And then there were three

Like it or loathe it, third-party funding is becoming an important tool in the litigation world. ESTHER MARTIN talks to the proponents and the detractors of what many view as the modern way of providing access to justice

The UK's blossoming litigation funding industry took a knock in June when the Court of Appeal threw out a flagship case. This was an approximate £100 million claim against City accountants Moore Stephens over auditing work for collapsed trading company Stone & Rolls. As a result, IM Litigation Funding, which provided financial support for Norton Rose's clients – the liquidators of Stone & Rolls – could face a hefty bill of some £2 million.

The decision underlines the high risks involved in litigation funding, where third parties – such as companies, banks or hedge funds – provide finance for legal actions in exchange for an agreed share of any damages awarded. Those who see the business as distasteful – for arguably reducing the court process to a money-making venture – will doubtless be quick to point out that the *Stone & Rolls* case shows the downside of such activity.

But regardless of this setback, the third-party funding sector is not going away anytime soon. Germany has been home to the practice for the last ten years and the UK for at least six (with IM Litigation Funding launching in 2002), although it is only in the past 18 months that it has begun to gain momentum.

In addition to *Stone & Rolls* – which looks likely to continue to be fought in the House of Lords – there are other notable UK cases. They include a royalties battle in which the London office of the US-based law firm Fulbright & Jaworski secured funding through third-party broker Commercial Litigation Funding (CLF) for production company Excelsior to sue ITV. In another royalty dispute, German funder Allianz ProzessFinanz recently financed a successful action by two former members of rock band Status Quo – Alan Lancaster and John Coghlan – against Handle Artists Management, other band members, Sanctuary Records Group and Mercury Records. London firm Seddons acted for the pair on a conditional fee agreement (CFA).

Norton Rose partner Sam Eastwood, who is acting for the liquidators of Stone & Rolls, comments: 'Though the use of litigation funding is not radical in itself, what is significant is the surge in new funders in the UK since summer last year. Two years ago it was hard to find such services. Also, large City law firms are now prepared to be involved.' In fact, almost all of London's leading practices now offer clients external financial options, or are looking at doing so.

New crop

The new crop of third-party funders that has emerged in the UK market since late last year includes German player Allianz ProzessFinanz, Juridica Investments (listed on AIM in December) and hedge fund MKM Longboat. And these are not the only potential sources of litigation finance. Calunius Capital co-founder Mark Wells says: 'There is a plethora of investment funds involved with no public profile. I liken the known funders to the tip of an iceberg. If the proposition makes sense, there is plenty of capital.'

His company is part of another emerging segment of the market – with brokers such as CLF, Global Arbitration & Litigation Services (GALS), Maxima Costs Chambers and The Judge – which has identified a niche in using investment and legal expertise to assist litigants through their options.

Another arrival at Europe's litigation funding party has come from the other side of the world. Claims Funding International (CFI) is a joint venture between Australian litigation funders IMF and compatriot class action specialists Maurice Blackburn, which was incorporated in Dublin last April. Managing director Peter Koutsoukis cites Ireland's attractions as its low corporate tax rate, the fact it is an English-speaking common law jurisdiction and its position on Europe's doorstep.

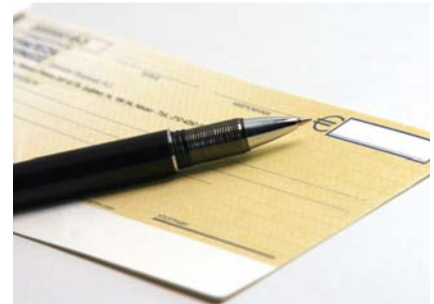
These 'new world' entrepreneurs bring experience from Australia's more mature litigation funding market and have their eyes cast across the Irish Sea to the UK and continental Europe. Mr Koutsoukis outlines the strategy: 'We are going to fund complex multi-party antitrust cases in Europe where businesses are seeking damages for losses caused by a cartel that has already had a decision against it from a regulatory body. The second area we are targeting is shareholder actions over losses suffered as a result of negligent, highly speculative or fraudulent behaviour. The sub-prime crisis will expose such conduct, which tends to be disguised during boom time.'

CFI's potential work includes representing businesses affected by the air cargo cartel, which an array of the world's major airlines have pleaded guilty over. 'Although no proceedings have been launched yet, we're looking to commence in a couple of jurisdictions shortly,' says Mr Koutsoukis. 'We are interested in countries such as France, the UK, the Netherlands and Germany, where there are stable legal structures in place and we can be confident in the ability to enforce judgments.' On the shareholder action side of their strategy, allegations concerning troubled UK bank Bradford & Bingley are another avenue for exploration.

