracts funders in part because such cases typically involve high-value claims,4 proceedings with no substantive appeal,5 potential for streamlined procedures, the ability to control litigation variables such as the arbitrator’s expertise, and the enforcement mechanisms of international conventions.6

Funders generally treat their investment portfolios as proprietary information.7 Moreover, most funding agreements are confidential, and the funders’ presence in disputes is often undisclosed.8 In a few international arbitration cases, the presence of third-party funding has become public. In some cases disclosure may be by design,9 while in others disclosure has been the result of disputes between the funder and the funded party and/or its counsel.10 As a relatively new practice that operates mostly behind the scenes, the basic mechanics of third-party funding are not always well-understood.

Funder participation raises a host of vital issues, such as the funders’ relationship with parties and counsel in managing the dispute, allocation of costs and security for costs, transparency and disclosure, confidentiality, attorney ethics, arbitrator conflicts of interest, tribunal powers, and potential relations with institutions.

4 Since 2001, ten arbitrations have yielded awards over USD 1bn (one investor-state arbitration and nine commercial awards), and another 20 arbitrations have resulted in awards of USD 500m or more (three investor-state and 17 commercial arbitrations). Michael Goldhaber, Arbitration Scorecard 2013, AM. LAW., June 24, 2013, http://www.americanlawyer.com/PubArticleTAL.jsp?id=1202608198051&Arbitration_Scorecard_2013&slreturn=20130714160934.

5 Although international arbitration is often critiqued as less speedy and cost-effective than corporate parties desire, the question is always “less” in comparison to what? In national legal systems, even those regarded as highly effective, the average length of a case, which usually includes appeal as of right, can be both long and unpredictable. In addition, complex commercial claims worth hundreds of millions, sometimes billions, of dollars undoubtedly require time to adjudicate and are often extremely expensive in any forum. That said, there is clearly room for improvement and several important reforms by various arbitral institutions are working toward that end.


8 See Maxi Scherer, Aren Goldsmith & Camille Fléchet, Third Party Funding in International Arbitration in Europe: Part 1—Funders’ Perspectives, 2 INT’L BUS. L. J. 207, 217-18 (2012) (“As a general matter, funders require that their involvement not be revealed, unless the client is compelled to do so.”).


10 See S&T Oil Equip. v. Juridica Invs. Ltd, 456 Fed.Appx. 481 (5th Cir. 2012) (where the identity of Juridica, a company funding an ICSID arbitration between S & T Oil and the Romanian government, became public when S & T Oil sued Juridica in U.S. federal court and appended a copy of the funding agreement).
The arrival of third-party funders will likely affect a broad range of participants in the arbitral process in addition to arbitrators, for reasons mentioned above, and the parties which receive funding. Counsel for litigants who which not coordinate with funders will at some point stand across from opposing counsel who do. And all law firms compete in a marketplace in which millions of dollars in legal fees come from funders.

Savvy business manager may incorporate confidentiality provisions into their arbitration agreements which either facilitate or preclude disclosure to third-party funders. Or the agreement may address costs in the event of funder participation. Issues in the arbitration agreement may require assessment not only arbitrators but even as a preliminary matter by institutions.

Investor-state arbitration has attracted particular attention by both funders and their critics. The cases interest funders because of the potential for sizeable recoveries. According to some anecdotal reports, at least two-thirds of ICSID cases filed in 2013 implicated claimants which had sought resources from a major funder.\(^\text{11}\)

In theory, funders can provide support for either claimants or respondents.\(^\text{12}\) The funding of claims, however, provides the greater upside potential, and therefore attracts more attention. Some critics thus express concern that significant new funding in investment arbitration cases will expand investor-state arbitration, creating a disproportionate burden on States.\(^\text{13}\) Others laud the development as bolstering increased access to justice, as investors whose claims were once considered too costly are now able to obtain financing.

Some critics express concerns that less-scrupulous funders may be willing to fund weak claims, willing to take high risks in exchange for potentially significant rewards, with a consequential increase in dubious cases. For some, this critique overlaps with concern about perceived disparities in investment arbitration that favor investors over States.\(^\text{14}\) Analogies to questions about class arbitration will not escape the thoughtful observer.\(^\text{15}\)

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\(^\text{11}\) This estimate was from only one (albeit major) funder on the Task Force. No reliable statistics exist about whether these parties actually obtained funding.

\(^\text{12}\) Defense-side funding may occur, for instance, when the defendant wishes to bring costly counterclaims or cross-claims (e.g., a claim for summary judgment), or, by sophisticated defendants willing to pay funders a portion of pre-calculated loss mitigated through a successful defense. See Scherer et al., supra note 8, at 211; Goffrey McGovern et al., Third-Party Litigation Funding and Claim Transfer (RAND 2010), at 22, available at http://www.rand.org/content/dam/rand/pubs/conf_proceedings/2010/RAND_CF272.pdf (last accessed Oct. 6, 2014). In practice, it rarely happens and, to date, no respondent-side funding has been reported in an investment arbitration case by a commercial third-party funder.

\(^\text{13}\) See De Brabandere & Lepeltak, supra note 5, at 8; Marco de Morpurgo, A Comparative Legal and Economic Approach to Third-Party Litigation Funding, 19 CARDOZO J. INT’L & COMP. L. 343, 384-85 (2011).


\(^\text{15}\) See William W. Park, La jurisprudence américaine en matière de class arbitration: entre débat politique et technique juridique, 2012 Revue de l’arbitrage 507
II. Salient Task Force Activities

The Task Force was launched in mid-2013. The authors serve as co-chairs, with Professor Stavros Brekoulakis as Rapporteur. A full list of Task Force members can be found on the ICCA website. The Task Force was composed to ensure representation of a full range of stakeholders from geographically and industry distinct perspectives, including arbitrators, in-house counsel and parties, external counsel, representatives with administrative functions in arbitral institutions, academics, and a range of funders.

The first meeting of the Task Force was a roundtable discussion held in London in February 2014. It focused on presentations and policy discussions among participants organized around a series of the most salient issues arising from the participation of third-party funders, with action items proposed for each topic. These topical discussions, which were each led by individual members, included the potential for conflicts of interest among funders and arbitrators, confidentiality and attorney privilege issues, allocation of costs and security for costs, internal and industry-based self-regulatory models for funders, and the implications of third-party funding in investment arbitration. These topics and the proposed action items are discussed in turn below.

A. Defining Third-Party Funders

Although not initially a distinct topic for discussion by the Task Force, the need for a working definition of Third-Party Funding quickly became clear. The significant disagreement about the exact nature of third-party funding is part of what contributes to open questions about whether, how, or to what extent it could or should be regulated. Although often described as a monolithic group, there is significant variety among funders. Funders have different types of cases as targets for investment, operate and fund in different jurisdictions and practice areas, and have widely variant internal practice guidelines.

One reason why third-party funding is difficult to define is that economic interests in a party or a dispute can come in many shapes and sizes. Arrangements may be structured as debt instruments, equity instruments, risk-avoidance instruments, or as full transfers of the underlying claims. Some agreements permit or require active participation of the third-party funder in key strategic decisions in the case, while other agreements are limited to periodic updates.

Conventional definitions are limited to agreements entered into after a dispute has arisen, but they can be entered into either before or after the case is filed. Moreover, many funding arrangements are not necessarily entered into between the principal funder and the party. Funders often create “special purpose vehicles” that are separate corporate structures from the funders themselves to facilitate the funding arrangement. In some

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17 Professor of Commercial Law and International Arbitration at Queen Mary
20 See Cento Veljanovski, Third-Party Litigation Funding in Europe, 8 J.L. ECON. & POL’Y 405, 430 (“[Third-party litigation funding investors] rely on Special Purpose Vehicles, which . . . are legal
situations, funders may provide financing directly to law firms. In addition to variations in structure, the conditions for funding and for recovery by a third-party funder also vary significantly. A typical agreement provides for funders to receive a percentage of recovery, and the percentage increases with the passage of time since the initial investment.

Even when funding agreements are entered into directly between a client and the funder, it is not simply a bilateral relationship. The funding arrangement often involves a symbiotic relationship with the party’s law firm. Law firms may encourage, facilitate, and (according to anecdotal evidence from funders) even initiate parties’ application for third-party funding. Outside funding can cover firms’ fees and reduce their own risk if, for instance, the case were instead to be structured around a contingency fee arrangement. Informal agreements, with various degrees of specificity, often exist between funders and law firms. These agreements, as well as the primary funding agreements with parties, may involve specified reductions in a law firm’s contingency fee or hourly rates; they may establish flat fee billing or some hybrid fee structure.

Although most third-party funding arrangements are generally entered into for profit, that is not always the case. For example, in the investment arbitration case brought by Philip Morris against Uruguay, The Bloomberg Foundation and its “Campaign for Tobacco-Free Kids” provided outside financial support for the Uruguayan government. This arrangement seems to have much more in common with pro-bono support for legal causes than more conventional definitions “third-party funding,” but arguably raises some similar issues.

In its initial discussions, the Task Force quickly decided that a working definition of third-party funding would be useful, both for discussion purposes and as a starting point for several of the practical projects that the Task Force will be taking up. Consensus on the Task Force was that a definition of third-party funding or third-party funders might vary depending on the purpose for which the definitions are used. As the Task Force first considered the potential for conflicts of interest as between funders and arbitrators, it developed a working definition for that context.

Although potentially subject to revision, that working definition developed by the Task Force is:

The terms ‘third-party funder’ and ‘after-the-event-insurer’ refer to any person or entity that is contributing funds or other material support to the prosecution or defense of the dispute and that is entitled to receive a benefit (financial or otherwise) from or linked to an award rendered in the arbitration.

This definition of third-party funders attempts to capture a more full range of funding relationships that currently exist, without being so overly broad as to require disclosure of entities such as minor equity investors or creditors. While there was significant consensus about this definition, there was also considerable debate and disagreement on the Task Force about whether this definition should include ordinary insurers.

On the one hand, traditional insurers have interests in and may also exercise control over key aspects of a party’s case strategy, such as control over settlement. As a practical matter, such control may, particularly in individual cases, be functionally similar to more conventional third-party funders and after-the-event insurers. For some members of the Task Force, these similarities raised questions of fairness in treating similarly situated entities in similar manner for the purposes of disclosure.

On the other hand, there were concerns that ordinary insurers are ubiquitous and have not historically been considered as subject to assessment with respect to potential arbitrator conflicts. Some members of the Task Force believed that this approach was a historical anomaly that should be corrected in conjunction with taking up the issue of third-party funding, while others suggested that exclusion of traditional insurers was a structural feature of dispute settlement that should not be tampered with and could be maintained as separate from the issue of third-party funding. One reason for this latter perspective is that before-the-event insurers generally do not specifically and intentionally identify an existing case as a specific target of their investment. As a result, before-the-event insurers may be presumed to be less directly involved in the specifics of case management than third-party funders are. This is undoubtedly a definitional issue that the Task Force will continue to explore in its future work.

B. Potential Conflicts of Interest with Arbitrators

Although some commentators have argued against the possibility of conflicts of interest as between funders and arbitrators, the Task Force quickly arrived at consensus that there are real and important concerns about potential conflicts. Several factors contribute to this perception, including the increase in the number of cases involving third-party funding, the highly concentrated segment of the funding industry that invests in international arbitration cases, the symbiotic relationship between funders and a small group of law firms, and, relatedly, the often close relations among elite law firms and leading arbitrators.22 Against this backdrop, after developing a definition, the first action item taken up by the Task Force was to consider disclosure obligations and potential for conflicts of interest with arbitrators.

At the time of its first meeting, these issues were already under consideration by the IBA Sub-Committee on the IBA Guidelines on Conflicts of Interest in International Arbitration, which was undertaking to amend the IBA Guidelines to address potential

conflicts of interest that may arise when third-party funders participate in arbitral disputes. The discussion below provides some background analysis of why amendments were needed to the IBA Guidelines to address issues relating to disclosure and potential conflicts of interest.

Even if funders are not formally parties, they do participate with varying degrees in various stages of an arbitration. Thus, one of the most obvious potential sources of conflict is if an individual arbitrator were repeatedly appointed in cases involving the same third-party funder. With law firms and parties, when the frequency of repeat appointments reaches a certain threshold, that history is generally regarded as raising possible concerns about influence or inter-dependency. For this reason, the 2004 IBA Guidelines required that when an arbitrator has had more than two appointments in the last three years by the same party and three or more appointments in the last three years by the same law firm, the repeat appointments must be disclosed. It is worth emphasizing that these past appointments are not necessarily a basis for disqualification, but they raise sufficient concern to warrant disclosure and to raise the possibility of disqualification.

Third-party funders also raise some unique concerns that are distinct from those that arise with either law firms or parties. For example, take the case of one party that is funded by a funder, which involves a particular individual as the presiding arbitrator in one arbitral dispute, but that same presiding arbitrator also serves as counsel to the claimant in another unrelated second arbitration, which is funded by the same funder who participated in selecting the participating arbitrator. The presiding arbitrator acting as counsel in the second arbitration has fees paid by the funder, and likely has significant contacts with the funder for the purposes of representation. The financial arrangement and ongoing contacts arguably raise questions about the presiding arbitrator’s impartiality and independence in the first arbitration.

The resolution of the problem illustrated above may seem self-evident, but only if the arbitrators are aware of the existence of the relevant funding agreements. Currently, parties have no obligation to reveal the participation of third-party funders in a dispute. The simple presence of a funder in an international arbitration case is therefore most often unknown or unknowable. More importantly, the nature of funders’ relationships with attorneys and funded parties is generally unknown, as are funders’ levels of involvement in case management and strategy, including the selection of arbitrators or expert witnesses.

Particularly given the very real possibility that the existence of the funding agreement may be later discovered (and has in fact caused problems in certain cases), one starting proposition for the IBA Sub-Committee and the Task Force was that some form of disclosure would be necessary, at least to arbitrators directly. Moreover, clearer

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23 IBA GUIDELINES ON CONFLICTS OF INTEREST IN INTERNATIONAL ARBITRATION, § 3.3.2 (2004) [IBA GUIDELINES].
24 Id. at § 3.3.7.
guidance was needed about when such participation may raise questions about potential conflicts for arbitrators, warranting disclosure or even recusal or disqualification.

The Task Force was invited to provide comments on the proposed draft Guidelines and passed along its assessments on these issues. The Task Force looks forward to publication of the amendments to the IBA Guidelines, which will occur just as this article is going to press.

C. Ongoing Work

Currently the Task Force has formed several Working Groups to address other issues, such as allocation of costs and security for costs, confidentiality and attorney-client privilege, guidelines for best practices among funders in international arbitration, and funding in investment arbitration. These topics are commented on in general terms below. It is important to note, however, that while the discussion below frames the relevant issues, work on these topics is ongoing and the final output of various Working Groups may vary as they consider more deeply even how to define the range and importance of various issues.

1. Allocation of Costs and Security for Costs

The presence of third-party funding is increasingly being raised as an issue in applications for security for costs, as well as in final applications regarding allocations of costs. There have been anecdotal reports of funded claimants who ultimately do not prevail being unable to pay costs. Because funding is relatively new, and understanding of the nature of funding and the reasons for it are not always very well understood among arbitrators, counsel, and parties, concerns have been raised about relying on assumptions and intuition instead of careful analysis in working through these issues in individual cases. Moreover, both of these issues are seminally important for funders as they affect the case profile and fundamental considerations in determining whether to fund it. The starting premise for the Task Force and this Working Group is that more guidance is needed regarding the various factors that might be relevant in addressing applications for costs and security for costs, and that a sensible approach can be developed that takes into account the various concerns and substantive issues.

2. Confidentiality and Attorney-Client Privilege

While some funders seek to avoid obtaining privileged information and written legal analysis from the claimant’s counsel, other funders habitually seek access to confidential information in order to assess and monitor the progress of cases in which they invest. After all, how does a third-party funder properly evaluate the causes of action without obtaining confidential or privileged information at the heart of a case?

This practice raises a host of difficult issues. Does providing such confidential or privileged information to third-party funders constitute a waiver? The answer to this question may in turn depend on whether the jurisdiction whose privilege rules apply recognize a privilege for third-party funders or a so-called common interest exception. Even a seemingly straightforward determination of which privilege rules apply may be difficult, and, once determined, considerable variation exists from country to country. Meanwhile, even in those countries with relatively well-developed third-party funder
regimes, answers to these questions are not always clear and it is a distinct possibility that different rules could apply to different parties and funders in the same proceeding. For these reasons, this Working Group is investigating whether it would be possible and productive to develop international standardized evidentiary privilege standards that relate to third-party funding.

3. Best Practices

One of the most striking features of third-party funding concerns how it is virtually immune to regulation in international arbitration. While some national systems have limited rules that apply to funders and their participation in national litigation, those rules end up having little or no effect on funding of international arbitration claims. One reason is that funding agreements generally select applicable law and forums for enforcement that avoid jurisdictions that prohibit or significantly limit funding arrangements.

This is one area where there was considerable disagreement among Task Force Members. Some believed that individual funders could and should develop internal rules to govern their conduct. The concern was that external guidelines, particularly imposed without any enforcement mechanism, would operate effectively as a burden on upstanding funders, while doing little or nothing to curb potential abuses by less-scrupulous funders.

