Third-Party Litigation Financing:
Legal and Ethical Issues & Proposals for Mandatory Disclosure

by Daniel E. Cummings

In recent years, third-party litigation financing (TPLF) has grown at a rapid pace, quickly becoming a multi-billion dollar industry.[1] TPLF is a practice in which a person or entity obtains financing from a third party to pay for the cost of litigation, typically in exchange for a portion of any litigation proceeds.[2] But TPLF poses several potential legal and ethical challenges. This article will discuss these issues and review recent proposals for mandatory disclosure of litigation financing agreements in litigation.

Third-Party Litigation Financing

As every lawyer knows, litigation can be very expensive. So what is a person with a meritorious claim to do when the cost of litigation makes converting that claim into a settlement or judgment out of reach? We are all familiar with the contingency fee agreement, whereby an attorney takes on a client's litigation risk in exchange for a piece of any litigation proceeds. But what happens if no attorney will take the case on a contingency? Or if a corporation wants to mitigate its risk in high-stakes commercial litigation? Or if a law firm lacks the means to finance the litigation costs of a years-long, complex class action case?

Into this void was born the phenomenon of TPLF. This practice first came into the mainstream in the fellow common law systems of Australia and the United Kingdom.[3] In recent years, the use of TPLF has grown at a rapid pace in the United States.[4]

Third-party funders—sometimes individuals, often institutional investors—lend money to litigants or attorneys to finance the cost of litigation.[5] These loans are usually 'non-recourse,' secured by an interest in a portion (often a fixed percentage) of any litigation proceeds.[6] While investors may fund a single lawsuit, often times litigation financing companies or law firms will bundle cases into litigation investment portfolios.[7]

TPLF is used to fund many types of litigation. Not only is it used for personal injury and class action suits, but also for complex commercial litigation, securities, antitrust, and intellectual property cases, as well as international arbitration.[8] And while TPLF is often known as a tool to finance a plaintiff's litigation costs, it is also utilized by defendants.[9] A defendant can pay a certain amount to a funder in exchange for the funder's agreement to pay a portion of any verdict.[10] By doing so, the defendant is able to mitigate its risk, similar to an insurance policy.[11]

Many large law firms have begun using TPLF, with at least 75 of the Am Law 100 firms (the top 100 law firms in the U.S. by revenue[12]) reportedly working with third-party funders

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Any views or opinions expressed in this article are solely those of the author and do not necessarily reflect or represent those of Justice Wright or the Nebraska Supreme Court.

to finance litigation costs.[13] One large litigation finance firm, Burford Capital LLC, is publicly traded on the London stock exchange and has over $2 billion invested in the legal market.[14] Last year, Burford acquired another litigation finance firm for $160 million.[15] TPLF is a booming industry that appears likely to continue its sharp growth.

Legal and Ethical Issues with TPLF

The rapid growth of TPLF in the American legal system has not been without its critics. While TPLF makes more funds available to finance litigation, some argue that it encourages meritless lawsuits and prioritizes profit over justice.[16] But beyond the general concern about frivolous lawsuits, there are particular legal and ethical issues which TPLF agreements raise.

One problem for TPLF agreements is the common law doctrine of champerty.[17] Champerty, prohibited at common law, is an agreement by an unrelated party to undertake another's suit in exchange for receiving part of the litigation proceeds.[18] This doctrine has been raised in some cases to successfully invalidate TPLF agreements, and unsuccessfully in others.[19] Proponents of TPLF argue that champerty is an 'outdated' doctrine, whose purpose of preventing meritless litigation is served by other modern rules and doctrines.[20] The Ninth Circuit has said that "[t]he consistent trend across the country is toward limiting, not expanding, champerty's reach."[21]

A few states have regulated TPLF under their usury laws, while others have concluded that these agreements do not constitute loans because of the contingent nature of the funder's recovery.[22] TPLF agreements are generally allowed in Nebraska, but are regulated under the Nonrecourse Civil Litigation Act, passed in 2010.[23]