The fallout from the global credit crisis has by no means stifled the burgeoning third-party funding market. Director Matthew Amey from brokers The Judge notes that litigation funding is 'a recession-proof industry', continuing: 'I've no doubt the impending recession will bring about more litigation to insure and fund.' And Mr Wells comments: 'There has not been an overall diminution of the investor base, in fact, quite the opposite. There are new sources of capital emerging, such as distressed debt funds.'

One key attraction of litigation funding for investors is that performance is independent of wider economic factors. Mr Wells explains: 'The fact that financing litigation has got nothing to do with the capital markets is definitely a good thing. And it compares relatively favourably in terms of returns. These investments are more complex than buying a bond and require a lot of time in due diligence, so the return has to be higher.'

Litigation funders' preparedness to mobilise resources comes amid



intimations of a favourable regulatory environment. While the European Commission's white paper on damages actions for breach of EC antitrust rules does not mention third-party funding, the accompanying staff working paper admits that the available funding methods can have a serious impact on victims' access to collective redress mechanisms. The paper envisages, among other things, the use of 'publicly or privately administered funds, by insurance companies or other players on the market, or by the claimant's lawyers working under a contingency fees agreement'.

In addition, the UK Office of Fair Trading (OFT) has endorsed third-party funding in its discussion paper as a possible solution to providing consumers with access to justice in competition cases. And the UK Civil Justice Council (CJC) has been working on proposals for regulating the litigation funding sector with a view to furthering its development.

Carving a niche

At the same time, the UK litigation funding market has been developing rapidly of its own accord. The London head of Allianz ProzessFinanz, Christian Stürwald, identifies three size segments that have emerged: small (cases valued at between £100,000 and £500,000); medium (£500,000 to £10 million); and large (£10 million-plus). A variety of cases are potentially suitable for funding – personal injury, trade marks, breach of contract, professional negligence, insolvency, shareholder and partnership disputes, and even tax – as long as the funder can be reasonably confident about a case's chance of success.

Some players are carving a niche for themselves. Class actions – such as those CFI is contemplating around Europe – are at the upper end of the value scale as they require a massive claim to be viable for funding, given the huge costs involved. Other funders are drawn to international arbitration, which offers the attractions of high amounts at stake, a commercial approach to proceedings, the ability to make reasonably accurate assessments of cost, timeline and outcome, along with strong recoverability – which is as important a factor for funders as the merits of a case.

Accountants Smith & Williamson have developed a unique prototype. Instead of going out to an external third-party funder, they use their own capital and experience to pursue insolvency claims and then share in the proceeds. Meanwhile, UK law firm Addleshaw Goddard has stepped into the ring by offering clients a 'cost free' litigation model that combines, where possible, a CFA, after-the-event (ATE) insurance and third-party funding. It has even been in talks with a major London insurer to strike a deal that would see the law firm brokering its own ATE insurance arrangements for clients.

Funders undertake a stringent risk assessment process before becoming involved in cases and typically look for what is calculated as a 60 per cent or greater chance of success. For their trouble they take a 20-50 per cent slice of recoveries. Mr Koutsoukis explains: 'We make a percentage of around one third for a standard case and it can be higher for the bigger, more complex actions.'

Allianz's broad funding base allows it a lower case-value threshold than many other market players, at £100,000, on which it would make around 20 per cent. Mr Stürwald comments: 'We're seen as a large provider and try to maximise access to justice by covering all the segments. It's arguably not ideal to have only huge cases, as losing some might undermine the funder. As such, we will also be heavily involved in mid-sized actions and seek to obtain a good mix of risk.'

Whereas the standard litigation funding concept is of providing means for cash-strapped plaintiffs to pursue claims against powerful corporate defendants, variations are developing in the UK market. One is the growing use of a risk transfer tool for litigants who can in fact afford their costs but who wish to reduce their level of financial exposure. These deals consist of a funder – such as a hedge fund – accepting a fee from a company in return for taking a percentage of risk in a case. Mr Wells explains: 'Such clients are large corporates (either claimant or defendant) that are able to pay costs, but uncertainty is a problem for them and they wish to reduce the potential hole in their balance sheet.'

After the event

Although the insurance world seldom causes excitement, it is another arena where a mini-revolution is breaking out on sharing litigation risk.

ATE insurance, which may be bought once a law suit has already been initiated, is a phenomenon more or less unique to the UK. With the government having scaled down legal aid, ATE policies have become an important way to plug the funding gap at the lower-cost end of litigation. Another factor is the jurisdiction's 'loser-pays' costs rule, where the defeated legal party must cover both sides' expenses. Mr Stürwald explains: 'ATE is almost unique to the UK because of the huge costs involved in litigating here – it can be at least five times more expensive than in Germany. It is more or less a requirement, otherwise a litigant would be facing the risk of catastrophic loss.'

