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Third-Party Funding of Lawsuits Permeates the Legal Landscape

The answers are not entirely clear, but one thing is certain: Third-party funding and financing is a developing, unsettled area of the law. As such, as in any new endeavor, attorneys and their clients should proceed with caution.

By **Neal M. Eiseman** | April 12, 2018 at 02:30 PM

You know the feeling: You're crunched for time as you scan the newspaper, the *New York Law Journal* or the Internet, reading only the first few paragraphs of an article, a newly reported case or a post. As a result, all too often you don't understand enough of what you've just read to fully appreciate

its significance. Over the past two years, I've always felt that way a bout third-party litigation funding. On its face, the idea of having a stranger use the courts to make a profit seems at odds with the common law doctrine of champerty and maintenance.

Champerty is an agreement to divide litigation proceeds between the owner of the litigated claim and a party unrelated to the lawsuit who supports or helps enforce the claim. Black's Law Dictionary (10th ed. 2014). It was developed to prevent the commercialization of (or trading in) litigation. *Justinian Capital SPC v. Westlb AG*, 28 N.Y.3d 160, 163 (2016). Maintenance is the continuation of something, such as a lawsuit. Black's Law Dictionary (10th ed. 2014).

Are those centuries-old doctrines now archaic? Does third-party funding provide a bona fide vehicle for individuals without the financial resources to level the playing field and pursue legitimate claims against larger, wealthier defendants?

In New York, Judiciary Law §489 codifies the champerty doctrine by providing that, when disputes involve notes and securities, individuals and companies are prohibited from purchasing an assignment with the intent of bringing an action or proceeding.**[1]** The Court of Appeals has held that the distinction that makes a difference is whether the third-party's intent to sue on the claim was the "primary purpose," if not the sole motivation, behind the third-party's involvement.**[2]** In light of this narrow judicial definition, the vast majority of third-party funding cases (which involve the claimant's right to seek relief for some type of injury) do not, on their face, constitute champerty.

Indeed, third-party funding of litigation has grown enormously in the past few years and it is now clearly big business. Last year, it became known that

billionaire Peter Thiel had financed Hulk Hogan's successful "sex tape" lawsuit against Gawker Media. That, however, is just the most popular tip of the iceberg. Just google "third-party funding or financing" and you will find scores of companies who specialize and actively promote it. Some even raise the money they use to make loans via IPOs. Lawrence S. Schaner and Thomas G. Appelman, "Third-party Litigation Funding in the United States," RArb_indb at 178 (2012). And not all third-party funders are limiting their sights to plaintiffs; some are funding defendants on the condition they share in the delta between what the plaintiff sought and the extent to which a successful defense reduced that sum.

Many attorneys are receiving unsolicited requests asking them to consider funding one or more of their clients' cases through the use of litigation funding. Last month, I received a letter from one located in New York City that asserted it will provide the claimant and the claimant's law firm funding for meritorious cases in return for a share of the recovery. The letter enclosed an article that included some hypotheticals illustrating some of the most popular kinds of litigation funding deals, including (1) single-case financing (where, for example, a law firm has one case with an expected recovery of $10 million and the funder provides $1 million to cover case costs and the funder receives $2 million back when and if a favorable judgment comes in) and (2) portfolio deals (where, for example, a law firm has five pending contingency cases with the potential to recover $20 million in fees and the funder provides $2 million and receives $4 million if and when a favorable judgment comes in).

Relatedly, there has been a large uptick in the proliferation of companies who offer money advances to plaintiffs at exorbitant interest rates. As you might expect, these companies traditionally sought out personal injury cases. However, that too is changing. Earlier this year, the *New York Times* reported