Despite the potential for disagreement, there was general consensus that a Working Group be created to consider the potential for developing such best practice guidelines, and the viability of an enforcement mechanism, such as membership or certification of compliance.

4. Investor-State Arbitration

For all the questions and issues raised by third-party funding in international arbitration generally, there remain additional issues specific to investment arbitration. As already noted, third-party funding is almost exclusively available for claimants, which in investment arbitration necessarily means investors. Anecdotal evidence also indicates that investment arbitration cases may be more expensive to bring and sustain than the typical commercial case, but also have more potentially higher value outcomes. All this suggests that third-party funding may (and perhaps already has begun to) increase the total number of investment claims brought against States.

Other related issues raised during initial Task Force discussions on this topic involve the relationship between third-party funding and political risk insurance, issues regarding the status of funders (can they qualify as an “investor” under BITs), and related questions about whether and to what extent States can be deemed to have consented to arbitrate with funders. Finally, the often undisclosed presence of third-party funders has also drawn criticism as inconsistent with current efforts to make investor-state arbitration more transparent.

Given the complexity and implication of these issues, the Task Force formed a special Investment Arbitration Working Group to consider them in depth. This Working Group has expanded beyond the initial Task Force membership in order to bring in specialized expertise and perspectives that are unique to investment arbitration. In
addition to the range of funders, arbitrators, and law firms drawn from the Task Force directly, the Investment Arbitration Working Group also includes (either in their official or in some instances in their personal capacity): the Secretary General of ICSID; representatives from various States, including the Dominican Republic, Egypt, Germany, Singapore, Slovakia Spain, the United States, and others; and representatives from international organizations such as the International Court of Justice, UNCTAD, and the OECD.

The Working Group has also tapped in-house counsel from major corporations who are active in investment arbitration, leading arbitrators who specialize in investment disputes, and academics doing specific research in the area of third-party funding of investment arbitration claims. A final list of the membership of the Investment Arbitration Working Group will be published soon.

The Investor-State Working Group is currently scheduled to meet in January 2015. While the Working Group will ultimately determine its own mission and activities at that meeting, its overall function will be to analyze relevant issues and make policy and practical recommendations. It may also build on the work of the larger Task Force regarding, for example, issues such as security for costs and proposed best practices for third-party funders—as those topics raise unique issues in investment arbitration.
The Litigation Finance Contract

Maya Steinitz
THE LITIGATION FINANCE CONTRACT

MAYA STEINITZ*

ABSTRACT

Litigation funding—for-profit, nonrecourse funding of a litigation by a nonparty—is a new and rapidly developing industry. It has been described as one of the “biggest and most influential trends in civil justice” today by RAND, the New York Times, and others. Despite the importance and growth of the industry, there is a complete absence of information about or discussion of litigation finance contracting, even though all the promises and pitfalls of litigation funding stem from the relationships those contracts establish and organize. Further, the literature and case law pertaining to litigation funding have evolved from an analogy between litigation funding and contingency fees. Much of that literature and case law views both forms of dispute financing as ethically compromising exceptions to the champerty doctrine. On that view, such exceptions create the risks of an undesirable loss of client control over the case, of compromising a lawyer’s independent judgment, and of potential conflicts of interest between funders, lawyers, and clients.

This Article breaks away from the contingency analogy and instead posits an analogy to venture capital (VC). It shows the striking resemblance of the economics of litigation funding with the well-understood economics of VC. Both are characterized by extreme (1) uncertainty, (2) information asymmetry, and (3) agency costs. After detailing the similarities and differences between these two types of financing, this Article discusses which contractual arrangements developed in the area of venture capitalism can be directly applied to

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litigation finance, which ones need to be adapted, and how such adaptation can be achieved. As much of the theory, doctrine, and practice of VC contracting can be applied or adapted to litigation finance, practitioners and scholars can be spared decades of trial and error in developing standardized contractual patterns.

In addition, the analogy turns most of the conventional wisdom in the field on its head. This Article argues that funders should be viewed as real parties in interest, funders should obtain control over a funded litigation, and attorneys should take funders’ input into account. In return, funders should pay plaintiffs a premium for the control they receive, subject themselves to a compensation scheme that aligns their interests with those of the plaintiffs, and enhance the value of claims by providing noncash contributions. Indeed, on the suggested view, noncash contribution—as much as if not more than, capital contribution—should be seen as a key benefit of litigation finance. Courts and regulators should devise rules that enhance the transparency of the industry—in particular the performance outcomes of various litigation funding firms and their ethical propensities. Such a legal regime will foster the emergence of a reputation market that will police the industry and support contractual arrangements.
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INTRODUCTION

Litigation finance—for-profit, nonrecourse funding of a litigation by a nonparty—is a new and rapidly developing industry globally, and in the United States in particular. So much so, that the RAND Institute for Civil Justice has dubbed it one of the “biggest and most influential trends in civil justice,” and the New York Times has recently reported on it at length on its front page and in its “Betting on Justice” series. More generally, litigation funding in all of its forms—law lending, contingency fees, and nonrecourse funding—is pivotal for understanding civil litigation as a whole: “[T]he most ... important phenomena of modern litigation are best understood as results of changes in the financing and capitalization of the bar.” For example, in the United States a market in bankruptcy claims emerged some twenty years ago and “nothing has changed the face of bankruptcy in the last decade as much as the new-found liquidity

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1. New York City Bar Ass’n, Formal Op. 2011-2 § I (2011) (“As of 2011, [the third-party litigation financing] industry has continued to grow, both as to the number and types of lawsuits financed and financing provided. The aggregate amount of litigation financing outstanding is estimated to exceed $1 billion.”). On trends in law firm finance, see Larry Ribstein, *The Death of Big Law*, 2010 Wis. L. REV. 749, 754-59, 788-97 (discussing both traditional and emerging law firm models).

2. *Third Party Litigation Funding and Claim Transfer*, RAND CORP., http://www.rand.org/events/2009/06/02.html (last visited Oct. 10, 2012); see also Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1270-71 & n.4 (2011). Litigation funding is accelerated by the global recession, which has created more claims but less funds to pursue them as well as an appetite for new, alternative assets. See id. at 1283-85. The expansion of litigation funding is also driven by a global transformation of legal services egged on by the Legal Profession Act 2004 (NSW) ch 2, pt 2.6, div 2, which allows incorporation of legal practices in Australia, and the Legal Services Act, 2007, c. 29, §§ 71-111, which allows investment in British law firms.


in claims.\textsuperscript{5} Due to litigation funding’s increasing salience, courts, legislatures, regulators, and academics have all, as of late, started grappling with the phenomenon head on.\textsuperscript{6}

Litigation funding is largely understood as composed of two subindustries. One is usually referred to as “consumer funding”—the funding of relatively small personal claims, predominantly personal injury and divorce cases.\textsuperscript{7} This subindustry has a somewhat longer history in the United States, going back approximately fifteen years, to what has in the past been called “law lending.” The second, newer subindustry is “commercial funding.” This industry relates to the funding of business disputes, such as disputes relating to intellectual property, antitrust, business contracts, and international commercial and investment arbitration—brought by sophisticated


parties and involving larger stakes. This Article focuses exclusively on commercial funding. Specialized investment firms dedicated exclusively to litigation funding have pioneered it in the United States. However, in addition, what started as a trickle of investments by hedge funds—not specializing in litigation but rather investing opportunistically—has recently turned into a flood.

But this growing industry is shrouded in secrecy and, to make matters more complicated, its funding structures are “as various as snowflakes.” Commentators have identified a variety of possible investment structures. These include recourse and nonrecourse loans, which can be either secured or nonsecured. Investments may take the form of a purchase, an assignment of a claim, or even the sale of an interest in the judgment. These, in turn, may be directly or indirectly syndicated. Funders may form joint ventures with other funders; law firms may cofinance with other law firms using cocounseling agreements; and insurance companies may offer

8. See id. at 13-15. See a discussion of the “first wave” and “second wave” of litigation funding, including a literature review relating to the former, in Steinitz, supra note 2, at 1277-78.

9. Although acknowledging that litigation funding is a controversial practice, this Article assumes that litigation funding is an industry whose time has come and proceeds from that premise to discuss how—not whether—it should take place.

10. Margie Lindsay, Third-Party Litigation Funding Finds Favour with Hedge Funds, HEDGE FUNDS REV. (Jan. 19, 2012), http://www.hedgefundsreview.com/hedge-funds-review/news/2139727/audio-party-litigation-funding-favour-hedge-funds. This information is also based on off-the-record interviews conducted by the author with various investors.

11. See Roger Parloff, Have You Got a Piece of This Lawsuit?, FORTUNE (May 31, 2011, 5:00 AM), http://features.blogs.fortune.cnn.com/2011/05/31/ have-you-got-a-piece-of-this-lawsuit; see also Neil Rose, Whatever You Want, LAW SOCIETY GAZETTE (Jan. 17, 2008), http://www.lawgazette.co.uk/features/whatever-you-want (“This is very much a bespoke market.”).

12. See Lindsay, supra note 10 (quoting Selwyn Seidel, Founder and Chairman of Fulbrook Management) (internal quotation marks omitted).


litigation insurance products. Other forms of indirect investments in legal claims, which are beyond the scope of this Article, include law firm loans offered by banks and equity investment in law firms.16

One litigation funding firm has disclosed its investment structures to its investors in the following terms:

The Company intends to make use of a wide variety of investment structures .... Examples of possible structures include, inter alia:

- funding the legal expenses associated with pursuing or defending a claim in exchange for a payment based on the claim’s outcome;
- acquiring an interest in all or a part of a claim or claimant at various stages during the adjudication process, including after a judgment or award has been rendered;
- lending money, either directly or through a law firm established by the Principals, to fund the activities of a law firm, the litigation of a portfolio of cases, or the litigation of a single case;
- arranging and participating in structures that remove the risk of liability from companies’ balance sheets;
- acquiring interests in intellectual property that is the subject of claimed infringement; and
- participating in post-insolvency litigation trust structures.17

Even within the paradigmatic investment structure of the first bullet above, which is modeled on the contingency fee, variations abound.18 How parties choose to structure their litigation funding agreements depends on a variety of factors such as: (1) the type of investor—ad hoc institutional investors, such as a hedge fund or

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16. Crystal, supra note 13, at 16; Roundtable Discussion Summary, in CONFERENCE PROCEEDINGS, supra note 13, at 21, 22; James E. Tyrell, Lawyer Investments in Claims, in CONFERENCE PROCEEDINGS, supra note 13, at 9, 9; Stephen Yeazell, Third-Party Finance: Legal Risk and Its Implications, in CONFERENCE PROCEEDINGS, supra note 13, at 18, 19.


18. See Rose, supra note 11 (“Allianz has a starting point of 30% of the first £350,000 recovered, and 20% on anything above that. IM relates its take to when monies are recovered, ranging from 25% for up to six months from the letter of intent, to 50% for over 18 months. S&W ranges anywhere between 15% and 45%. In general, a funder will be looking for at least three or four times the sum invested.”).
bank, or specialized institutional investors, either private or public; (2) the investor’s needs; (3) regulatory or ethical restrictions; and (4) tax considerations.\textsuperscript{19}

Despite the increasing importance and growth of the industry, there is a complete absence of either information about or discussion of litigation funding contracting—both its theory and its practice.\textsuperscript{20} Further study of litigation funding agreements is badly needed. To state the obvious, the litigation funding contract is the foundation and framework of the funding relationship. The absence of any guidance on how to contract for litigation funding significantly raises the transaction costs of such funding because parties must start from scratch when entering a litigation funding agreement.\textsuperscript{21} This void also creates an uneven playing field for unsophisticated clients who cannot afford to negotiate a form contract presented by an experienced funder. In other words, there is both an efficiency-based and justice-based need for academic discussion of the litigation finance contract, both of which this Article seeks to address. Additionally, the void leads to a public policy discourse based, at least partially, on ignorance of how funding arrangements operate in practice or in theory. Finally, by breaking away from the analogy to contingency fees, and positing instead an analogy to venture capital, it becomes clear that in addition to a justice argument in favor of litigation finance—for example, access to justice—litigation financiers may be valuable because they can enhance the value of lawsuits, to the benefit of the original claim holders, by way of noncash contributions.

This Article therefore aims to fill this gap. The Article develops an analogy between the economics of venture capital (VC) and of litigation finance. Both are forms of finance characterized by extreme (1) uncertainty, (2) information asymmetry, and (3) agency

\textsuperscript{19.} See Burford IPO memo, \textit{supra} note 17, at 12-17, 21-22.\textsuperscript{20.} Given the novelty of the phenomenon, no model contracts exist. As discussed below, funders regard such contracts as proprietary and include nondisclosure clauses in them. Few cases dispute the funding agreement itself and, therefore, no examples of contracts can be gleaned from courts’ opinions. Even fewer cases have led to public disclosure of the actual underlying contracts. These are discussed \textit{infra} Part I.\textsuperscript{21.} As one litigator framed it, in a private conversation, “litigators like me find themselves in a position where they have to negotiate highly complex financial deals. This is not what we are trained to do. And it’s too time consuming to expect a partner from the finance department to assist since he cannot bill for that time.”
costs.\textsuperscript{22} Therefore, much of the theory, doctrine, and practice of VC contracting, which developed over more than half a century to deal with similar problems, can be adapted to the litigation funding context. This insight can represent a quantum leap for practitioners and scholars—who will not have to muddle through decades of trial and error—and can allow them to start from a standardized set of contractual patterns.

Part I explores, as a case study, Burford’s investment in the high-stakes, high-profile Chevron/Ecuador dispute. It illustrates that certain funding relationships make use of VC features but mostly in order to address funders’ interests, whereas the unequal bargaining power, regulatory restrictions, and underdeveloped reputational markets conspire to prevent the development of correlating protections for the plaintiffs.

Part II describes the economics of litigation funding. It details how the ethical constraints—for example, the risk of plaintiffs losing control to funders, of waiver of attorney-client privilege, and of diminished independent judgment by lawyers—translate in economic terms into magnified agency costs and information asymmetries. Part II also applies economic, finance, and behavioral literature to an analysis of legal claims as assets, showing these assets to be highly risky and uncertain.

Part III describes VC’s lessons learned—how to control similar extreme uncertainty, information asymmetry, and agency costs through organizational and contractual arrangements—and suggests arrangements that protect plaintiffs while accommodating value enhancements by funders. This Part sets out the benefits of organizing litigation finance firms as limited partnerships, with an incentive-aligning compensation scheme, that are incentivized and expected to provide plaintiffs with noncash contributions. This Part also suggests that contracts between litigation finance firms and plaintiffs make use of staged financing, representation in case management, certain negative covenants, and exit provisions. And it emphasizes the role of reputation and therefore transparency in policing ethics. This analysis suggests that control should be allocated to funders, but that funders must pay for it—including with upfront cash when appropriate. It also suggests how the contract

\textsuperscript{22. See infra Part II.C-D.}
between the litigation finance firm and its investors, on the one hand, and the attorney retention agreement, on the other, can be structured to support the litigation finance firm-plaintiff contract.

The Article concludes with a set of conceptual and practical recommendations. These include reframing our understanding of funders as real parties in interest, extending attorney-client privilege to facilitate the noncash contribution of funders, pricing and paying for the complete control endowed to plaintiffs by operation of law, and encouraging plaintiffs and their lawyers to disfavor funders who are not specialized and organized as proposed herein.

I. A CASE STUDY: BURFORD’S INVESTMENT IN THE CHEVRON/ECUADOR DISPUTE

This Part will explore Burford’s investment in the Chevron/Ecuador dispute as a case study of: (1) how private ordering in litigation funding is evolving to adopt contractual structures not dissimilar to those documented in the VC industry pertaining to funders' interest in reducing extreme uncertainty, information asymmetry, and agency costs; and (2) how regulatory restrictions coupled with a lack of transparency and the consequently limited reputational markets conspire to prevent the development of the correlating protections of the plaintiffs, such as compensation for transfer of control, noncash contribution, and monitoring.

*Fortune* magazine covered Burford’s investment in the Chevron/Ecuador dispute based on the premise that Burford is ... “the largest and most experienced international dispute funder in the world,” as its promotional materials state, so we’re not looking here at some aberrational outlier in the field.... [And,] we can be assured that Burford’s conduct probably represents the very best practices the young industry has to offer.23

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A. Background: The Chevron/Ecuador Dispute

On February 14, 2011, an Ecuadorian court issued an $18 billion judgment against Chevron in an environmental litigation brought against it by a group of indigenous peoples in the Amazonian rain forest of Ecuador. The litigation stems from personal injuries and environmental damage in the form of the pollution of rain forests and rivers in Ecuador. These damages are a result of oil operations conducted by Texaco, subsequently acquired by Chevron in 2001, during drilling operations that lasted from 1964 to 1990. When Chevron acquired Texaco, it also “acquired” what became known as the Chevron/Ecuador case.