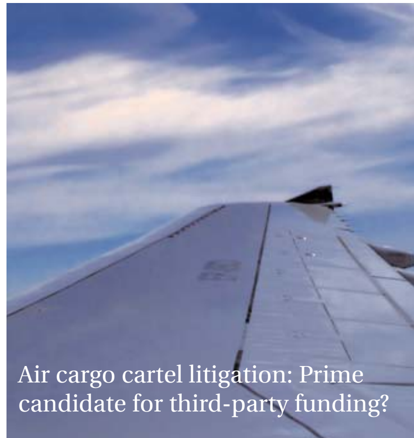
While litigation funding in the UK has surged recently, the ATE market has also been booming. Mr Amey points out: 'A year or two ago there were only a couple of providers in the market. Now people have much greater choice – although I think there's more to come.'

Even more enticing for consumers is the industry's recent move towards offering deferred and contingent premiums. Mr Amey says the amounts being insured have been spiralling upwards: 'If you asked two years ago, the biggest policy would have been £1-2 million. Now capacity is such that £10 million cases are obtaining cover. It gets more difficult over £20 million to put something together, but we would definitely look at it.'

Mr Amey is a fervent believer in ATE insurance: 'It is far and away the most relevant and cost-effective mechanism for transferring risk. An insurance premium might only cost several hundred thousand pounds, as opposed to millions for funding. I don't know how long funders can charge the multiples they do – a 30 per cent return. I don't think it can be sustained – which will make it less and less attractive to hedge funds looking for big returns.

'Commercial lawyers are not alive to how useful ATE insurance can be. There's a perception that it's not available, too expensive or that – because it has developed out of the personal injury sector – you have to be on a conditional fee arrangement to get it. However, the advantage of ATE insurance is that a client can wipe the cost of litigation off the balance sheet. The top 100 London-based law firms are coming round to it, but they're only beginning to discover what can be done.'

He also points out the commercial benefits for legal practices of understanding the uses of ATE insurance: 'More entrepreneurial law firms are realising that they can offer something extra and capture institutional clients, as opposed to those that aren't advising about it. These are early days but it's inevitable that the norm will be for everyone to get ATE insurance in the commercial sector.'


Air cargo cartel litigation: Prime candidate for third-party funding?

Merging tools

Other commentators are less enthusiastic. Norton Rose's Mr Eastwood says: 'Third-party funding is largely a response to the fact that ATE insurance didn't really work. It is difficult to obtain for large amounts and it can take a long time for cases to be reviewed.'

But there is no doubt that it is a useful tool in the funder's kit bag. Whereas a lower-value case might not offer a sufficient return to obtain full third-party financing, it can be made viable by reducing the funder's risk with a combination of ATE insurance and/or a CFA. Allianz ProzessFinanz's Mr Stürwald predicts: 'ATE insurance and funding will merge in the UK. The levels of indemnity are growing almost every month and funders can provide for costs that insurance doesn't cover.'

But The Judge's Mr Amey is convinced insurance is the strongest industry competitor: 'From the funders' perspective, third-party is much more lucrative in the short term – the returns on a single case can be phenomenal. But I don't believe the market is as big as some think, so I don't anticipate there'll be a massive explosion of third-party funding. Clients will get savvy and won't want to part with that much of their proceeds, so insurance will be the long-term winner.'

Outside the UK, Germany is the other key centre for European litigation funding. Grünecker Kinkeldey Stockmair & Schwanhäusser partner Dr Ulrich Blumenröder recalls: 'When it first started a decade ago, the third-party concept was considered sort of sleazy – that is, for someone to press a plaintiff into litigation and use the court system to make money they wouldn't be entitled to otherwise. However, since 2002 it has picked up and been accepted as a normal way to pursue reimbursements.' He says there are around five prominent funders in the market: 'They are involved in all kinds of commercial, personal injury and patent litigation and – this is only hearsay – I have even heard of third-party funding for matrimonial disputes.'

A feature of the German market is that companies are able to acquire claims so as to enforce them. This is standard practice, according to Dr Blumenröder: 'Some specialise in certain types of complaint and there are all kinds of agreements available.'

A significant new law could also impact on German litigation funding. The country's longstanding ban on lawyers working under contingency fees was ruled unconstitutional in 2006, and the amending statutory provision permitting legal practitioners to work on a contingency basis in cases where the plaintiff couldn't otherwise seek justice took effect at the beginning of July.