In addition to potential legal and regulatory issues, TPLF poses some ethical issues of which attorneys should be aware.[24] One issue is waiver of attorney-client privilege. If a litigant shares confidential information or documents with a litigation funder in order to obtain litigation financing, the attorney-client privilege could be waived.[25] In one commercial litigation case, a federal district court held that "any documents otherwise protected by the attorney-client privilege that [the plaintiff] shared with any prospective funder lost their protection under the attorney-client privilege when shared with third party funders."[26] But Nebraska law provides by statute that attorney communications with litigation funders does not waive the attorney-client privilege.[27]

Related to the attorney-client privilege is the attorney's ethical duty of confidentiality.[28] Lawyers are allowed to reveal information related to the representation of a client with the client's 'informed consent.'[29] To ensure that a client's decision is informed, an attorney should fully advise the client about the TPLF agreement, including any risk of waiving the attorney-client privilege for information shared with the funder.[30]

TPLF agreements also run the risk of running afoul of the ethical prohibition on fee-splitting by attorneys with non-attorneys.[31] Rule 5.4(a) of the Model Rules of Professional Conduct generally prohibits lawyers from "shar[ing] legal fees with a nonlawyer," subject to certain exceptions.[32] The purpose of this rule is "to protect the lawyer's professional independence of judgment."[33] An agreement by a lawyer to give a litigation funder a portion of a contingency fee or a security interest in a contingency fee may run afoul of this provision.[34] Often, funders work around this rule by contracting directly with the client, rather than the attorney.[35]

An attorney also must ensure that a litigation funder does not interfere with the attorney's duty to exercise independent judgment in the best interests of the client. Rule 2.1 of the Model Rules requires an attorney to "exercise independent professional judgment" in representing a client.[36] Rule 5.4(c) prohibits an attorney from allowing a third-party that pays the client's legal fees "to direct or regulate the lawyer's professional judgment in rendering such legal services."[37] Most of the time, the interests of the client and the funder are aligned, with both seeking maximum recovery in the litigation. But in some cases, such as the decision of whether to accept a settlement offer, these interests may depart.[38] In such a case, the attorney must remember the duty of independent judgment to the client, notwithstanding that the attorney may have a professional relationship with the litigation funder.[39] While a client may agree to allow the funder to participate in settlement decisions, the attorney's duty is always to the client, and the attorney's advice must be based on the best interests of the client.[40]

Other legal and ethical issues have been raised about TPLF agreements, including how such agreements affect the ability of a named plaintiff in a class action case to adequately represent the other members of the class.[41] In some cases, a litigation funder may be responsible for sanctions or fees levied by the court, depending on its level of control over the litigation.[42] And the presence of a third-party funder may be relevant to a proportionality analysis in a discovery dispute under Rule 26(b)(1) of the Federal Rules of Civil Procedure, which considers, among other things, "the parties' resources."[43]

Proposals for Mandatory Disclosure of TPLF Agreements

While there have been many proposed reforms related to TPLF, the most prominent proposal at the moment is for mandatory disclosure of TPLF agreements in litigation.[44] While disclosure does not resolve or address all of the legal and ethical issues raised by TPLF, it would allow the parties to litigate the legal impact, if any, of these agreements.

Most prominently, in June 2017 the U.S. Chamber Institute

for Legal Reform, along with a host of other business, industry, and legal reform organizations, proposed an amendment to the Federal Rules of Civil Procedure for mandatory disclosure.[45] The proposed rule would add to the mandatory initial disclosures under Rule 26(A)(1)(a) a disclosure of "any agreement under which any person, other than an attorney permitted to charge a contingent fee representing a party, has a right to receive compensation that is contingent on, and sourced from, any proceeds of the civil action, by settlement, judgment or otherwise."[46] The Chamber proposed this same amendment in 2014.[47] The federal courts' Advisory Committee on Civil Rules tabled the proposed amendment at that time, concluding that while "the questions raised by third-party financing are important," the issues "may change as practices develop further."[48] It concluded that adopting the rule at that time would be "premature."[49] In its renewed proposal this year, the Chamber argued that the continued growth of TPLF created an even greater need for disclosure.[50] Litigation funders opposed the Chamber's initial proposal by arguing that TPLF agreements are not legally relevant in most litigation, and that a rule mandating disclosure in all cases is unnecessary.[51]