The award is the largest judgment ever imposed for environmental contamination in any court, and the litigation has been ongoing for over seventeen years. The costs of the litigation up to the contracts listed below, that the contract, although lengthier and more involved than some, is not an aberration as it relates to the issues discussed herein. That said, it should be noted that this investment has some features that may distinguish it from most investments. The Chevron/Ecuador litigation is a cross-border litigation. Underlying it is a form of class action. An unusually large foreign judgment had already been rendered at the time of the investment. For a prophecy that litigation funding of transnational disputes is set to rise, see Cassandra Burke Robertson, The Impact of Third Party Financing on Transnational Litigation, 44 CASE W. RES. J. INT’L L. 159 (2011). Additional contracts reviewed include those underlying the following litigations: In re Parmalat Sec. Litig., 659 F. Supp. 2d 504 (S.D.N.Y. 2009); Trust for the Certificate Holders of Merrill Lynch Mortg. Investors v. Love Funding Corp., 918 N.E.2d 889 (N.Y. 2009); Anglo-Dutch Petroleum Int’l, Inc. v. Haskell, 193 S.W.3d 87 (Tex. App. 2006). Also reviewed were the “Minor Investor” contracts relating to the Chevron/Ecuador investment discussed below, see Exhibits to Declaration of Kirsten L. Hendricks, Chevron Corp. v. Donziger, No. 11-cv-00691-LAK (S.D.N.Y. Nov. 29, 2011), ECF No. 355 [hereinafter Minor Funder Contracts], and, for the sake of comparison, standard forms of consumer investment contracts developed to comply with different states’ consumer protection legislations, see, e.g., Purchase Agreement Between Dean Plaintiff and Oasis Legal Finance, LLC (Sept. 13, 2010) (on file with author).

25. See id.
27. See Chevron Corp., 768 F. Supp. 2d at 594 & n.2.
judgment were borne by the attorneys who took the case on a contingency basis.29 Far from concluding the dispute, the Ecuadorian judgment was the opening gunshot in a new phase of appellate proceedings in Ecuador and parallel proceedings in the United States and in various foreign and international fora.30

In a satellite litigation in which Chevron is currently suing claimants’ former lead attorney, Steven Donziger, and advancing various allegations under the RICO statute, Chevron requested, and was granted by U.S. District Court Judge Kaplan, Donziger’s entire case file—documents spanning nearly two decades.31 Among these documents was the funding agreement between the plaintiffs and Burford.

B. The Investment Structure

Burford invested $4 million as a first round of investment in the Ecuadorians’ case in exchange for a 1.5 percent stake in any recovery, and agreed to provide two additional rounds of investment, in the amount of $5.5 million each, entitling it to a 5.5 percent share of the recovery.32 The investment was effected through a Cayman Islands entity called Treca Financial Solutions (Treca). Treca entered into a funding agreement (hereinafter, the Treca Agreement or Agreement) with Friends of the Defense of the Amazon (FDA), a nonprofit, and some forty named individuals (Claimants) who represent thousands of other villagers. Fortune magazine summed up the deal:

If Burford ponies up the full $15 million and the plaintiffs end up recovering $1 billion, Burford will get $55 million. If the plaintiffs recover $2 billion, Burford gets $111 million, and so on.

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Not Apologize for Pollution, Even to Save $8.5 Billion, N.Y. Times, Feb. 4, 2012, at A7.

29. See Keefe, supra note 28.


But here’s the best part for investors: If the plaintiffs recover less than $1 billion—all the way down to a mathematical floor of about $69.5 million—Burford still gets the same payout it would have received if there had been a $1 billion recovery. In other words, if there were a $69.5 million recovery, Burford would still get $55 million, though that sum would, under the circumstances, constitute almost 80% of the pot. In that event, by the way, the remaining 20% would not go to the plaintiffs; rather, it would go to other investors, who are also supposed to get their returns on investment (not just their capital outlays) before the plaintiffs start seeing a dime. In fact, under the “distribution waterfall” set up by the 75-page contract, it is only after eight tiers of funders, attorneys, and “advisers” (including the plaintiffs’ e-discovery contractor) have fed at the trough that “the balance (if any) shall be paid to the claimants.”

The deal is structured as an assignment of all litigation rights to a trust set up by the Claimants and governed under Ecuadorian law (the Trust). The Trust holds “all of the litigious rights as well as any and all interest in the Claim, the Award, any proceedings of the enforcement enforce [sic] the Award, and any proceeds ... of any of the foregoing held by the Claimants as of the date of the assignment ... (collectively, the ‘Litigation Rights’).” The term “Award”—namely the actual, ex post value of the claim, if successful—is, in turn, described in a page-long definition and includes:

[The] gross ... value awarded ... by virtue (directly or indirectly) of ... the Claim, whether by negotiation, arbitration, mediation, diplomatic efforts, lawsuit, settlement, or otherwise ... plus ...
any recovered interest, penalties, attorneys’ fees and costs ... plus ... any interest awarded or later accruing ... [And also] cash, real estate, negotiable instruments, choses in action, contract rights, membership rights, subrogation rights, annuities, claims, refunds ... [And] including ... the value of, or any obligation to perform or conduct, any investigation or other assessment (including ... to assess risk to any human or the environment), clean-up, remediation, or mitigation or prevention or measures arising from or relating to the Claim ... “Award” shall include [all of the above] awarded by the courts of the Republic of Ecuador otherwise than to the Claimants as a result of the application of ... Ecuador’s Environmental Management Act. 37

Once the Trust is established, the FDA must cause each claimant to assign all of his or her litigation rights in exchange for a “beneficial interest in the Trust.” 38 Each Claimant must further “irrevocably assign to the Trust all of his ... rights under th[e] Agreement.” 39 In a section titled “Independent Actors,” the parties agree that the arrangement “does not create any joint venture, partnership, or any ... type of affiliation, nor [does it] create a joint ownership of the Claim.” 40 Once the Trust is established, the Trustee must “execute and deliver to the Funder a joinder agreement by which it assumes the obligations ... to be performed by the Claimants, whether or not those Claimants are signatories to” the Treca Agreement. 41 The Trustee and FDA must grant the Funder a “valid, perfected and

37. Id. sched. 3. The term “Claim” itself is defined to include “proceeding[s] in any jurisdiction ... as the same may be varied or enlarged by the addition of claims and/or additional parties ... and shall include ... appellate, annulment[,] ... enforcement, ancillary, parallel or alternative dispute resolution proceedings[,] ... diplomatic or administrative proceedings[,] ... arrangements, settlements, [and] negotiations.” Id.
38. Id. § 8.2. Any Claimant who “executes an Assignment Agreement shall have exactly the same rights, obligations and expectations with respect to the Claim and the Award ... as such Claimant had immediately prior to executing” the assignment. Id.
39. Id. § 8.3.
40. Id. § 16.1. The stated purpose of this section is to avoid any tax implications such structures may entail, id., but in all likelihood, the purpose is also to avoid any fiduciary duties, id. § 16.4 (“N[othing in this Agreement shall give rise ... to] a fiduciary, lawyer-client, agency or other relationship between the Parties or between their counsel, notwithstanding the information or observations or opinions that may be shared between them.”).
41. Id. § 8.4.
first ranking security interest” in the claim and the award. In other words, if a court awards remedial measures for the benefit of the harmed community, the Claimants must pay the monetary value of the Funder’s portion of such remedial measures. The Claimants may also need to pay the Funder if any award is granted to nonparties.

The extensive provisions relating to perfecting a first ranking security, transferring all rights and proceeds into a Trust, and installing trusted lawyers and Trustees to manage the Trust are all mechanisms put in place in order to address one of the greatest uncertainties relating to litigation, especially transnational litigation or arbitration—the uncertainty regarding the cross-border enforceability of the rights in an award, as well as the award itself.

The investment in the Chevron/Ecuador litigation has been syndicated by Burford, the “Major Funder,” among a variety of “Minority Funders.” Chevron describes in a pleading the entire web of investment relationships in the following terms:

42. Id. § 8.5
43. Commentators who have written about the commodification problem of litigation funding have suggested that this may have a chilling effect on accepting remedial measures. This risk is heightened in tort cases. See infra notes 124-25. It is very likely that these provisions would not be enforced as against public policy. It is also likely that a court would cap an arrangement whereby upward of 80 percent of the settlement proceeds go to the Funder. For example, this is achieved in United States contingency fee cases through the “lodestar standard”—the standard courts use to assess the reasonableness of attorneys’ fees in class action cases. According to this standard, courts multiply counsel’s reasonable hours by a reasonable hourly rate, which is then adjusted by several factors. See Lindy Bros. Builders, Inc. v. Am. Radiator & Standard Sanitary Corp., 487 F.2d 161, 166-69 (3d Cir. 1973) (establishing the lodestar standard). See generally Jonathan R. Macey & Geoffrey P. Miller, Judicial Review of Class Action Settlements, 1 J. LEGAL ANALYSIS 167, 193 (2009) (analyzing court standards of review for class action settlements).
44. On the challenges of enforcing against foreign assets in transnational litigation and international arbitration, see Jane L. Volz & Roger S. Haydock, Foreign Arbitral Awards: Enforcing the Award Against the Recalcitrant Loser, 21 WM. MITCHELL L. REV. 867, 871 (1995).
45. See generally Intercreditor Agreement between Treca Financial Solutions, Torvia Limited, and others (Oct. 31, 2011) [hereinafter Intercreditor Agreement] (on file with author); Minor Funder Contracts, supra note 23. The Intercreditor Agreement is a contract entered into by the Claimants via their representative FDA, Treca/Burford as a “Major Funder,” certain other “Minority Funders,” and the American and Ecuadorian counsel for the Claimants. It is incorporated by reference into the Treca Agreement, supra note 32, sched. 4, and it ensures all of the Treca Agreement provisions apply equally to all past, present, and future investors, Intercreditor Agreement, supra, § 1.28.
Defendants secured new funding from litigation investment firms, attorneys, and freelance investors. Much of their new funding came from New York-based Burford Advisors .... [A]t the same time they executed the Treca Funding Agreement and the Intercreditor Agreement, the parties were finalizing an agreement with Torvia Limited, a company incorporated under the laws of Gibraltar and owned by Russell DeLeon, a person of interest in an ongoing federal criminal investigation (“Torvia Agreement”). Torvia initially invested $2 million in the litigation on March 4, 2010 and further transferred $1.25 million to [the former lead plaintiffs’ attorney] on August 17, 2010 for a 3% cut of the “Net Plaintiff Recovery” from the Judgment.46

Having provided an overview of the agreement, the following Subsections will highlight similarities between Burford’s approach to the funding of the Ecuadorians’ claims and mechanisms developed by venture capitalists to protect themselves against challenges arising from information asymmetry, agency costs, and extreme uncertainty. These mechanisms include control, staged financing, information sharing, the duty to cooperate, negative covenants, and operational efficiencies. This will set the stage for the general theoretical discussion of litigation finance contracting in Parts II and III.

C. The Distribution of Control Between Burford and the Ecuadorian Claimants

The Trust described above is directed and controlled by “the Claimants’ Representatives, or a board of managers constituted under the Trust Deed.”47 These representatives and managers have, specifically, “the right to direct and control the Trustee with respect to the pursuit of the claim,” including “the litigation strategy, ... the appointment and direction of counsel[,] and approval of any settlement that the Claimants’ Representatives or ... board may authorize.”48 The Trust Deed is to be drafted in cooperation by

46. Chevron’s Memorandum of Law in Support of Its Motion for an Order of Attachment and Other Relief at 12-13, Chevron Corp. v. Doziger, 840 F. Supp. 2d 773 (S.D.N.Y. 2012) (No. 11-cv-00691-LAK) (citations omitted); see also id. at 13-14 (going on to list additional individuals and entities investing anywhere from $50,000 to $1 million).
47. Treca Agreement, supra note 32, § 8.1(b).
48. Id.
Claimants’ and Funders’ attorneys, and the drafting of the deed is subject to a special dispute resolution mechanism that is different than the one governing the rest of the agreement. For instance, “the Trustee is the only person entitled to ... pursue the Claim and enforce ... the award.” All proceeds of the award are to be paid to the Trust and then distributed in accordance with the Intercreditor Agreement.

The Agreement states that both sides agree their “common interest is served by settling the Claim for a commercially reasonable amount.” In a provision that seems contradictory with the investment structure described above, and which is probably meant to provide cover in relation to the rules of professional responsibility that leave absolute control over settlement in clients’ hands, the Agreement also states that “the Claimants may at any time without the consent of the Funder either settle or refuse to settle the Claim for any amount.”

The key mechanism that provides control to the Funders is the installment of “Nominated Lawyers.” The Nominated Lawyers are defined as lawyers “selected by the Claimants with the Funder’s approval.” The law firm of Patton Boggs LLP has been selected to serve in this capacity, and they have selected James Tyrrell as the lead Patton Boggs lawyer. In fact, the execution of engagement agreements between the Claimants and Patton Boggs, a firm with close ties to the Funder, is a condition precedent to the funding.

49. Id. § 8.1(d).
50. Id. § 8.1(a).
51. Intercreditor Agreement, supra note 45, § 2.2.
52. Treca Agreement, supra note 32, § 4.2.
53. Id. § 4.2.
54. Id. sched. 3.
55. Id. sched. 1, §§ 2.1(a), 3(b).
56. Id. § 2.1(c). The ties between Burford and Patton Boggs generally, and the lead Patton Boggs attorney named in the Agreement specifically, has been described thus:

Tyrrell is a former [partner] of Burford[’s] chairman ... from the days when both were partners at Latham & Watkins,... [As Burford was negotiating the Treca Agreement, it was] subleasing its office space from Patton Boggs’s New York office, which Tyrrell heads.... [And, most importantly,] Burford is a client of Tyrrell’s.

Parloff, supra note 11.
Patton Boggs is also one of the “Active Lawyers”—the lawyers conducting the representation.\(^57\)

In addition to being actively involved in conducting the representation, the Nominated Lawyers control the purse strings. During the course of the litigation, authorization of the named, lead Nominated Lawyer must be obtained for all expenses,\(^58\) and only he can effect the payment.\(^59\) At the conclusion of the litigation, the award proceeds must be delivered to either the Nominated Lawyers or the Trustee, who will manage and distribute them according to the distribution waterfall.\(^60\) In addition to exerting control, it is clear that the Nominated Lawyers, who among other things control the purse strings and serve as monitors, supervise the costs and course of the litigation.\(^61\)

**D. Staged Financing and Right of First Refusal**

In the timing of Burford’s provision of funds under the Agreement we see a form of staged financing common in venture capital. As discussed above, the litigation funding firm’s capital commitment is to be funded in three tranches: an initial tranche of $4 million and two additional tranches of $5.5 million each.\(^62\) The Funder retains a right of first refusal on subsequent rounds, and if it declines to fund a tranche, the Claimants have a right to secure funding from other sources.\(^63\) In addition, the Funder has termination rights: it

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57. Treca Agreement, supra note 32, sched. 1, § 3(c). The overlap is reinforced in the definition of the “Nominated Lawyers Representative,” which is defined as James Tyrrell or, if he “ceases to act in [that] capacity, then another lawyer prominently and actively involved in the Claim selected by the Claimants with [Burford’s] approval.” Id. sched. 3 (emphasis added).

58. Id. sched. 1, § 2.1. “Expenses” are defined at length and include, among other things, fees and expenses of lawyers, and fees and expenses associated with any court or arbitral proceedings, id., but exclude “any expenses of the Claimants themselves” and any “awards against the Claimants,” id. sched. 1, § 2.2(a), (d).

59. Id. sched. 1, § 2.1.

60. Intercreditor Agreement, supra note 45, §§ 2-3.

61. The explicit language of the contract declares that the Funder is engaged in the business of investment and not the practice of law or other professional activities, and that it will not “give or interfere with counsel’s giving of legal advice.” Treca Agreement, supra note 32, § 16.2-3. This language, however, is probably intended to avoid a charge of the unauthorized practice of law in any of the jurisdictions implicated in the Agreement.

62. See supra note 32 and accompanying text.

63. Treca Agreement, supra note 32, §§ 2.1(f), 19.1. However, such funding from third
may terminate the Agreement in case of a breach of a material condition, representation, or warranty, as well as due to a breach of the duty to cooperate—discussed below. The staged financing reduces information asymmetry, uncertainty, and agency costs.

E. Information Sharing, Duty to Cooperate, and Common Purpose

A detailed information-sharing regime is prescribed in a provision entitled “Claimants’ Duty to Co-Operate.” It provides that the Claimants “irrevocably instruct the Nominated Lawyers to keep the Funder fully and continually informed of all material developments ... and to provide the Funder with copies of all material documents.” In a separate provision, the Agreement emphasizes that the Claimants’ duty to cooperate is “of the essence of the Agreement” as well as a “condition thereof.” And in fulfillment of another condition precedent, the Claimants instruct the Nominated Lawyers to provide the Funder all material documentation and material written advice provided by the Nominated Lawyers to the Claimants, to “respond to reasonable requests for material information from the Funder” on an ongoing basis, and to inform the Funder of any form of discontinuance of the action.