that “settlement advance companies” are trying to cash-in on the #MeToo movement by reaching out to women with sexual harassment claims and offering advances that only need to be paid back—again, at what would normally be considered usurious interest rates—if the claimant collects. Matthew Goldstein and Jessica Silver-Greenberg, “How Some in the Finance Industry Are Trying to Cash In on #MeToo,” *New York Times*, Business Section, p.1 (Jan. 28, 2018). The high interest rates are considered “advances” and not “loans.” Consequently, they do not appear to be within the ambit of New York’s usury laws. Id. With increasing frequency, settlement advance companies are reaching out to any class of claimants in any industry or any area of the law who appear to possess solid legal claims and who may require funding to pursue them. Three weeks ago the *New York Times* reported that federal prosecutors are investigating finance companies providing cash advances—some of whom charge up to 100 percent interest—and trial lawyers who refer their clients to those companies. “Suing and Can’t Wait for Payout? Cash Advances With a Catch Draw Scrutiny,” *New York Times*, Business Section, p.3 (March 20, 2018).

Commercial litigators and their clients who are considering entering into agreements with funders need to be careful and to consider a number of sensitive legal and ethical issues before striking a deal, including:

• To what extent, if any, will the funder have a say in decisions regarding the litigation strategy, pre-trial discovery and settlement decisions? Can this create a conflict over what’s in the best interests of the client?

• Are the third-party funding agreements discoverable?

• Are communications, including settlement discussions, with the third-party funder or lender privileged and non-discoverable? If not, will this prejudice the client's case?

• Does the judge have the right to know a third-party funder is involved? Does a jury? If so, would that prejudice the client?

Many commercial cases are arbitrated and not litigated, thereby raising other questions when a third-party funder looms behind-the scenes. For example:

• The duty to disclose on the part of the arbitrator is essential to a fundamentally fair arbitration proceeding. After all, the arbitrator needs to know about third-party funding to be able to make necessary disclosures. Is a party legally obligated to make disclosures about its funder? Ethically, should it be? For example, do the arbitrator and the funder have a prior relationship? Has the funder funded other cases where the arbitrator was (or is) involved—either as an arbitrator or involving clients in the arbitrator's law firm? Does the arbitrator know anyone at the third-party funder?

• Arbitrations are private proceedings. To what degree, if any, can the funder be actively involved in the arbitration? Can it participate in the arbitrator selection process? Can it participate in pre-arbitration conferences? Attend the evidentiary hearings? Should funders be treated in the same way as insurance carriers who are defending (and perhaps also indemnifying) their insured?

• And, as with the funder who may control or have some influence over some portion of a litigation, can the presence of a third-party funder in arbitration pose irreconcilable legal and ethical conflicts where counsel may be caught between what the funder wants and what is truly in the clients' best interests?

The answers are not entirely clear, but one thing is certain: Third-party funding and financing is a developing, unsettled area of the law. As such, as in any new endeavor, attorneys and their clients should proceed with caution.

Endnotes:

[1] Judiciary Law §489, entitled "Purchase of Claims by Corporation or Collection Agencies," provides that "No person or co-partnership, engaged directly or indirectly in the business of collection and in adjustment of claims, and no corporation or association, directly or directly, itself or by or through its officers, agents or employees, shall solicit, buy or take an assignment of, or be in any manner interested in buying or taking an assignment of a bond, promissory note, bill of exchange, book debt, or other thing in action, or any claim or demand, with the intent or for the purpose of bringing an action or proceeding thereon; provided however that bills receivable, notes receivable, bills of exchange, judgments or other things in action may be solicited, bought, or assignment thereof taken, from any executor, administrator, assignee for the benefit of creditors, trustee or receiver in bankruptcy, or any other person or persons in charge of the administration, settlement or compromise of any estate, through court actions, proceedings or otherwise."

[2] *Justinian Capital SPC v. Westlb AG*, *supra*, which upheld the dismissal of a purchaser's complaint based upon the investment manager's champerty defense because the underlying agreement was "a sham transaction" between the owner of a claim who did not want to assert it and an undercapitalized assignee which never assumed the $500,000 risk required to quality for the safe harbor protection—an exception whereby conduct is otherwise deemed champertous under Section 489 is permissible if the notes or securities have an aggregate purchase value of $500,000 or more. This exception exists due to the state legislature's desire in 2004 to facilitate the

fluidity of sophisticated large-scale commercial transactions in the New York debt markets.

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