In 2016, the U.S. District Court for the Northern District of California amended its local rules to mandate disclosure of TPLF agreements in class action cases.[52] At first, the court proposed an amendment that would have clarified that its mandatory disclosures of any persons or entities with financial interests in the litigation (applicable to all cases) includes litigation funders.[53] Ultimately, the court did not amend the local rules as initially proposed, but amended them to provide that "[i]n any proposed class, collective, or representative action, the required disclosure includes any person or entity that is funding the prosecution of any claim or counterclaim."[54]

This year, a bill was introduced in the U.S. House of Representatives that would require disclosure of TPLF agreements in class action litigation.[55] The proposed Fairness in Class Action Litigation Act of 2017, which aims to reform (and some would argue curtail) class action litigation, requires that, "In any class action, class counsel shall promptly disclose in writing to the court and all other parties the identity of any person or entity, other than a class member or class counsel of record, who has a contingent right to receive compensation from any settlement, judgment, or other relief obtained in the action."[56] While the bill passed the House and has been sent to the Senate, its likelihood of being passed into law is unclear.[57]

Regardless of whether the Fairness in Class Action Litigation Act ultimately becomes law, it illustrates the growing demand for mandatory disclosure of TPLF agreements. While not a cure-all for every issue raised by TPLF, many argue the importance of bringing the behind-the-scenes impact of litigation funders on our legal system into the light.

Conclusion

TPLF is a growing phenomenon in the American legal system and does not appear to be going away any time soon. The increased availability of litigation funding can have a positive impact by enabling greater access to justice. But the injection of billions of investor-dollars into our legal system is not without concern. Attorneys should, as always, be mindful of their ethical obligations to their clients when working with third-party funders.

As TPLF has grown, so have its critics and the calls for reform. Proposals for mandatory disclosure appear to represent a middle-ground. Disclosure does not place any substantive limitations on TPLF, but brings greater transparency to its use. The momentum behind mandatory disclosure is growing, and seems likely to carry the day at some point in the future.

Endnotes

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2 Victoria Shannon Sahani, *Judging Third-Party Funding*, 63 UCLA L. REV. 388, 392-98 (2016) (defining and discussing third-party litigation funding).

3 Maya Steinitzt, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1275-82 (2010); Rickard & Behrens, *supra* note 1, at 2.

4 Barrett, *supra* note 1.

5 Sahani, *supra* note 2; Laura Metzger et al., *Litigation Finance: A Brief History of a Growing Industry*, ORRICK: DISTRESSED DOWNLOAD, Mar. 24, 2016, http://blogs.orrick.com/distressed-download/2016/03/24/litigation-finance-a-brief-history-of-a-growing-industry/.

6 Sahani, *supra* note 2, at 392; *see also Non-Recourse Debt*, INVESTOPEDIA, http://www.investopedia.com/terms/n/nonrecoursedebt.asp (defining non-recourse debt).

7 Barrett, *supra* note 1; Metzger, *supra* note 5; *see also Burford Capital Closes $500 Million Complex Strategies Investment Fund*, BURFORD CAPITAL LLC, July 3, 2017 (Press Release), http://www.burfordcapital.com/newsroom/burford-capital-closes-500-million-complex-strategies-investment-fund/.

8 Metzger, *supra* note 5; Steinitzt, *supra* note 3, at 1271, 1277-78.; Jennifer A. Trusz, *Full Disclosure? Conflicts of Interest Arising from Third-Party Funding in International Commercial Arbitration*, 101 GEO. L.J. 1649, 1658 (2013).

9 Sahani, *supra* note 2; Steinitzt, *supra* note 3, at 1276.

10 Sahani, *supra* note 2; Steinitzt, *supra* note 3, at 1276.

11 Sahani, *supra* note 2; Steinitzt, *supra* note 3, at 1276.

12 *See* THE AMERICAN LAWYER, http://www.americanlawyer.com/ (the producer and publisher of the Am. Law 100).