The contract then goes on to specify, with some detail, the duties of cooperation, including duties to:

devote sufficient time and attention[,] ... provide all ... material Documentation[,] ... submit to examination by the [lawyers] for the preparation of written statements[,] ... consult with the [lawyers] as they [prepare to pursue, enforce or settle] the Award[,] ... appear at any proceedings or hearings[,] ... [and]

parties must be consistent with the Intercreditor Agreement. Id. § 2.1(f).

64. Id. §§ 11.1, 13.4.

65. See infra Part III.B.2.a.

66. Treca Agreement, supra note 32, § 5.

67. Id. § 5.1. In an attempt to preserve the attorney-client privilege over the communication between Claimants and the Nominated Lawyer, the provision goes on to state the following: “The Claimants and the Funder agree that the Nominated Lawyers may not disclose information or documents that the Nominated Lawyers reasonably believe could or would jeopardize any privilege.” Id.

68. Id. § 13.4.

69. Id. § 13.1(a)-(d).
cause all persons related to the Claim ... to submit to examination by the [lawyers].\textsuperscript{70}

Given that the information sharing regime structured by the Agreement would potentially create a waiver of attorney-client privilege, work-product doctrine, and similar protections, as discussed below,\textsuperscript{71} the contract includes a number of provisions aimed at minimizing this risk. For example, the Agreement states that “[t]he Parties acknowledge and mutually represent to each other that it is their common purpose ... to enable the Claimants to pursue their Claim,”\textsuperscript{72} as well as, broadly, “that they have a ‘common legal interest’ in the Claim, [the] Agreement, and any discussion, evaluation and negotiation and other communications and exchanges of information relating thereto.”\textsuperscript{73}

The parties designate as “Common Interest Material” legal advisers and attorneys’ work product protected by any privilege in any jurisdiction, as well as “information ... prepared by the Funder.”\textsuperscript{74} The parties express their intention that “any Common Interest Material shall at all times remain subject to all applicable privileges and protections from disclosure,” and assert that “[i]t is the good faith belief of the [parties] that common interest privilege attaches to the Common Interest Material.”\textsuperscript{75}

The Agreement also creates a broad category of “Confidential Information” in a clause that provides a glimpse into the information the parties anticipated exchanging.\textsuperscript{76} The term encompasses matters such as transactional documents and discussions relating to them; “the existence of the funding ... [and] the identity of the Funder[s]; ... the factual, legal ... [and] economic ... background of the claim; ... the procedural status of the claim; the planned strategies and the tactics[;] ... the expected recover[y;] ... billing arrangements[;] ... litigation risk product[s] [and] information on litigation risk markets[;] ... [and] risk modeling.”\textsuperscript{77} The Agreement

\textsuperscript{70} Id. § 5.1.

\textsuperscript{71} See infra notes 116-17, 137-40 and accompanying text.

\textsuperscript{72} Treca Agreement, supra note 32, § 4.1.

\textsuperscript{73} Id. § 13.2.

\textsuperscript{74} Id. sched. 3; see also id. § 12 (“Confidentiality”); id. § 13 (“Information and Privilege”).

\textsuperscript{75} Id. § 13.3.

\textsuperscript{76} Id. sched. 3.

\textsuperscript{77} Id.
specifically prohibits any “announcement concerning the existence of th[e] Agreement, the funding of the Claim ..., or the identity of the Funder.”78 In other words, in this Agreement the parties forgo any reputational benefits that may be reaped from making the involvement of a Funder known, especially one that is a market leader. And, neither party may disclose “for a period of seven ... years following [the] termination of th[e] Agreement any Confidential Information or Common Interest Material.”79

These multiple, elaborate, and at times contradictory provisions capture the tension between the economic imperatives to reduce information asymmetry and the recognition that the law operates to increase it.

F. Negative Covenants, Representations, and Warranties

The Treca Agreement contains a number of negative covenants, representations, and warranties designed to address the problems of extreme uncertainty, information asymmetry, and agency costs.80 Examples include the Claimants’ covenants not to engage in any conduct that is “likely to have a material adverse impact in any way on the Claim [or] the value of the Recovery,”81 not to execute “any documents which would materially or adversely affect the Claim or the recoverability of the Award,”82 not to engage in any conduct “that would result in the Funder receiving proportionately less payments or less favourable treatment” as compared with other rights holders in the litigation,83 and not to “institute any [legal] action ... against any Defendant.”84 By anticipating actions that may

78. Id. § 12.3.
79. Id. § 12.2.
80. “A representation is a statement of fact as of a moment in time intended to induce reliance.” TINA L. STARK, DRAFTING CONTRACTS 12 (2007). A misrepresentation gives rise to a cause of action sounding in tort and allows restitutionary recovery, rescission, and—if fraudulent—punitive damages. Id. at 14-15. A warranty is a promise by the maker of a statement that the statement is true. Id. at 13. Its breach gives rise to a cause of action sounding in contract and may afford the injured parties damages. Id. at 14-15. Therefore, such broad representations and warranties provide the Funder with breach of contract and tort claims.
81. Treca Agreement, supra note 32, § 5.2.
82. Id. § 10.2(g).
83. Id. § 10.2(h).
84. Id. § 5.3.
be beneficial to the Claimants but not to the Funders, these provisions address agency costs. Claimants agree not to sell any further portions of the case to other investors without first providing notice to the Funder, nor to do so in a way that is inconsistent with the associated Intercreditor Agreement.\textsuperscript{85}

The contract includes a representation that Claimants have received "legal advice in relation to [the] Agreement and all other arrangements between themselves, the Funder and the Nominated Lawyers,"\textsuperscript{86} as well as, more broadly, that they have "received independent legal advice on the terms and effect of the Transaction Documents."\textsuperscript{87} This language is aimed at a potential charge of a conflict of interest between the Funder and the Claimants.

The Claimants further represent and warrant that they have not made any material omissions;\textsuperscript{88} that they have disclosed "all documentation and other information in [their] possession or control relevant to the Claim that is ... likely to be material to the Funder’s assessment of the Claim and [that they] believe[ ] ... that the Claim is meritorious and likely to prevail;"\textsuperscript{89} and that they did "not fail[ ] to disclose ... any facts ... which ... would ... have led the Funder not to enter into the[e] agreement."\textsuperscript{90} These overlapping and somewhat redundant representations and warranties address information asymmetries.

Finally, any attempt to seek relief for breach of the Treca Agreement in a court of law, as opposed to the international arbitration institute specified in the agreement; to seek any other relief or remedies in any forum; or to assert personal jurisdiction over the investors in a U.S. court, all constitute a breach of the Agreement.\textsuperscript{91} Instead, the parties opt for confidential international

\textsuperscript{85.} \textit{Id.} § 2.1(f). They also covenant not to assign or convey the Agreement or any rights or obligations thereunder. \textit{Id.} § 22.1.

\textsuperscript{86.} \textit{Id.} § 6.1.

\textsuperscript{87.} \textit{Id.} § 10.2(d).

\textsuperscript{88.} \textit{Id.} § 10.2(h). For an example of a court recognizing that a litigation funding agreement may be terminated because of an omission of material fact, see \\

\textsuperscript{89.} Treca Agreement, \textit{supra} note 32, § 10.2(1).

\textsuperscript{90.} \textit{Id.} § 10.2(p).

\textsuperscript{91.} \textit{Id.} §§ 7.8, 23.7-.8. For further discussion of the dispute resolution mechanism in its entirety, see \textit{infra} notes 93-96 and accompanying text.
arbitration and, more broadly, for a highly structured and somewhat unusual dispute resolution mechanism.

All but one of the provisions of the Agreement are governed by the laws of England.92 The Trustee and the FDA’s obligation to provide a valid, perfected, first-ranking security interest is governed by the law of New York.93 All disputes other than the disputes regarding the value of a noncash award are subject to international arbitration by a three-member panel administered by the International Centre for Dispute Resolution (ICDR).94 Disputes regarding noncash award value are to be resolved by a single arbitrator, who is an accounting or valuation expert, in an expedited process.95 The legal seat chosen for any arbitration is London, but the physical location of any proceeding is in the Cayman Islands.96 As noted, the drafting of the Trust Deed has a separate dispute resolution mechanism.97

The champerty doctrine, discussed below, creates a legal gray zone for litigation funding in many jurisdictions;98 this is a characteristic and, more specifically, a risk factor of litigation as an asset. By tailoring the dispute resolution process and penalizing any attempt to turn to national courts, the parties are endeavoring to reduce and control this risk factor and the uncertainty that the prospect of litigating the Agreement creates. More broadly, these restrictions on using domestic and foreign courts of law are aimed at minimizing the uncertainty relating to the many unsettled and controversial issues regarding the possible interpretation of a third-party litigation funding agreement by American and other courts.99 They are also more generally aimed at minimizing the uncertainty inherent in dispute resolution by a judge or jury.100

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92. Treca Agreement, supra note 32, § 23.1.
93. Id.
94. Id. § 23.2-4.
95. Id. § 23.4.
96. Id. § 23.5.
97. See id. § 8.1(d).
98. See infra notes 131, 134-35 and accompanying text.
99. See generally Steinitz, supra note 2, at 1278-82 (putting the United States regulatory environment regarding litigation funding in a global context). On the more relaxed attitudes of international arbitration tribunals towards litigation funding, see generally J.M. Matthews & M. Steinitz, Editorial, Special Issue: Contingent Fees and Third Party Funding in Investment Arbitration Disputes, TRANSNAT’L DISP. MGMT., Oct. 2011.
100. Some have described international arbitration as more predictable relative to domestic adjudication by judges, and certainly juries, because of the perceived tendency of
G. Operational Efficiencies

The Treca Agreement seeks to enhance returns to the Funders’ investors by minimizing any tax liabilities that may be imposed on the Award. The Claimants commit to structure the Award, as broadly defined,101 “in the most tax-efficient manner practicable” and to “consider ... commercially reasonable methods,” such as a trust, to achieve that purpose.102 And any taxes that cannot be avoided are to be borne by the Claimants under the Agreement.103

Other value enhancements by litigation funders via operational efficiencies can be inferred from the parties’ anticipation of information exchange regarding accountants, law firms, advisors, and suppliers; business plans and business relationships; market opportunities and marketing plans; and algorithms, intellectual property, ideas, know-how, knowledge, and research.104 These represent noncash contributions that the Funder will be bringing to the table.

With this concrete example of Burford’s investment in the Chevron/Ecuador litigation, the following Section turns to a general discussion of the economics of litigation finance generally.

II. THE ECONOMICS OF LITIGATION FINANCE

A. The Litigation Finance-Venture Capital Analogy in a Nutshell

The term “venture capital” refers to capital that is pooled, invested in securities, usually stocks, of enterprises in different stages of development, often in their early days, and professionally managed.105 Venture capital funds (VCFs) raise money from arbitrators—who rely on satisfied attorneys, that is, attorneys who have not lost in their courtroom—to reappoint them in future cases. See Stephanie E. Keer & Richard W. Naimark, Arbitrators Do Not “Split the Baby”: Empirical Evidence from International Business Arbitrations, 18 J. INT’L ARB. 573, 576-78 (2001) (discussing both the perception and the empirical evidence of arbitration decisions).

101. See supra note 37 and accompanying text.
104. Id. sched. 3.
individuals and institutions for investment in early-stage businesses that offer high potential returns on investment but carry significant risk of failure. The risk is mitigated through diversification—VCFs develop portfolios of companies, referred to individually as a “portfolio company.”

As noted earlier, the term “litigation finance firms” refers to the practice of specialized funds investing in litigation by providing finance in return for an ownership stake in a legal claim and a contingency in the recovery. Like VCFs, which create and manage portfolios of high risk in potentially high-return companies, litigation finance firms develop portfolios of high-risk, high-return litigations.

To state the obvious, both litigation finance and VC are forms of finance. Financial contracts, generally speaking, are designed to respond to three problems: uncertainty, information asymmetry, and agency costs. The special character of VC contracting—the essence of which is investment in high-technology, cutting-edge, science-based companies—is that it presents these problems in an extreme form. The same is true of litigation finance, the essence of which is investing in legal disputes before all facts and procedural aspects have been ascertained, leading to risks similar to those inherent to VC investing.

Before expounding on these and other similarities, it should be noted that there are also important dissimilarities. The first difference, from which others follow, is simply the nature of the asset

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107. Sahlman, supra note 105, at 474-75. Venture capital firms are usually set up as either open-end funds or closed-end funds. The analysis below applies equally to both. Venture capital is also sometimes provided by “angel investors”—individuals, often times friends or family members—who provide seed funding at very early stages of the enterprise’s life. Similarly, individuals—be they family members or professional investors—may provide funding to a litigant with an expectation of making a profit should the litigant prevail.
in question. VCFs invest in companies—usually early-stage companies.\textsuperscript{110} Litigation finance firms invest in legal claims.\textsuperscript{111} One consequence of this difference is that there is more of an understanding and a track record relating to the performance of the former asset but not of the latter one.

Another consequential difference relates to the social utility of the asset in question. The positive social utility of VC is universally accepted: “The venture capital market and firms whose creation and early stages were financed by venture capital are among the crown jewels of the American economy. Beyond representing an important engine of macroeconomic growth and job creation, these firms have been a major force in commercializing cutting-edge science.”\textsuperscript{112} To name but a few examples of companies that were created with the support of VC, one could list Apple, Intel, FedEx, and Microsoft.\textsuperscript{113} Conversely, the social utility of litigation funding is controversial.\textsuperscript{114}

Finally, this non-exhaustive list of differences must include the fact that any litigation funding scheme involves not only investors, an investment fund, and an investment, but also attorneys—sometimes acting purely as the representative of the plaintiff and sometimes acting also as investors in the litigation, through contingency fees or other forms of alternative billing schemes. The involvement of an attorney creates a triangular attorney-client-funder relationship, which raises its own set of agency problems. The attorney-client relationship is a regulated relationship, and this regulation further complicates the agency problems:

Beyond concerns relating to control[,] ... [fragmentation of the attorney’s relationship with the client, on the one hand, and the funder, on the other] creates conflicts between an attorney’s interest to maximize fees and those of the financier to do the same. These divergent interests may lead one to settle early but the other to proceed to trial .... Similarly, if fee splitting is prohibited and the attorney receives a flat or hourly fee instead of a percentage of the recovery, the attorney has less incentive to properly vet a case as [he] transfer[s] all risk to the funder.

\textsuperscript{110. See supra note 106 and accompanying text.}
\textsuperscript{111. See supra notes 7-8 and accompanying text.}
\textsuperscript{112. Gilson, supra note 109, at 1068.}
\textsuperscript{113. Sahlman, supra note 105, at 482.}
\textsuperscript{114. See infra text accompanying notes 124-28.}
This moral hazard can increase if claims are then securitized and further distributed. While both attorneys and funders, as savvy repeat players, have an interest in creating and preserving reputational gains, this interest may pull them in different directions in any given litigation and may not be aligned with the client's interest.115

Conflicts of interest are not the only complication created by the triangular attorney-client-funder relationship, which is artificially fragmented through the operation of the rules of legal professional responsibility. Client or attorney communication with the financier, which is necessary for the financier to monitor the litigation, breaks the attorney-client privilege.116 “[A] lack of such communication creates information asymmetries between the attorney and the funder and lowers the funder’s ability to supervise the attorney’s work,” thereby significantly reducing the potential to have an “agents-watching-agents” effect, namely the potential cross-monitoring of the lawyers and funders.117

In sum, the triangular, fragmented attorney-client-funder relationship creates, by design, expanded information asymmetries and has the side effect of magnifying agency costs. The next Subsection further elaborates on how the ethics regime regulating litigation funding must affect our understanding of legal claims as assets. Specifically, it addresses how the path-dependent regulation of third-party funding, originally developed to address the role third-party funding played in land disputes amongst lords in medieval England,118 affects valuation of legal claims today. It sets the stage for the argument that we should break away from this path and instead connect to the path through which the law governing venture capitalism developed.