13 U.S. Chamber letter, *supra* note 1, at 6 (citing Roy Strom, *With Profits Up 75 Percent, Burford's Results Reveal Evolving Litigation Funding Industry*, THE AMERICAN LAWYER, Mar. 14, 2017, http://www.americanlawyer.com/id=1202781274593/With-Profits-Up-75-Percent-Burfords-Results-Reveal-Evolving-Litigation-Funding-Industry); *Law Firm Solutions*, BURFORD CAPITAL LLC, http://www.burfordcapital.com/what-we-do/for-law-firms/ (explaining how Burford Capital provides capital for litigation to law firms and noting that it has invested up to $100 million in a single law firm portfolio).

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17 Steinitzt, *supra* note 3, at 1286-91; Metzger, *supra* note 5; ABA Comm'n on Ethics 20/20 Informational Report to the House of Delegates 9-12 (Feb. 2012) (discussing ethical issues raised by "alternative litigation financing"); U.S. Chamber letter, supra note 1, at 11-13; *but see Litigation Finance is not Champerty, Maintenance or Barratry*, BURFORD CAPITAL LLC, July 30, 2013, http://www.burfordcapital.com/blog/litigation-finance-not-champerty-maintenance-barratry/.

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19 *WFIC, LLC v. LaBarre*, 2016 PA Super 209, 148 A.3d 812 (2016); *Osprey, Inc. v. Cabana Ltd. P'ship*, 340 S.C. 367, 532 S.E.2d 269 (2000).

20 *Litigation Finance is not Champerty*, *supra* note 17.

21 *Del Webb Communities, Inc. v. Partington*, 652 F.3d 1145, 1156 (9th Cir. 2011) (interpreting Nevada law).

22 Compare *Lawsuit Fin., L.L.C. v. Curry*, 261 Mich. App. 579, 683 N.W.2d 233 (2004) with *Anglo-Dutch Petroleum Int'l, Inc. v. Haskell*, 193 S.W.3d 87 (Tex. App. 2006); *see also* Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 FORDHAM J. CORP. & FIN. L. 55, 57-59 (2004); Jean Xiao, Note, *Heuristics, Biases, and Consumer Litigation Funding at the Bargaining Table*, 68 VAND. L. REV. 261, 272 (2015); Bernardo M. Cremades, Jr., *Usury and Other Defenses in U.S. Litigation Finance*, 23 KAN. J.L. & PUB. POL'Y 151 (Winter 2013-2014); ABA Comm'n on Ethics Report, *supra* note 17, at 12-13.

23 Neb. Rev. Stat. §§ 25-3301 to 25-3309.

24 *See* generally ABA Comm'n on Ethics Report, *supra* note 17.

25 *See Miller UK Ltd. v. Caterpillar, Inc.*, 17 F. Supp. 3d 711 (N.D. Ill. 2014); *Leader Techs., Inc. v. Facebook, Inc.*, 719 F. Supp. 2d 373, 376-77 (D. Del. 2010) (declining to extend the 'common

interest privilege' – an exception to the rule that disclosure of privileged materials to third parties is a waiver of attorney-client privilege for parties with a 'common legal interest' – to litigation funders); Steinitzt, *supra* note 3, at 1324; U.S. Chamber letter, supra note 1, at 15.

[26] *Miller UK Ltd.*, *supra* note 25, at 731-34.

[27] Neb. Rev. Stat. § 25-3306 ("No communication between the attorney and the civil litigation funding company as it pertains to the nonrecourse civil litigation funding contract shall limit, waive, or abrogate the scope or nature of any statutory or common-law privilege, including the work-product doctrine and the attorney-client privilege.").

[28] Model Rules of Prof'l Conduct r. 1.6 (Am. Bar. Ass'n 2014).

[29] Model Rules 1.6(a).

[30] ABA Comm'n on Ethics Report, *supra* note 17, at 24-25.

[31] Model Rules 5.4(a); Steinitzt, *supra* note 3, at 1291-92.

[32] Model Rules 5.4(a).

[33] *Id*. at cmt. 1.