115. Steinitz, supra note 2, at 1324.
118. Steinitz, supra note 2, at 1287.
B. Ethical Bounds to Third-Party Profit Making in Litigation

Litigation funding is a controversial industry. Proponents of litigation funding cite access to justice, leveling of the playing field between plaintiffs and defendants, free speech, and private enforcement of the law as key advantages of the practice. 119 Third-party funding promotes access to justice by enabling plaintiffs who have meritorious cases to bring litigation they would otherwise be unable to bring and to avoid premature settlements at a discount due to the exhaustion of funds. 120 Funding can level the playing field not only at the level of any given dispute but also on a system-wide level, altering the social function of courts by systemically equalizing the ability of society’s “have-nots” to use the courts to affect the path and content of judge-made law via litigation. 121

First Amendment arguments in support of litigation funding include the recognized notion that the right to sue is a First Amendment right particularly, but not exclusively, in the context of civil rights litigation, as well as the more contentious claim that restricting certain forms of law firm financing is a violation of attorneys’ freedoms of speech and association. 122 Last but not least, private law enforcement is the enforcement of the law by private parties pursuing legal action for profit, often times using nonclient financing. “[T]o a unique degree, American law relies upon private

119. See id. at 1276 n.12, 1303 (commenting on access to justice and on how litigation funding can alter repeat players’ power dynamics).
120. Id. at 1276 & n.12.
121. See id. at 1299-1301, 1303-18 (building upon Marc Galanter’s classical essay Why the “Haves” Come Out Ahead: Speculations on the Limits of Legal Change, 9 LAW & SOC’Y REV. 95 (1974)).
122. NAACP v. Button, 371 U.S. 415, 428-29 (1963) (holding that litigation to enforce civil rights is a form of expression protected by the First and Fourteenth Amendments). In a currently pending lawsuit before three federal district courts, the plaintiffs’ firm Jacoby & Meyers has sued the states of New York, New Jersey, and Connecticut claiming that state laws prohibiting nonlawyers from owning a stake in law firms unconstitutionally restricts freedom of speech and association as well as interstate commerce. See Jacoby & Meyers, LLP v. Presiding Justices, 847 F. Supp. 2d 590, 591-92 (S.D.N.Y. 2012); Complaint at 3-4, Jacoby & Meyers Law Offices, LLP v. Justices of the Supreme Court of N.J., No. 11-cv-02866-JAP (D.N.J. May 18, 2011), ECF No. 1; Complaint at 3-4, Jacoby & Meyers Law Offices, LLP v. Judges of the Conn. Superior Court, No. 11-cv-00817-CFD (D. Conn. Mar. 18, 2011), ECF No. 1; see also Case Comment, Constitutional Law: First Amendment Limitations on State Regulation of the Legal Profession—Litigation as a Protected Form of Expression, 1963 DUKE L.J. 545, 550-54.
litigants to enforce substantive provisions of law that in other legal systems are left largely to the discretion of public enforcement agencies.\footnote{123}

The industry’s critics retort with fear of a deluge of nonmeritorious claims, a distaste for nonparty profiteering from litigation, a concern about commodification of causes of action, and an objection to the use of the taxpayer-funded court system for investment purposes.\footnote{124} The most vocal opponent of the litigation finance industry in the United States is the U.S. Chamber of Commerce, which describes the practice in these words:

In a typical case[,] a hedge fund, acting on behalf of already wealthy investors, will seek to accumulate yet more money—not by investing in business enterprise or wealth creation—but by gambling on the outcome of a legal action for damages. They have no interest in the justice or otherwise of [sic] the case—only in the chances of success—as they will demand a share of the damages awarded in return for putting up the stake money.\footnote{125}

Another key concern is that third-party funding will diminish clients’ control over their claims generally, and in particular in connection with the decision of when and for how much to settle: “The argument against litigation funding based on the client’s

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\footnote{123. John C. Coffee, Jr., Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 COLUM. L. REV. 669, 669 (1986); see also Coffee, supra note 117, at 341-42 (arguing that nonprofit groups in Europe should join forces with litigation funders); Louis Kaplow & Steven Shavell, Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income, 23 J. LEGAL STUD. 667, 674-75 (1994).


diminished control is, in essence, one of separation of ownership and control between the client and the funder (like the attorney in contingency cases)."126 The Chamber of Commerce report emphasizes that “litigation-financing arrangements undercut the plaintiff’s control over his or her own claim because investors inherently desire to protect their investment and will therefore seek to exert control over strategic decisions in the lawsuit.”127

From the courts’ perspective the difficulty posed by litigation funding is that

organisations like [the funders] play more shadowy roles than lawyers. Their role is not revealed on the court file. Their appearance is not announced in open court.... [T]he court is in a position to supervise litigation conducted by persons who are parties to it; it is less easy to supervise litigation, one side of which is conducted by a party, while on the other side there are only nominal parties, the true controller of that side of the case being beyond the court’s direct control.128

Despite the controversy, litigation funding is rapidly expanding and is, in all likelihood, here to stay.129 To date, those studying the young litigation funding industry have focused almost exclusively on the ethics of the practice and its relation to the rules of profes-

126. Steinitz, supra note 2, at 1323. That article goes on to argue that:
   This is, however, a conceptual confusion that is caused by the tendency to treat third-party funding as identical to attorney funding, in which the party with the purse strings exerts undue control. But unlike the case of attorney funding, with litigation funding and claim transfer the client relinquishes full or partial ownership over its claim. (In fact, arguably, the attorney and client are now both agents of the funder who co-owns part of the entire claim.) The law should acknowledge that the client relinquishes or should relinquish partial control over the litigation as it transfers partial ownership thereof. This, of course, should be factored into the pricing of the finance in favor of the client.
   Id. at 1323-24. The argument herein builds on this view and elaborates on how we can conceptualize and regulate the funder-client relationship once we let go of the path-dependent contingency lawyering analogy and view the funders as real parties in interest.
127. BEISSNER ET AL., supra note 125, at 7.
sional responsibility. This Article breaks away from this paradigm. However, before turning to that discussion, it is worth touching on the historical and current ethical constraints on litigation funding in order to reframe those constraints as forces that shape the economics of litigation funding.

Where allowed, litigation funding is an exception to the ancient common law prohibition on champerty. A champertous agreement is one in which an owner of a legal claim and a third, unrelated party agree to divide amongst themselves the proceeds of a litigation, if successful. It has also often been referred to pejoratively as an arrangement between an “officious intermeddler” and a litigant whereby “the intermeddler helps pursue the litigant’s claim as consideration for receiving part of any judgment proceeds.” The origin of the champerty doctrine is in medieval English law, wherein maintenance (the provision of something of value to a litigant in order to support a litigation), champerty (maintenance for a profit), and barratry (the bringing of vexatious litigation) were crimes and torts. During the nineteenth and twentieth centuries these crimes and torts have been abolished throughout the common law world and replaced with legal ethics rules. During the first decade of the twenty-first century the common law world trend to loosen up champerty restrictions—now predominantly an ethical violation—continued.

Nonetheless, champerty is very much a live and operative doctrine in many jurisdictions. In the United States, champerty is

131. Steinitz, supra note 2, at 1286-87 (quoting BLACK’S LAW DICTIONARY 262 (9th ed. 2009)).
133. For example, in England the crime of champerty has been abolished. See Criminal Law Act, 1967, c. 58, § 13, sch. 1 (Eng.). In Australia, champerty and maintenance have been abolished through statutes such as Maintenance and Champerty Abolition Act 1993 (NSW) and the Wrongs Act 1958 (Vic) s 32.
134. The two pivotal decisions are the English Court of Appeal’s decision in Arkin v. Borchard Lines Ltd., [2005] EWCA (Civ) 655, [16], [45], [2005] 3 All. E.R. 613, which held that third-party funding is acceptable and even desirable as a way of increasing access to justice, and the Australian High Court’s decision in Campbells Cash & Carry Pty Ltd. v Fostif Pty Ltd. (2006) 229 CLR 386, 434-35 (Austl.), which permitted third-party funding and even approved of the funder having broad powers to control the litigation.
a common law doctrine which varies by state and entails fact-specific, case-by-case analysis: “Of the twenty-eight states that permit maintenance in some form, sixteen explicitly permit maintenance for profit. The remaining states probably permit champerty—it is just that they do not explicitly cite the investment by contract into a stranger’s suit as a permissible form of maintenance.”

Champerty is not the only ethical hurdle to litigation funding. Law lenders, who provide recourse loans, are subject to usury laws, namely the prohibition on excessive interest rates. Lawyers involved in financed cases must make sure not to run afoul of professional responsibility rules such as the prohibition on fee sharing, the duty to exercise independent professional judgment, and the duty of loyalty to the client. Close attention has particularly been given, in the context of the rise of litigation funding, to the need not to violate or waive attorney-client privilege or the protection of the attorney work-product doctrine when communicating with funders.

Particularly in the United States, ethical rules rooted in the desire to allow plaintiffs to retain maximum control over their claims have naturally led to discussions of the industry in ethical terms, creating a clear obstacle to litigation funding. In economic terms, however, current ethical rules greatly increase information asymmetries, and the described conflicts of interest increase agency costs, while the nature of legal claims—as assets—contributes to extreme uncertainty. The following Subsections will show that litigation funding shares those same characteristics with VC, paving the way for the argument that the successful approaches to

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135. Anthony J. Sebok, The Inauthentic Claim, 64 Vand. L. Rev. 61, 107 (2011); see also id. at 98-120 (providing a survey and analysis of the law of maintenance, champerty, and assignment in all fifty-one jurisdictions and concluding that the answer to the question of how states determine whether, and to what degree, nonlawyer third parties may support meritorious litigation is complex and that confusion reigns over the doctrines and their application).


138. Id. R. 5.4(a)-(d).

139. Id. R. 1.7 cmt. 1.

140. See id. R. 1.6(a) (“A lawyer shall not reveal information relating to the representation of a client.”); id. cmt. 3 (discussing the attorney work-product doctrine).
structuring VC can be applied, and in some cases adapted, to litigation funding.

C. Information Asymmetry and Agency Costs

Venture capitalists face extreme information asymmetry because the entrepreneurs have all the information about the invention. In particular, the fact that the company’s technology often involves cutting-edge science creates substantial information asymmetries in favor of the entrepreneur, a specialist in said science, over the venture capitalist. Information asymmetries between investors and entrepreneurs are further expanded due to the fact that the intentions and abilities of the entrepreneurs are hard to observe and assess.141

Litigation financiers face similar asymmetries, because the plaintiffs have private knowledge of the facts, including knowledge of potentially key facts, harmful “smoking gun” documents, potentially harmful or weak witnesses, and the like.142 Current ethical rules act to reinforce plaintiffs’ disincentive to share that private knowledge with anyone other than their attorneys by withholding privilege from communications to nonattorney parties.143

The plaintiff’s intentions and abilities are as hard to observe as those of an entrepreneur. For example, a plaintiff’s willingness or capacity to cooperate effectively with counsel—for instance, by timely producing documents, or by ensuring that witnesses make themselves available for deposition—are unknown to the funder. Whether and to what degree the plaintiff is susceptible to “litigation fatigue” caused by the emotional stress of litigation, or is an effective witness, are similarly unknown. These information asymmetries are compounded by the deliberate information asymmetries that result from the attorney-client privilege, discussed above.

Venture capitalists face extreme agency costs because the success of the venture depends on the efforts of the entrepreneurs, who have been compensated up front.144 The importance of future managerial

141. See Gilson, supra note 109, at 1076-77.
142. See supra notes 116-17 and accompanying text.
143. See supra notes 137-40 accompanying text.
144. See Gilson, supra note 109, at 1083-84.
decisions in the early stage venture creates agency costs that are amplified by the fact that an entrepreneur’s interest in the venture, which is now backed by VC, is appropriately understood—in the same manner as litigation—as an option. Therefore, the entrepreneur is now in a conflict of interest vis-à-vis the VC investors with respect to such issues as the desirable level of risk and the investment duration. The entrepreneur will now be inclined to assume more risk and hold the investment longer than she would have had the venture been self-financed. The venture capitalist, by contrast, will be incentivized to liquidate the investment as early as possible. This latter agency problem has been referred to as “grandstanding” or the “early harvesting” problem.

The early harvesting problem in the VC context is identical to the early settlement problem—one of the most commonly cited concerns of both proponents and opponents of litigation funding. Here, the concern is that funders are incentivized to settle early for a discounted but secure amount rather than proceed to a costly trial that may result in a loss or low recovery. They are also incentivized to underinvest in the litigation because they face diminishing returns the longer the litigation proceeds. And the plaintiff, who no longer bears the risk of a loss, may now have an incentive to resist a reasonable and rational early settlement in favor of a late settlement.

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145. Id. at 1077; see also Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. POL. ECON. 637, 650-52 (1973) (describing corporate stocks in terms of options).
146. Gilson, supra note 109, at 1077.
147. Id. at 1074.
148. See id. at 1074-75; Paul A. Gompers, Grandstanding in the Venture Capital Industry, 42 J. FIN. ECON. 133, 133 (1999) (testing, specifically, “the hypothesis that young venture capital firms take companies public earlier than older venture capital firms in order to establish a reputation and successfully raise capital for new funds,” and showing, inter alia, that “young venture capital firms have been on the board of directors a shorter period of time ... and time the IPO to precede or coincide with raising money for follow-on funds”).
150. Steinitz, supra note 2, at 1313; see also Macey & Miller, supra note 43, at 192-94 (2009) (discussing similar agency problems between contingency fee lawyers and clients in settlement negotiations); Steinitz, supra note 2, at 1313 (“Both problems are exacerbated by the fact that [funders] make decisions across a portfolio of cases—trading off a small gain in one case for a larger gain in another case achieved with the same time-investment and reputational costs.”).
settlement or even a risky and expensive trial.\textsuperscript{151} Litigation financiers also face extreme agency costs because success depends on plaintiffs’ cooperation in the prosecution of the case after they have transferred the risk—litigation costs—and a large portion of the rewards—a significant percentage of the recovery.\textsuperscript{152} This particular agency problem, or moral hazard, is well known from the insurance context in which insurers take on the burden of litigation but require, via contractual obligations, the cooperation of the insured.\textsuperscript{153}

\section*{D. Legal Claims as Assets and Extreme Uncertainty}

Ventures backed by VC are characterized by great uncertainty and high failure risk and are therefore typically not financed by banks.\textsuperscript{154} The general uncertainty inherent in financing is magnified in the VC context because the portfolio company is at an early stage and most of the important decisions bearing on the portfolio company’s success remain to be made. The quality of the company’s management has yet to be ascertained and investors do not have certainty regarding the technological soundness or science underlying the venture’s business.\textsuperscript{155} Further, one of the key risks associated with a VC portfolio company’s investment returns is their variability.\textsuperscript{156} Research has shown that while a small number of VC investments yield a very high return many more result in partial or

\textsuperscript{151} See Steinitz, \textit{supra} note 2, at 1313 n.166.
\textsuperscript{153} See, e.g., id.; Michelle Boardman, \textit{Insurers Defend and Third-Parties Fund: A Comparison of Litigation Participation} 15-16 (George Mason Law & Econ. Ctr., Working Paper, 2011) (noting that courts might imply a duty of cooperation even absent a contractual obligation). Insurance funding of defense is a long-standing form of litigation finance as is contingency fee, on the plaintiff’s side.
\textsuperscript{154} See Paul A. Gompers & Josh Lerner, \textit{The Venture Capital Cycle} 127 (1999) [hereinafter Gompers & Lerner, \textit{The Venture Capital Cycle}] (explaining why traditional sources of financing are unsuitable for VC projects); Paul Gompers & Josh Lerner, \textit{The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements}, 39 J.L. & Econ. 463, 465 (1996) [hereinafter Gompers & Lerner, \textit{Covenants}] (discussing the high-risk investments of venture capitalists and the tools they use to better manage such investments). In addition, banks do not invest in litigation financing because it is financing provided upfront with no expected cash flow for an extended period of time. I thank Victor Goldberg for this comment.
\textsuperscript{155} See Gilson, \textit{supra} note 109, at 1076-77.
\textsuperscript{156} See id. at 1076.
complete loss. For these reasons, VC returns have been likened to options—both are characterized by a very small chance of a very large payout.157

Litigation funding has a similar degree of extreme uncertainty as does VC. In the case of litigation funding, the litigation is usually at an early stage and discovery of facts is preliminary at best. Furthermore, when the subject matter of the litigation requires specialized know-how—for example, in intellectual property cases, which can be technology-centered, or in antitrust cases, which can involve advanced economic theory—or when the case involves new legal frontiers where doctrine and precedent are undeveloped—such as in cross-border human rights and mass tort cases158—subject matter uncertainty can increase overall uncertainty in the same manner that scientific uncertainty operates in the VC context.

The client’s and the attorney’s control over the litigation create further uncertainty for the financier. The attorney’s influence over the litigation, as discussed below,159 is not dissimilar to management’s influence over a portfolio company. In other words, the quality of the attorney’s decision making, a relative or complete unknown to the funder, contributes to the uncertainty, especially when the attorney has been retained prior to the funder’s involvement and without the funder’s input.160

But the most significant source of uncertainty for litigation funding is the nature of litigation itself. According to a new body of literature that applies financial theory to law, litigation should be

157. John H. Cochran, The Risk and Return of Venture Capital, 75 J. Fin. Econ. 3, 5 (2005); Gilson, supra note 109, at 1076; see also Sahlman, supra note 105, at 482-83 (emphasizing the great uncertainty regarding returns on individual VC projects). For example, one of the earliest VC investments, American Research and Development Corporation’s “ARD,” the first-ever professional VCF formed in 1946, invested in Digital Equipment Corporation and yielded a return of more than 70,000 percent. See SPENCER E. ANTE, CREATIVE CAPITAL: GEORGES DORIOT AND THE BIRTH OF VENTURE CAPITAL 107-08, 196 (2008).

158. The Supreme Court is, as of this writing, hearing a pivotal case with broad implications as to the question of whether corporations can be held accountable for cross-border human rights and environmental abuses. Kiobel v. Royal Dutch Petroleum Co., 132 S. Ct. 472 (2011). I note this example because the test case described in Part I is a cross-border mass-tort case.

159. See infra Part III.A.

160. See Steinitz, supra note 2, at 1313 (discussing the motives underlying attorney underinvestment in any given litigation).
analyzed as an option, because during the course of a case each party has an option to settle or select trial. This choice suggests the application of an option pricing model to legal valuation: “The case assessment of a civil action follows a random walk like that of a stock. The up-down movement of probability (expectations [of the parties]) is a function of information dissemination.”

Similarly, according to financial theorists of law, legal probability is not statistical or objective. It is logical and subjective, changing over the lifetime of a litigation as facts unfold. Thus, while the law and economics literature models probability as an empirical and quantifiable concept, when mathematicians considered the application of probability to legal action they rejected the notion that statistical probability could apply or that such probability was measurable.

Further, while classical economic theory of law assumes that decision standards of deliberative bodies—such as courts and arbitral tribunals—are a fixed point of reference, both financial theorists and behavioral economists of law argue, and show, that the assumption that these bodies apply consistent standards in similar disputes is unrealistic. This is because judicial proceedings are not predictable and because the ability of parties and their lawyers to predict such outcomes are inherently, and deeply, flawed.

In particular, behavioral economic analysis of the law literature, which emerged in the late 1990s and the 2000s and has focused in no small part on litigation, shows that litigation behavior can be expressed in terms of three important “bounds” on human behavior: bounded rationality, willpower, and self-interest. Each of the

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162. See Rhee, supra note 161, at 645-50 (distinguishing statistical probability from logical probability—the latter being a relationship between premises, facts, inferences, and conclusions—and discussing the mathematical literature).

163. See id. at 637. The decision of a deliberative body “does not exist ex ante as a fixed reference point that the parties must discover, but is simply an ex post result that the parties achieve if they opt for trial.” Id. at 663-64 (emphasis added).

three bounds has a documented effect on the ability to generate sound predictions of the litigation process.\footnote{165}

For example, parties, lawyers, judges, and juries operate based on heuristics and biases, creating uncertainty as to a dispute’s outcome. Further, empirical evidence reveals that litigants are not optimal processors of information. Consequently, parties’ assessments of the likely outcome of the litigation diverge, rather than converge, as more facts are disclosed—usually, through the discovery regime.\footnote{166} It turns out that in reality shared information is likely to be interpreted egocentrically by disputants.\footnote{167} Parties tend to "either be overoptimistic in the assessments of cases or construe the fairness of the situation in a self-serving fashion."\footnote{168} Self-serving inferences and the sunk costs bias have been shown to explain why certain procedural mechanisms designed to cause more upfront information sharing and evaluation, “like liberalized summary judgment ... standards and mandatory disclosures ... may not have the desired pro-settlement effects” intended.\footnote{169}

Several studies have demonstrated that even experienced litigators are not good predictors of claim value. “The results are consistent: lawyers, insurance adjusters, and judges all err by very substantial amounts when asked to estimate either the settlement value or predicted trial outcomes.”\footnote{170} Empirical research shows that

\begin{footnotes}


166. \textit{See Rhee, supra note 161, at 653.}


168. Langevoort, supra note 165, at 1510-11.

169. \textit{Id. at 1511; see also} Samuel Issacharoff & George Loewenstein, \textit{Second Thoughts About Summary Judgment}, 100 \textsc{Yale L.J.} 73 (1990); Samuel Issacharoff & George Loewenstein, \textit{Unintended Consequences of Mandatory Disclosure}, 73 \textsc{Tex. L. Rev.} 753 (1995); Donald C. Langevoort, \textit{Where Were the Lawyers? A Behavioral Inquiry into Lawyers’ Responsibility for Clients’ Fraud}, 46 \textsc{Vand. L. Rev.} 75, 100-01 (1993) (suggesting that once lawyers commit to client representation they may be biased in their construal of information and hence miss warning signs of client fraud); Elizabeth F. Loftus & Willem A. Wagenaar, \textit{Lawyers’ Predictions of Success}, 28 \textsc{Jurimetrics J.} 437, 450 (1988) (discussing the effects of overoptimism on how lawyers assess the probability of success).

\end{footnotes}
lawyers tend to be generally overconfident, and especially so in cases in which they initially made highly confident predictions.\footnote{171}{See Loftus & Wagenaar, supra note 169, at 450.}

Additionally, most lawyers are not experienced trial lawyers since the vast majority of cases settle.\footnote{172}{Steven Shavell, Foundations of Economic Analysis of Law 410 (2004) ("[O]ver 96 percent of civil cases do not go to trial.... [I]n 2001 almost 98 percent of federal civil cases were resolved without trial.... [B]ecause many disputes are settled before any complaint is filed, 96 percent or 98 percent may understated the settlement rate.").} They therefore do not have the required experience that would, perhaps, have afforded them the ability to soundly assess the likelihood of how a judge or a jury would decide. The rarity of trials also complicates efforts to value or model litigation outcome because it results in a lack of adequate data upon which lawyers or financiers can rest their predictions.

Furthermore, while there is a huge number of settlements—the market in settlements is estimated to have an annual value of $50 billion, which is similar to the U.S. housing market—this market is unusual in that we have no information about it.\footnote{173}{Yeazell, supra note 170, at 6.} Consequently, pricing information for civil settlements badly lags behind information about comparable markets. “Lacking information about comparable transactions, litigants and their lawyers price [settlements] in the dark.”\footnote{174}{Id. at 2.} Financial economics has conclusively shown that accurate predictions of future prices by individual participants, even in normal markets, are impossible, and there is no reason why this truth does not apply with more force to the predictions of legal decisions given that a civil action is not subject to market pricing, is not supported by risk management services or a derivative market, and is one of the most illiquid of assets.\footnote{175}{Rhee, supra note 161, at 627.}

In sum, it appears that parties and their lawyers cannot be expected to accurately predict the decisions of deliberative bodies, accurately assess the risks inherent in litigation, or reliably valuate a claim. In other words—and alluding to one, oft-cited definition of risk and uncertainty, according to which risk exists when alternative future states of the world occur with quantifiable probability,
whereas uncertainty exists when alternative future states of the world occur without quantifiable probability—investing in legal claims is both a risky and a highly uncertain endeavor. Therefore, it is not surprising that emerging evidence, as well as the budding literature, suggests that litigation finance returns are highly variable. Indeed, some have gone so far as characterizing litigation finance in its entirety as “speculative” and “subprime.”

The upshot, however, is that case outcomes are not completely random. Although litigation finance is highly uncertain, funders may still be able to enhance value through aggregation of claims in a diversified portfolio and through noncash contributions including investment of human capital such as expertise, enhancing reputation, and monitoring. In this—as in the magnified information asymmetries and agency costs characteristic of litigation funding—litigation funding is similar to venture capital.

With this overview of legal claims as risky and uncertain investments, of the magnified information asymmetries, and of agency costs in mind, the next Part offers solutions adapted from VC. Organizationally, the hallmark solutions are the use of limited partnerships—in which investors are passive limited partners, and the general partner is a company comprised of investment professionals who contribute expertise, more so than funds—and an incentive-aligning compensation scheme. Contractually, the cornerstones are staged financing, the role of management, use of negative covenants, mid-length investment terms with mandatory distributions, and liquidation. Also key are reputation markets.

The next Part focuses on the recommended contract between the litigation funding firm and the plaintiff because this relationship is the heart of the arrangement, is the focus of the concerns surrounding litigation finance, and is a new relationship regarding which there is virtually no publicly available information. But the Part also briefly makes recommendations regarding the litigation funding firm’s contractual relationships with its investors and highlights the special role the attorney retention agreement can

176. Frank H. Knight, Risk, Uncertainty and Profit 19-20 (1921).
play in supporting the desirable litigation funding firm-plaintiff equilibrium.

III. VENTURE CAPITAL’S LESSONS LEARNED: CONTROLLING EXTREME UNCERTAINTY, INFORMATION ASYMMETRY, AND AGENCY COSTS THROUGH ORGANIZATIONAL AND CONTRACTUAL ARRANGEMENTS

A. Recommended Organizational Structure

Organizational features of VCFs and the choices made in structuring the funds, such as profit-sharing rules and self-liquidation, have long-lasting effects on the behavior of venture capitalists and profound implications for the financed portfolio company and the funds’ investors.178 The key organizational features—limited partnerships, compensation, and noncash contribution—are discussed in this Section.

1. Limited Partnerships and Syndication

Most of the financial literature regards the structure of private equity organizations, and in particular the reliance on limited partnerships with finite durations, as critical to their success.179 The typical form of organization in the VC market involves institutional investors who rely on VCFs, structured as limited partnerships, to manage their investments.180 The institutional investors are the passive limited partners, and the general partner (GP) is a money management company that employs professionals with specialized expertise. These professionals select and then monitor the VCF’s investments on behalf of the ultimate investors with the expectation of going back to the market to raise additional funds for future

179. Paul A. Gompers & Josh Lerner, The Determinants of Corporate Venture Capital Success: Organizational Structure, Incentives, and Complementarities, in Concentrated Corporate Ownership 17, 17, 19-20 (Randall K. Morck ed., 2000) (examining the finance literature’s maxim that the structure of VCFs “has been identified as critical to their success,” and concluding that the key determinant is the presence of “a strong strategic focus”).
180. Gilson, supra note 109, at 1070; see also Michael J. Halloran et al., Agreement in Limited Partnership, in 1 Venture Capital & Public Offering Negotiation 1-1, 1-4 to 1-5 (Michael J. Halloran ed., 3d ed. 2011); Sahlman, supra note 105, at 487.
funds. The limited partnership agreement sets the fund’s corporate governance arrangements. Pursuant to the laws that govern limited partnerships, the limited partners are precluded from interfering in the day-to-day fund management, especially as it may relate to investments in a given portfolio company. Usually, the investment is then syndicated to include additional VCFs as investors in the fund’s portfolio.

2. Compensation

The GP’s compensation is composed of a small annual management fee calculated as a low percentage of committed capital—2 percent is common—and “carried interest,” which is usually 20 percent of the realized profits. Although superficially homogeneous, there are subtle and important differences across the compensation provisions in VCF-investor agreements, with larger, more established VCFs, for example, providing for more variable compensation schemes that are more finely tuned to reflect performance.

The compensation scheme plays a central role in the VC setting because the limited partners cannot use many of the methods of disciplining managers found in corporations—such as a powerful board of directors and the market for corporate control. “[I]ndividual partnership agreements are rarely renegotiated ... [and] compensation is one of the most contentious issues between limited and

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181. Gilson, supra note 109, at 1071.
182. Id.; see also Sahlman, supra note 105, at 489.
183. Gilson, supra note 109, at 1071. This alone solves some conflicts of interest that currently exist in litigation funding but are beyond those that arise in the triangular attorney-client-funder relationship and therefore are not the focus of this Article. For example, the individuals who invest in the litigation funding firm may do so in order to gain access to the confidential information of, or cause trouble to, a competitor who is the target of a funded lawsuit.
184. Id. at 1073; see also Josh Lerner, The Syndication of Venture Capital Investments, 23 FIN. MGMT. 16, 16-17 (1994) (researching the patterns of syndication and explaining the different motivations of syndicating the first round of investments as opposed to later rounds and the conflicts of interest between the lead investor and other investors in later rounds).
185. Gilson, supra note 109, at 1072. This is a generic description of the compensation structure. For a more nuanced, empirical analysis of VC compensation agreements, see also Kate Litvak, Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements, 76 U. CHI. L. REV. 161, 172-75 (2009).
general partners of venture funds.\footnote{186} If adopted in the litigation funding industry, similar compensation structure will, as detailed in the next Section, align the GP’s interests with those of both the investors and the plaintiffs.

3. Noncash Contribution

“The GP’s principal contribution to the [VCF] is expertise, not capital.\footnote{187} Although not formally—that is, contractually—required, the GP “is also expected to make ... noncash contributions to the portfolio company ... [in the form] of management assistance, ... intensive monitoring of the portfolio company’s performance ... and the use of the [GP]’s reputation to give the portfolio company credibility with potential customers, suppliers, and employees.”\footnote{188} For this reason, “[v]enture capitalists are generally seen as value-added investors who have played a significant role in the development of many entrepreneurial businesses.”\footnote{189}

This point has far-reaching implications for how we conceptualize the role of litigation funders. Perhaps one of the key insights that the analogy between the two forms of financing provides is the noncash contributions of the GPs to the fund and the investments—that is, the litigations. Given the uncertainty and variability of legal claims, it could be argued that the major value added by the GP to the litigation funding firm is similarly the expertise of the principals. Rather than attempting to restrict this contribution as we do now by frowning upon any shift of control from the plaintiff to the litigation funding firm—and rather than impeding communication between the funder, on the one hand, and the plaintiff and

\footnote{187. Gilson, \textit{supra} note 109, at 1071.}
\footnote{188. \textit{Id.} at 1072.}
\footnote{189. Vance H. Fried et al., \textit{Strategy and the Board of Directors in Venture Capital-Backed Firms}, 13 J. Bus. Venturing 493, 493 (1998); see also Christopher B. Barry et al., \textit{The Role of Venture Capital in the Creation of Public Companies: Evidence from the Going-Public Process}, 27 J. Fin. Econ. 447, 449 (1990) (examining a set of IPOs “by [VC]-backed companies between 1978 and 1987,” and finding “that venture capitalists specialize their investments in firms to provide intensive monitoring services,” and further finding that “[t]he quality of their monitoring services appears to be recognized by capital markets through lower underpricing for IPOs with better monitors”).}
her lawyer, on the other—the law should endorse and facilitate private ordering that opts into these value-enhancing arrangements. They benefit the plaintiffs as much as they do the funder.

The principals of litigation funding firms tend to be seasoned lawyers who build heavily on their reputation and connections within the legal community. Their background and standing as senior lawyers position them to select promising cases, assets that the investors—pension funds, university endowments, wealthy individuals, and so on—do not have specialized expertise in selecting for themselves. They can and do assist in case development, for example making litigation strategy choices and developing novel legal theories. In other words, they can enhance value by reducing unique, case-specific risk. In addition, litigation funding firms appear to be in the early stages of developing subject-matter specializations. Some funds, for example, invest exclusively or predominantly in intellectual property cases. Other funds concentrate on international arbitration and have in fact evolved from firms that specialize in conducting discovery or enforcement in foreign jurisdictions. Some funds emphasize their intention to avoid investing in class actions. Such subject-matter expertise will further enable funders to reduce unique risk.

The personal experience and reputations of these lawyers-cum-financiers further position them to monitor both plaintiffs and

190. See Steinitz, supra note 2, at 1300.
191. Lindsay, supra note 10 (“Fulbrook, sa[id] Seidel, is different from other litigation funders. ‘We not only evaluate a case and fund it by advancing capital, but we also put together integrated human resources to evaluate and enhance claims. We do not just advance money, but also work with the claim after it’s funded to try to enhance, to give value. This is a little different than most established funders,’ he explain[ed].”).
192. See Steinitz, supra note 2, at 1316-17.
lawyers, thereby reducing the costs of the litigation. Lawyers are in a better position to know how other lawyers may squander resources. If allowed, this is the second key way in which litigation funding firms can enhance value not only for themselves and their investors, but also for the plaintiffs. Finally, the involvement of the litigation funding firm, “if [it becomes] known to the opposing party, [is likely to serve] as a signal ... regarding the strength of the case.”

Given the strong similarities between the economic problems of VC—which have resulted in the evolution of these organizational structures—and those that characterize litigation funding, litigation funding firms would be well served by organizing similarly. Namely, litigation funding firms should be specialized funds that operate based on the principles of modern portfolio theory. The pooled investments that are litigation funding firms should be organized as limited partnerships. This structure will recognize that the GPs should exert disproportionate control over the investments and over their management. Their compensation structure should also be composed of a small management fee and a large uplift in case of success. This compensation structure will align the GP’s interests with those of the investors—the GP’s disproportionate control over the various investments and over the litigation funding firms notwithstanding—and facilitate the GP’s noncash contribution to both investors and plaintiffs. Finally, this structure will isolate investors from their cases, avoiding potential conflicts with defendants.

With this suggested organizational structure in mind, the next Sections will describe in brief the recommended contractual structure for the litigation funding firm-investor contract, the attorney retention agreement, and in length the key contract: the litigation funding firm-plaintiff contract. The emphasis on the litigation funding firm-plaintiff contract is due to its centrality to the claim transfer transaction, the near-complete lack of publicly available information regarding these crucial contracts, and the fact that the

196. See Steinitz, supra note 2, at 1276, 1336.
197. Id. at 1305.
198. See infra Part III.B.1.a.
litigation funding firm-investor contract and the retention agreement should be quite similar to the well-documented and theorized VCF-investor contract and contingency fee agreements, respectively. I will nonetheless describe both briefly, for the sake of completion and in order to show their beneficial effects by way of their “braiding,” described below, with the litigation funding firm-plaintiff contract.

B. Recommended Contractual Structure

This Section will detail the recommended structure of the three contracts that govern litigation finance: the litigation funding firm-investor contract, the litigation funding firm-plaintiff contract, and the attorney retention agreement.