[34] ABA Comm'n on Ethics Report, *supra* note 17, at 29; U.S. Chamber letter, *supra* note 1, at 14-15.

[35] *See* Jasminka Kalajdzic et al., *Justice for Profit: A Comparative Analysis of Australian, Canadian and U.S. Third Party Litigation Funding*, 61 AM. J. COMP. L. 93, 128–29 (2013).

[36] Model Rules 2.1.

[37] Model Rules 5.4(c).

[38] *See* ABA Comm'n on Ethics Report, *supra* note 17, at 21-24; U.S. Chamber letter, *supra* note 1, at 16-17.

[39] *See* Model Rules 2.1.

[40] *See id.*; ABA Comm'n on Ethics Report, *supra* note 17, at 26-27.

[41] U.S. Chamber letter, *supra* note 1, at 20-21; Rickard & Behrens, *supra* note 1, at 3; *see also* Fed. R. Civ. P. 23(a)(4) ("(a) Prerequisites. One or more members of a class may sue or be sued as representative parties on behalf of all members only if: . . . (4) the representative parties will fairly and adequately protect the interests of the class.").

[42] U.S. Chamber letter, *supra* note 1, at 19-20; Rickard & Behrens, *supra* note 1, at 3; *see also* Model Rules 11 and 37; *Abu-Ghazaleh v. Chaul*, 36 So. 3d 691, 695 (Fla. Dist. Ct. App. 2009) (holding third-party litigation funders liable for attorney fees based on the filing of a frivolous suit).

[43] Fed. R. Civ. P. 6(b)(1); U.S. Chamber letter, *supra* note 1, at 19-20; Rickard & Behrens, *supra* note 1, at 3.

[44] *See* generally Russell et al., *supra* note 1.

[45] U.S. Chamber letter, *supra* note 1.

[46] *Id*.; *see also* Fed. R. Civ. P. 26(A)(1)(a).

[47] Advisory Committee on Civil Rules Report to the Standing Committee on Rules of Practice and Procedure of the Judicial Conference of the United States 3-4 (Dec. 2014), http://www.uscourts.gov/sites/default/files/fr_import/CV12-2014.pdf; Letter from U.S. Chamber Institute for Legal Reform et al. to Jonathan C. Rose, Secretary of the Committee on Rules of Practice and Procedure of the Administrative Office of the United States Courts, Apr. 9, 2014, http://www.uscourts.gov/sites/default/files/fr_import/14-CV-B-suggestion.pdf; Lisa A. Rickard, *TPLF Transparency: A Proposed Amendment to the Federal Rules of Civil Procedure*, U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, July 6, 2014, http://www.instituteforlegalreform.com/resource/tplf-transparency-a-proposed-amendment-to-the-federal-rules-of-civil-procedure.

[48] Advisory Committee Report, *supra* note 47, at 3-4.

[49] *Id*.

[50] U.S. Chamber letter, *supra* note 1, at 2.

[51] Letter from Gerchen Keller Capital LLC et al. to Jonathan C. Rose, Secretary of the Committee on Rules of Practice and Procedure of the Administrative Office of the United States Courts, Oct. 21, 2014, http://www.uscourts.gov/sites/default/files/fr_import/14-CV-B-1-suggestion.pdf.

[52] Russell et al., *supra* note 1; U.S. Chamber letter, *supra* note 1, at 10.

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[54] Standing Order for all Judges of the Northern District of California, § 19 (Jan. 2017); *Notice Regarding Civil LR 3-15*, UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA, https://www.cand.uscourts.gov/news/210.

[55] H.R. 985, 11th Cong. § 1722 (2017) (Fairness in Class Action Litigation Act of 2017).

[56] H.R. 985 § 1722; Daniel Fisher, *House Bill Would Make Life Much, Much Harder for Class-Action Lawyers*, FORBES, Feb. 16, 2017, https://www.forbes.com/sites/danielfisher/2017/02/16/house-bill-would-make-life-much-much-harder-for-class-action-lawyers/#6fbfbb847910.

[57] *See* H.R. 985, CONGRESS.GOV, https://www.congress.gov/bill/115th-congress/house-bill/985/text.