1. The Litigation Finance Fund-Investor Contract

The way to achieve the organizational structure recommended above is through the contract between the investors and the litigation funding firm. The litigation funding firm-investor contract should be similar to the VCF-investor contract: a limited partnership agreement. This means that it will be characterized by “[near-] complete control vested in the GP, [a] highly incentivized compensation [scheme], mandatory distribution of realized investments, and mandatory liquidation after a fixed term.” 199 These are described briefly below.

a. Control and Compensation

As noted before, the GP’s main contribution is its noncash contribution. In order for the investors to benefit from the GP’s skill and experience, however, they must give significant discretion and control to the GP. In fact, GPs of VCFs obtain control that is completely disproportionate to both their capital contribution and their carried interest. 200 The consequence is a VCF corporate governance scheme that brings the general corporate governance

199. Gilson, supra note 109, at 1087-88.
200. Id. at 1088; see also Litvak, supra note 185, at 173, 175.
problem of the separation of ownership and control to an extreme.\textsuperscript{201} Such discretion is counteracted through the compensation structure. Most of the GP’s compensation, as discussed above, consists of the carried interest. The distribution of carried interest, which happens only when profits are realized, is simultaneous to the GP and to the investors. The GP’s carried interest compensation can be subjected to claw back provisions.\textsuperscript{202} Such a compensation structure compensates for the conflicts created by the separation of ownership and control by realigning the interests of the GP and the investors.\textsuperscript{203}

\textit{b. Mandatory Distributions and Liquidation}

The aforesaid compensation structure creates another agency problem: under certain circumstances it may incentivize the GP “to prefer investments of greater risk than the investors” would prefer.\textsuperscript{204} One response to this agency problem is the VCF’s fixed term. “The ... fixed term assures that at some point [in time] the market will [fix and] measure the GP’s performance, making [it] readily observable” to future investors in successor funds.\textsuperscript{205} Fixed terms are key to reputation markets, which, in turn, are key for the ability to raise successive funds.\textsuperscript{206} Moreover, both “[m]andatory distribution of the proceeds from realized investments and the ... fixed term ... allow the investors to measure the [GP’s] performance against [available] alternatives.”\textsuperscript{207}

The desirability of separation of ownership and control coupled with an incentive-aligning compensation structure are applicable in a straightforward fashion to the recommended litigation funding

\textsuperscript{201} Gilson, \textit{supra} note 109, at 1088. Also referred to as the Berle-Means problem, this term refers to the fact that shareholders as individuals lack the ability to control a corporation even though in the aggregate they are its owners. The professional management—who are conceptually employees of the shareholders—have greater control over the corporation’s resources than do the actual owners. \textit{See generally} Adolph A. Berle & Gardner C. Means, \textit{The Modern Corporation and Private Property} 3-5, 64-67 (rev. ed. 1968).

\textsuperscript{202} Gilson, \textit{supra} note 109, at 1089.

\textsuperscript{203} \textit{Id}. Gilson describes how this compensation structure creates an incentive for the GP to realize profitable investments prematurely and how so-called “claw back provisions” deal with this particular agency problem. \textit{See id}. at 1072, 1074 (internal quotation marks omitted).

\textsuperscript{204} \textit{Id}. at 1089.

\textsuperscript{205} \textit{Id}. at 1090.

\textsuperscript{206} \textit{See id}.

\textsuperscript{207} \textit{Id}. at 1089-90; \textit{see also} Sahlman, \textit{supra} note 105, at 499.
firm-investor contract. It is already the case that—at least in some reported cases—investors, in fact, typically do not know which cases the litigation funding firm is invested in. The key difference between the VCF-investor contract and the litigation funding firm-investor contract is the need, in the latter case, for an ethical wall between the investors and the litigation funding firm so that any privileged information provided to the litigation funding firm is preserved, assuming the latter benefits from the attorney-client privilege. Such a wall will obviously increase the information asymmetry between the investors and the litigation funding firm. But the limited partnership structure already accounts for such expanded information asymmetry.

The application of the use of mandatory distribution and liquidation is a bit less straightforward. Although these are beneficial for the investors—and although the average length of a large-scale business dispute litigation is three years, making it naturally suited for midterm investments—any given litigation may take longer. The most obvious example is when an appeal may be required. Therefore, a plaintiff may wish to contract for a commitment to provide additional funds or at least a right of first refusal for funds from the GP’s successor funds.

2. The Litigation Finance Fund-Plaintiff Contract

This agreement is the heart of the suggested scheme because at the heart of litigation finance is the transfer of all or part of a claim from the plaintiff to the funder. This section will explore the key features such a contract should include: staged financing, negative covenants, representation in management, highly incentivized compensation, and appropriately timed exit provisions. It will also note the important role of a reputation market as an economic force that further binds, informally and implicitly, the GP.

208. See Parloff, supra note 11.
a. **Staged Financing**

The first recommendation is to contract for staged financing. Staging, a widely used financing technique in VC, refers to the infusion of capital over time.\(^{210}\) It helps mitigate all three problems: extreme uncertainty, information asymmetry, and agency costs.\(^{211}\) In staged financing,

> the venture capitalist retains the option to abandon the venture whenever the forward looking net present value of the project is negative. Financing rounds are usually related to significant stages in the development process such as completion of design, pilot production, first profitability results, or the introduction of a second product. At every stage, new information about the venture is released.\(^{212}\)

Thus, generally speaking, uncertainty is decreased with every further round of investment because new information becomes available.

First round investors are not obligated to participate in later rounds of investment though they may do so, but they would have to negotiate the terms of such later rounds at the time such investments are made, which is usually after certain milestones have been reached. In contrast, the VCF may reserve the right to participate in the later rounds through a right of first refusal provision.\(^{213}\) Often, the entrepreneur retains the right to seek additional financing from sources other than the VCF if the latter does not wish to further invest or if it is requiring too high a price in order to do so.\(^{214}\)

Litigation funding can similarly be staged. Examples of relevant milestones in the litigation context would be the survival of a case past an important motion, such as a motion to dismiss, the completion of some or all of the documentary discovery, the completion of a first round of depositions, or the exchange of expert reports. At

\(^{210}\) Gilson, *supra* note 109, at 1073.

\(^{211}\) Id. at 1078-81.

\(^{212}\) Cornelli & Yoshia, *supra* note 106, at 1; see also Sahlman, *supra* note 105, at 505.

\(^{213}\) Gilson, *supra* note 109, at 1073.

\(^{214}\) Id. at 1079.
each one of these junctures new information is revealed and uncertainty reduced. Financiers may participate in future rounds of investments but the elimination of the right of first refusal may be a desirable modification in the litigation funding context. Such a modification would strengthen the plaintiff vis-à-vis the funder, thus addressing the litigation-specific public policy concerns regarding disproportionate control without disrupting the equilibrium achieved in the VC context.

Beyond shifting exogenous uncertainty from the funder to the entrepreneur or plaintiff, staged financing aligns the interests of the funder and the entrepreneur or plaintiff by tying additional funding to performance and achievements. Endogenous uncertainty, namely uncertainty caused by the entrepreneur’s or plaintiff’s ability to influence the value of the venture through his or her actions or inaction, is also reduced by staged financing because such staging increases the incentives of the entrepreneur or plaintiff to expand the effort needed to maintain or enhance the value of the venture or litigation.215 In other words, it reduces agency problems.216

The first information asymmetry problem addressed by staged financing is the fact that when deciding between various possible investments—be they startup companies or litigations—a funder has to differentiate between desirable and undesirable investments even though the funder is disadvantaged in comparison to the entrepreneur or plaintiff because the latter have better, private information regarding his or her skills, or about the merit of his or her claim in the case of litigation. It is obviously in the self-interest of the entrepreneur or plaintiff to overstate the quality and likely outcome of the company or of the litigation. “Because the incentive[s] created by staged financing [are] more valuable to a good entrepreneur [or plaintiff] than a bad one,” staging operates as a sorting mechanism.217 The readiness of an entrepreneur or plaintiff

215. Id. at 1080.
216. Id. at 1079-80; see also Paul A. Gompers, Optimal Investment, Monitoring, and the Staging of Venture Capital, 50 J. Fin. 1461, 1461-63 (1995) (finding that “[a]gency costs increase as the tangibility of assets declines, the share of growth options in firm value rises, and asset specific grows;” noting that “higher R&D intensities” function similar to discovery by “lead[ing] to shorter funding durations;” and providing evidence that staging “allows [VCs] to gather information and monitor the progress of firms”).
217. Gilson, supra note 109, at 1080.
to hold off and receive additional rounds of funding only after milestones have been achieved serves as a signal of skill or of the merits of the case, as applicable. Such a signal is particularly important in the absence of a performance track record in the case of a first-time entrepreneur or a nonrepeat-player plaintiff.218

In both contexts, the information asymmetry problem persists beyond the initial selection phase. In fact, the information asymmetry gap is likely to increase over time as the entrepreneur or plaintiff learns more about the company or the litigation. The information asymmetry is even more pronounced in the litigation funding context than in the VC context because of the limitations on communication set by the attorney-client privilege and because of the value-diminishing effect that any disclosure of communication between the attorney and the client to the funder would have if privilege is not extended. Staged financing, by pegging additional funding to the achievement of milestones—and by imposing penalties should the entrepreneur or plaintiff fail to meet those milestones, which have been specified ex ante—renders the entrepreneur’s or plaintiff’s projections more credible.219

Staged financing is also understood by economists as one of three mechanisms that allocate control. The typical VC arrangement allocates to the VCF control over the entrepreneur and the enterprise through at least three mechanisms—one of which is the mechanism of staged funding. The second and third mechanisms are the use of negative covenants and representation on the portfolio company’s board of directors.220 The latter two mechanisms provide for control, and reduce uncertainty, in between financing rounds.221 The former mechanism provides control at the time of the funding rounds themselves and, by providing an “out,” reduces overall uncertainty.222

219. Gilson, supra note 109, at 1081.
220. Id. at 1073-74.
221. Id. at 1082.
222. Id. at 1078-79.
b. Role in Management

The problem of control, from an economics rather than ethics perspective, is that the entrepreneur, and by analogy the plaintiff, exercises discretion and control over the portfolio company’s or the litigation’s day-to-day decision making.223 They also have increased information as the company or litigation develops. Furthermore, since no contract between an entrepreneur and a venture capitalist can anticipate every possible disagreement,224 the venture capitalist typically plays a role in the operation of the company.225 Control in the form of representation on the portfolio company’s board of directors often takes the form of “disproportionate representation or even [complete] control of the portfolio company’s board of directors.”226

Venture capitalists sit on boards of directors, help recruit and compensate key individuals, work with suppliers and customers, help establish tactics and strategy, play a major role in raising capital, and help structure transactions such as mergers and acquisitions. They often assume more direct control by changing management and are sometimes willing to take over day-to-day operations themselves. All of these activities are designed to increase the likelihood of success and improve return on investment.227

223. See supra note 201.

224. As such, the VC and litigation funding contracts are “incomplete contracts.” On incomplete contracts, also known as relational contracts, see Ian R. Macneil, Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law, 72 Nw. U. L. Rev. 854, 886-900 (1978), and Ian R. Macneil, Reflections on Relational Contract Theory After a Neoclassical Seminar, in IMPLICIT DIMENSIONS OF CONTRACT 207, 207-17 (David Campbell et al. eds., 2003).

225. Sahlman, supra note 105, at 508 (documenting that lead venture investors spend an average of 100 hours in direct contact with each portfolio company).

226. Gilson, supra note 109, at 1082; see also Fried et al., supra note 189, at 493, 495 (noting that “[o]ne of the most significant value-added activities of the venture capitalist is involvement with strategy,” and contrasting boards of VC-backed funds with “board members in public companies who are typically either managers (insiders) or outsiders hand-picked by the CEO. As a result they may emphasize politeness and courtesy at the expense of truth and frankness” (internal quotation marks omitted)).

227. Sahlman, supra note 105, at 508; see also id. at 506 (“Most agreements call for venture capitalist representation on the company’s board of directors ... Often, the agreement calls for other mutually acceptable people to be elected to the board.”).
Applying this insight to litigation funding, one could envision a recognized role for the litigation financiers in the day-to-day management of the litigation. Such a role can include the raising of additional funds, helping in formulating legal tactics and litigation strategy, and assisting in structuring the ultimate settlement agreement in the same manner as VCFs help structure key deals executed by portfolio companies.

The influence funders appear to require in particular over the attorney—of both her selection and her strategic decisions—can be viewed as the functional equivalent of the VCF’s representation on the portfolio company’s board of directors. Therefore, part of the newly allocated control could take the form of approval of the selection of attorneys, who are the “managers” of litigation because they usually make most, if not all, of the tactical and strategic decisions during the course of the litigation. Control allocated to the funder will encourage ongoing monitoring of the investment, namely of the company or the litigation.\textsuperscript{228}

As the analysis of the financing of the Ecuadorean plaintiffs in the Chevron/Ecuador dispute in Part I illustrates, control, or at least involvement in and influence over the selection or approval of attorneys, is de facto practiced by some in the industry.\textsuperscript{229} Such involve

\textsuperscript{228} See M.J. Goldstein, Should the Real Parties in Interest Have to Stand Up?—Thoughts About a Disclosure Regime for Third-Party Funding in International Arbitration, TRANSNAT’L DISP. MGMT., Oct. 2011, at 9-10 (“A decade ago when third-party finance in international arbitration was truly in its infancy ... [funders imposed] contract terms on the financed party that created release points for the financers. Finance contracts ... not infrequently provided that a financer could discontinue financing if developments in the case gave rise to a materially increased risk ... of an unfavorable outcome. Some finance contracts of that era provided that the financed party ... bore an obligation to prosecute the arbitration in a reasonably prudent fashion, and upon breach of this duty the financer could elect to discontinue financing while retaining its interest in the proceeds—this election being provided either expressly or, less transparently, as a principle of the applicable contract law selected by the financer in its standard contract. And some such contracts included as express conditions the commitment of the financed party to seek from the arbitral tribunal an accelerated determination of one or more issues material to the claimant’s prospects of ultimate success—so that the financer could reach an early decision point to continue or terminate financing based on re-assessment of the risk.”).

\textsuperscript{229} The Australian legal system has arrived at a similar conclusion and allows for a good measure of funder control. The lead case is the High Court’s 2006 decision \textit{Campbells Cash & Carry Pty Ltd. v Fostif Pty Ltd.} (2006) 229 CLR 386 (Austl.), in which a five-to-two majority held that third-party funders may exercise significant control over the litigation, and that this control is not an abuse of process and does not offend the public policy in states that have abolished maintenance and champerty. \textit{Id.} at 388-89. The New York City Bar notes in its
ment, influence, and control can take the form of installing a chosen lawyer, as in the Chevron/Ecuador example; providing a list of preapproved law firms to select from; or passing over a claim due to the existence of a representation not acceptable to the funder.

But the transfer of control has a price for the venture capitalist. The capital structure of VC represents a calculus of the private value for control—namely, it assigns a value to the transfer of control from the entrepreneur to the VCF. Litigation financiers would similarly have to pay for the additional control. Moreover, the pricing of the control in the litigation funding context would have to take into account the extra control—indeed, absolute control—endowed by operation of law to the plaintiff, an endowment that takes the form not only of the champerty doctrine but also the duties of loyalty and independent judgment, which require that the attorney be controlled by the client alone.

c. Negative Covenants

Control is also exercised in VC through the use of negative covenants. Examples of the restriction of the entrepreneur’s discretion through the use of negative covenants include restrictions on the entrepreneur’s ability to make certain key decisions that may significantly influence the course of business of the venture, or the ability to significantly depart from any business plan approved by the VCF. By analogy, litigation funding contracts can and do include covenants that require approval by, or at least consultation in good faith with, the litigation funding firm before making strategic litigation decisions such as forum selection, the filing of key

opinion that a client may agree to permit a financing company to direct the strategy or other aspects of a lawsuit, including whether and for how much to settle, and similarly acknowledges the potential value of funder involvement, but leaves it to private contracting rather than interpret the law as allocating any control to the funder. See New York City Bar Ass’n, supra note 1, § II.E.

230. See Bernard S. Black & Ronald J. Gilson, Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, 47 J. Fin. Econ. 243, 252-53, 258-59 (1998) (discussing models that seek to explain the incentive function of capital structure and that calculate the private value for control); see also Rhee, supra note 161, at 629-38 (discussing the standard economic model of bargaining).

231. See supra notes 115-17, 126-27, 131-40 and accompanying text.

motions, and the decision to settle. Each level of control, as discussed, will have to be bargained and paid for. Indeed, one can envision legal claims so attractive that a funder will not only foot the bill but also pay an additional cash amount to the plaintiff.

d. Highly Incentivized Compensation, Exit, and Reputation

As mentioned before, the GP’s compensation is composed of a small management fee, which represents a small percentage of committed capital and, more significantly, the carried interest, which represents a much larger percent, often twenty. This compensation structure responds to the agency costs and information asymmetry problems by creating a powerful performance incentive that aligns the incentives of the VCF with that of the portfolio company, as the overwhelming majority of the fund managers’ compensation depends on the success of the portfolio company.233 This compensation structure does, however, incentivize the entrepreneur to take on more risk than she would have had the risk/reward balance not been altered by the provision of capital by the VCF. But since the risk has shifted from the entrepreneur to the VCF, the latter now has an incentive to monitor the portfolio company.

In the litigation funding context, such a structure is only a slight modification of the contingency fee, in which there is no management fee at the outset, but it includes a return on investment that is usually a large percentage of the settlement or judgment.234 At the conclusion of an investment, a VCF exits by selling the portfolio company or by taking it public. The limited partnerships usually have ten year terms, or medium-term investments.235 This creates

a strong incentive [to the GP] to cause the fund’s portfolio company investments to become liquid as quickly as possible.

Assuming that the GP has invested [all] of a fund’s capital by

233. Gilson, supra note 109, at 1083.
234. See Herbert M. Kritzer, Seven Dogged Myths Concerning Contingency Fees, 80 WASH. U. L.Q. 739, 757-59 (2002) (challenging the myth that contingency fees are standardized at a rate of 33 percent and, instead, documenting a broad range of fee arrangements); Rose, supra note 11 (documenting the broad range of percentages and associated contingencies in the litigation finance context).
235. Gilson, supra note 109, at 1074.
the midpoint of the fund’s life, the GP then must seek to raise additional capital for a new fund in order to remain in the VC business. Because the performance of a GP’s prior funds will be an important determinant of its ability to raise capital for a new fund, early harvesting of a fund’s investments will be beneficial to the GP.236

Whereas VCFs exit during an IPO or the sale of the company, a successful exit for the litigation funder takes the form of either a settlement or a favorable judgment. That means that instead of investment bankers and the markets pricing investments, it is juries, judges, and arbitral tribunals who substitute for markets in the litigation funding arena.237 And because the average life of a complex business litigation is three years,238 litigation naturally presents a similar medium-term investment horizon.

The equilibrium struck by the organizational and contractual structure of VC, including the characteristic implicit contractual provisions of such arrangements, is supported and policed first and foremost by the market forces of the greater VC market—including the force of reputation. For example, a claim by an entrepreneur that a venture capitalist declined an IPO when one was offered by a reputable investment banker would quickly circulate through the community and hurt the venture capitalist in the future when competing with other venture capitalists.239 This is especially true given that the pool of portfolio companies that merit investing in, and the pool of VCFs, are both small. Effective reputation markets are characterized by the following: First, the party that has discretion and whose reputation is in question, namely the investment firm, must be a repeat player. Second, market participants must have similar normative views on what is appropriate behavior on the part of financiers. Third, compliance or breach of the implicit contract, described below, by the litigation funder must be observable.240

236. Id. at 1074-75; see also Bernard S. Black & Ronald J. Gilson, Does Venture Capital Require an Active Stock Market?, J. APPLIED CORP. FIN., Winter 1999, at 36, 44.
237. See Yeazell, supra note 170, at 2.
238. See supra note 209 and accompanying text.
239. See Gilson, supra note 109, at 1087.
240. Id. at 1086; see also D. Gordon Smith, Venture Capital Contracting in the Information Age, 2 J. SMALL & EMERGING BUS. L. 133, 157-62 (1998) (discussing the characteristics of the
The analogy between litigation funding and VC helps us see that some of the protection to plaintiffs that counterbalances the transfer of control in the suggested investment structure comes from the “braiding” of the VCF-investor contract with the VCF-entrepreneur contract—especially the braiding of reputation and exit.

“Braiding”—observable in business contexts characterized by high levels of uncertainty such as VC and corporate acquisitions—refers to the intertwining of two or more contracts such that each contract includes provisions that operate as implicit terms in support of the arrangements contained in the other. As a consequence of braiding, the contractual efficiency of both of the braided contracts is increased.241 Often, formal contracting in one contract is used to create arrangements that render transparent the abilities and character of the parties, thus creating trust. That trust supports a second “braided” contract. Braiding has been observed in situations in which the project’s—or, in our case, the litigation’s—exact trajectory or goal cannot be defined and predicted with precision, but rather emerges over time and through the parties’ joint efforts.242 Analogously, the manner of the litigation’s development is uncertain: costs, duration, and the disposition of pretrial disputes—to name but just a few examples—are unclear and communication and cooperation between two or more parties—the litigation funding firm, the plaintiff, and the lawyers—are required. Also analogous is

241. Gilson, supra note 109, at 1091; see also Ronald J. Gilson et al., Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine, 110 COLUM. L. REV. 1377, 1386, 1422-23 (2010); id. at 1377 (“Parties respond to rising uncertainty by writing contracts that intertwine formal and informal mechanisms ... in a way that allows each to assess the disposition and capacity of the other to respond cooperatively and effectively to unforeseen circumstances. These parties agree on formal contracts for exchanging information about the progress and prospects of their joint activities, and it is this information sharing regime that ‘braids’ the formal and informal elements of the contract and endogenizes trust.”).

242. Gilson et al., supra note 241, at 1385; see also Ronald J. Gilson et al., Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration, 109 COLUM. L. REV. 431, 450-51 (2009) (“In the new arrangements ... the primary output is an innovative ‘product,’ one whose characteristics, costs, and manufacture, because of uncertainty, cannot be specified ex ante... [T]he process of specification and development will be iterative ... Thus, central to these transactions are communication and cooperation across the two (or more) firms—the design, specification, and determination of manufacturing characteristics will be the result of repeated interactive collaborative efforts by employees of separate firms with distinct capabilities.” (emphasis added)).
the nature of the complex commercial disputes that are invested. These too have imprecise goals, such as whether to go to trial, engage in mediation, or negotiate a settlement, and then what type of relief to pursue.

In the VC context, two forms of braiding are at play: the braiding of the reputation markets and the braiding of exit. The VCF’s noncash contribution is most valuable to the portfolio early on in the venture’s life. As the venture develops, and the entrepreneurs gain experience and develop their own reputation, the value of the VCF’s management experience, reputation, and similar noncash contribution diminishes. As a consequence, the value of the VCF’s noncash contribution to a given portfolio company diminishes over time, and the closer that portfolio company gets to a sale or to an IPO, the more profitable it is for the VCF to reinvest its noncash contribution in new ventures with less experience and reputation. Economies of scope, however, create a nexus between cash and noncash contributions because cash contribution acts as a signal that enhances the reputation of the portfolio company. Therefore, “recycling the venture capital fund’s noncash contributions also requires recycling its cash contributions.”

The braiding of exit enables investors to evaluate a GP’s capabilities and candor, and therefore align the GP's interests with those of the investors. The need to exit the relationship with the investors forces the VCF also to exit its relationship with the entrepreneur. The VCF’s exit from its relationship with the entrepreneur, in turn, gives the entrepreneur a performance incentive.

The operation of the reputation markets is similarly braided. They constrain the GP in its dealings with the entrepreneur because reputation affects the investor-VCF relationships, which are necessary for future fund raising by the GP. The entrepreneur receives a “windfall” in the form of fair play and competence by the GP who wishes to maintain a good reputation in order to succeed in raising new funds.

Like the limited universe of portfolio companies, the universe of commercial disputes large enough to yield the three- to four-times

243. Gilson, supra note 109, at 1076.
244. Id.; see also Gilson et al., supra note 241, at 1412-15.
245. See Gilson, supra note 109, at 1072, 1075-76; Gilson et al., supra note 241, at 1392-97.
multiplier return, as a third of the settlement or award, is limited. Additionally, a finite list of “Biglaw” firms serve as gatekeepers of such claims.\textsuperscript{246} Therefore, the conditions are ripe for a reputation market to emerge.

For the full benefits of the organizational and contractual structure offered herein to inhere in the litigation funding industry, we must witness the emergence of a robust, mature litigation finance reputation market. And for that to happen, transparency regarding both contractual arrangements and a fund’s performance is necessary. There are indications that we are heading in that direction. For example, recent negative publicity regarding Burford’s investment in the Chevron/Ecuador case in financial publications such as \textit{Fortune} is a reputational cost to the firm and its principals. The intense focus on the industry generally, which is only likely to increase given how much litigation funding is expected to reshape civil litigation, is further reason to believe that the emergence of a reputation market is imminent.\textsuperscript{247}

Beyond the need for the three attributes discussed above to be present in the litigation funding reputation market, it is advisable for investors and plaintiffs who wish to benefit from the favorable effect of reputation on their litigation finance contract to prefer specialized, repeat-player firms. Similarly, courts should encourage transparency by refraining from sealing finance contracts when they are subject to litigation, as they currently often do.\textsuperscript{248} Finally, good practice guidelines should be developed.

In sum, if litigation funding firms will organize in the same manner as VCFs, as I suggest, the benefits of the braiding of reputation and exit will inhere to both the investors and the plaintiffs in

\textsuperscript{246.} See Yeazell, \textit{supra} note 170, at 5-6 (estimating the average value of a federal lawsuit settlement as $10,000). \textit{The American Lawyer}’s— the leading trade publication— \textit{Am Law 100} list can fairly be considered the list of gatekeeper “Biglaw” firms. \textit{See The Am Law 100 2011, AM. LAW.} (May 1, 2011), http://www.americanlawyer.com/PubArticleTAL.jsp?id=1202550268433.


\textsuperscript{248.} This has been the case, for example, in a recent dispute between Juridica, a litigation finance firm, and a former investee, S & T Oil Equipment & Machinery. \textit{See S & T Oil Equip. & Mach., Ltd. v. Juridica Invs. Ltd., No. 11-H-0542, 2011 WL 1565996 (S.D. Tex. Apr. 25, 2011), appeal dismissed, 456 F. App’x 481 (5th Cir. 2012).}
a similar fashion as in the VC context. Both instances of braiding will serve to enhance the efficiency of the litigation funding firm-investor and the litigation funding firm-plaintiff contracts. In addition, the need to go back to the markets and raise successive funds will buttress the protection of plaintiffs, despite the relinquishment of control.

Like the litigation funding firm-investor contract, the attorney retention agreement is important, and implicit, in an analysis of the litigation funding firm-plaintiff’s contract. The litigation funding firm-investor contract is braided not only with the litigation funding firm-plaintiff contract but with the attorney retention agreement as well. Therefore, the next Subsection describes briefly this agreement as well as its braiding effects.

3. The Attorney Retention Agreement

Attorneys’ retention agreements, also known as engagement letters, are nonmandatory, have come into the mainstream in the past couple of decades, and are underresearched. Nonetheless, some general practices are observable. Retention agreements often include “boiler plate” provisions such as identification of the client and definition of the scope of representation, withdrawal from and closing of representation, and dispute resolution. Some questionable provisions, such as a “right to settle” provision purporting to disallow settlement without the lawyer’s consent, also appear with some frequency. Fees, costs, and billing, including clarifications regarding the advancement of costs by the lawyer, are at the heart of even the most concise of retention agreements.

As retention agreements get more complex, they include contingency fee representations and closing calculation clauses, and settlement structures become more common and elaborate. These

250. See Wells, supra note 249, at 49.
251. Becker, supra note 249, at 328 (noting that some of the agreements studied provided that the client would not settle the case without a lawyer’s consent or without the consent of both client and lawyer, and characterizing such provisions as questionable given the client’s absolute right to decide on settlement, enshrined in the rules of professional responsibility).
252. Id. at 329-32.
detail methods for accounting for final distribution to the client when various items are to be deducted from the gross recovery and order of payment. Such agreements also provide for division of fees among lawyers. Last but not least, cooperation clauses that place an affirmative obligation on the client to cooperate with the attorney and, at times, specify the form of cooperation expected—for example, supply of documents and attendance at hearings—appear in both standard and customized agreements.253

It is clear that some of these elements would braid the litigation funding firm-plaintiff relationship on the one hand, with the plaintiff-attorney relationship on the other. Cooperation with the attorney would by necessity benefit the litigation funding firm who is similarly concerned with client shirking once risk has been shifted onto the litigation funding firm. The attorney’s monitoring of the client benefits the litigation funding firm. The fee arrangements, including negotiating and specifying division of fees, and precise mechanisms for collecting fees out of the settlement or judgment can similarly benefit the funder who has a parallel collection concern and interest in avoiding ex post disputes regarding calculating the division of the spoils.

This is doubly true because a key concern for investors in litigation—especially international arbitration or transnational litigation, as previously discussed—is securing a right in the judgment or award and effecting a collection. Conversely, VCFs do not face such a risk of an entrepreneur running off with the spoils at the time of exit, via sale or IPO, because VCFs hold shares in the portfolio company so any withdrawal necessarily involves compensation for the entrepreneur’s equity in the enterprise.254

All of this braiding enhances the efficiency of the litigation funding firm-plaintiff relationship as well as that of the attorney and her client. And, as noted before, the more inclusive the attorney-client arrangement is of the funder—for example, if the client authorizes certain types of information to be divulged to the funder either in the retention agreement or ad hoc during the course of the representation—the more all parties can enjoy enhanced efficiency generated by the agents-watching-agents effect. The more lawmak-

253. See id. at 328-40.
254. See Gilson, supra note 109, at 1086.
ers protect attorney and/or client communication with the funder under such doctrines as the common-interest doctrine, the more clients and others will benefit.  

CONCLUSION

Preliminarily, the key contribution of the foregoing analysis is that VC contracts can be viewed as a template and springboard for parties contemplating entering into litigation funding arrangements. Despite the absence of publically available samples or forms, a model for similar contracting already exists and there is no need to reinvent the wheel. The litigation funding industry can be spared years of evolution by looking at, and learning from, the VC industry. VC contract theory, practice, and doctrine can guide plaintiffs, lawyers, financiers, and courts on what can be done, what should be done, and how to do it. In particular, many of the concerns raised by critics of litigation funding—pressure to settle early, or late; loss of client control; compromise of attorney’s independent judgment—are reframed in one, all-encompassing system of checks and balances that satisfies both ethical and economic concerns.

Just as VCFs purchase shares and thereby become part owners of a portfolio company, litigation funders should be viewed as co-owners of the legal claim and therefore as real parties in interest. Some conceptual consequences follow. These conceptual points should guide lawmakers and regulators. First, funders should ob-

255. But see Leader Techs., Inc. v. Facebook, Inc., 719 F. Supp. 2d 373, 376 (D. Del. 2010) (refusing to extend the common-interest exception to include a financier); Bray & Gillespie Mgmt. LLC v. Lexington Ins. Co., No. 6:07-CV-222-Orl-35KRS, 2008 WL 5054695, at *3 (M.D. Fla. Nov. 17, 2008) (ruling that the attorney-client privilege between Juridica and Bray & Gillespie had not been established).

256. See FED. R. CIV. P. 17(a). At least one U.S. court of appeals has taken that approach when the funder financed and controlled the litigation. He was to receive 18.33% of any award the plaintiffs received plus reimbursement for the expenses of the case. Additionally, [the Funder] had to approve the filing of the lawsuit; controlled the selection of the plaintiffs’ attorneys; recruited fact and expert witnesses; received, reviewed and approved counsel’s bills; and had the ability to veto any settlement agreements.

Abu-Ghāzaleh v. Chaul, 36 So. 3d 691, 693 (Fla. Dist. Ct. App. 2009). Consequently, the court held that given the level of control exerted by the funder, he had risen to the level of “party.” Id. at 694.
tain control over the funded litigation. *Second,* attorneys *should* take funders’ input into account. *Third,* litigation funding firms should be allowed, and required by their investors, to monitor their investment. Lawmakers should facilitate this key function—which enhances value for the client as well as for its co-owner(s)—by extending the attorney-client privilege to the funders and possibly the attorney work-product doctrine to work-product that is developed by the funder, that is legal in nature, and that is in direct relation to the litigation.

*Fourth,* funders should pay plaintiffs a premium for the control they receive, be compensated through a scheme that aligns their interests with those of the clients, and enhance the value of the claim by providing noncash contributions, including monitoring and reputation.

*Fifth,* regulators and lawmakers, including judges, should consider the critical role of reputation markets which, in turn, rely on the transparency of the industry. In particular, providing information regarding the performance outcomes of litigation funding firms and their ethical propensities when dealing with plaintiffs and investors will facilitate the emergence of a reputation market that can police the industry and support contractual arrangements. This necessitates choosing transparency over secrecy whenever the option arises. For example, when requested to seal a litigation finance contract, such decision makers can instead follow the precedent set by Judge Kaplan in the Chevron/Ecuador litigation.257

*Sixth,* there is also a cautionary note to both investors and plaintiffs that they should disfavor intermediaries who are not organized as described herein, such as hedge funds that do not specialize in litigation funding, and therefore cannot effectively monitor or reduce unique risk and are not subject to reputation markets.

257. See *supra* note 31 and accompanying text. Several consumer financing companies doing business in New York State have entered into a stipulation with the Attorney General of New York that requires the law lending firms who are members of the American Legal Finance Association to follow certain guidelines. See Assurance of Discontinuance Pursuant to Executive Law § 63(15), Eliot Spitzer, Att’y Gen. N.Y. (Feb. 17, 2005), available at http://www.americanlegalfin.com/alfasite2/documents/ALFAAgreementWithAttorneyGeneral.pdf (showing the American Legal Finance Association’s agreement with the Attorney General of New York and the Bureau of Consumer Frauds and Protection to comply with certain business practices).