German litigation funders are also active in Switzerland and Austria – which Dr Blumenröder points out have similar laws to Germany. Mr Stürwald notes that although Austria is a fairly small market, Switzerland is 'quite lucrative for funders as there are relatively big cases there'.

However enthusiastic the proponents of litigation funding might be, it remains subject to some serious ethical and regulatory questions. For one thing, will it drive an upsurge in litigation and fan the flames of dreaded US-style class actions?

Industry players counter this concern by arguing it is in funders' interests to only back meritorious actions with a high chance of success. Mr Stürwald points out: 'Cases are looked at by a number of experts before they are funded, so any increase is only likely to be a slight rise in the good cases. It is also worth noting that about 80 per cent of funded actions achieve settlement out of court.'

Meanwhile, Mr Amey concedes that third-party funding is a possible catalyst for US-style class actions, but adds 'it would be difficult to make it happen in the UK with the current opt-in group litigation procedure. It would be an administrative nightmare.' And

while class actions and third-party funding go hand in hand in the Australian market, CFI's Peter Koutsoukis points out: 'The existence of adverse costs will always ensure that only cases with substantial merit go forward. Australia has had a class action system that allows all plaintiffs in one action since 1992, but there has been no explosion of these cases at all.'

Influence and control

Another issue is the degree of influence funders may exert in a case. At one end of the debate, Mr Koutsoukis is unapologetic about his conviction that funders should be involved: 'In Australia we're allowed to have control. We closely supervise the lawyers and take part in strategy decisions, such as which barrister or ADR process is chosen. We go along to mediations and arbitrations and express opinions.' Likewise, in Germany, Mr Stürwald relates: 'We can be fairly robust about our negotiations there. We carry the risks, so we would like to have a view and a voice.'

In the UK and Ireland, however, legal principles on maintenance and champerty are a concern for litigation funders. The former is unlawful meddling in a suit by providing either party with the means to carry it on, while the latter is where an outside party which has promoted litigation shares in the proceeds of a lawsuit. Although these crimes were abolished in the UK in 1967, lingering common law doctrines invalidating champertous agreements mean that funders must tread carefully. Mr Koutsoukis says: 'We are going to take a big backwards step in the UK. We can assist with the evaluation of claims and make suggestions, but can't in any way exercise control.'

In fact, the legal position for funders is still murky, according to Mr Amey: 'There needs to be more clarity from case law or the ministry of justice about what would constitute a foray into maintenance. *Arkin v Borchard Lines* [a prominent 2005 third-party funding case] didn't resolve all of these issues.'

> While there are many reservations about third-party funding of litigation, the industry has come a long way towards respectability

Meanwhile, Mr Wells explains Calunius Capital's approach: 'A transaction between two well-advised commercial entities would generally be viewed as enforceable. But with unequal knowledge, or provocative terms from a control perspective, there is still a risk it could be set aside for maintenance/ champerty reasons.'

However, funders have a strong argument in their favour – that their involvement increases the accountability of legal teams. Mr Koutsoukis points out: 'Law firms like to rack up costs on an hourly basis, but the presence of a funder comprised of lawyers makes things run more efficiently.' And from a practitioner's perspective, Mr Eastwood affirms: 'Funders have expertise and, unlike the client, a lack of emotional attachment. Their insight into the workings of law firms can bring useful discipline into the running of cases.'

But a possible problem with third party participation is conflicting interests. Mr Amey explains: 'People aren't exposed at the same trigger points. For instance, the funder might want to push on when the client doesn't. Settlement holds the most potential for disagreement and should be discussed between the parties at the outset.' There could be as many as four stakeholders on one side of a case – the litigant, a solicitor working on a CFA, an insurer and a funder – and Mr Amey observes: 'It has to be recognised as something to be managed carefully, with appropriate checks and balances. We have to be careful we don't lose sight of what the objective is.'

Regulation

While in Germany litigation funding doesn't fall under any existing regulatory umbrella, supervision of the industry is a live issue in the UK – with the CJC's July summit expected to back proposals for a 'light touch' in regulation. Topics of discussion include reforming the rules of court to allow for disclosure of funding details, a security-for-costs mechanism, and ensuring lawyers' independence from funders. At the moment, few cases are publicly known to be third party-funded, and Mr Eastwood notes that 'in theory there should be transparency'.

But most industry players believe regulation is not necessary for the higher-value end of litigation funding and are concerned it might stifle the market. Mr Amey comments: 'Companies can look after themselves. These are ultimately commercial deals, with representation by lawyers. The issue is whether there needs to be regulation for individual litigants in smaller cases.' Mr Stürwald similarly remarks: 'Some ground rules would help everyone, but I'm fairly comfortable with self-regulation. With cases running for one-to-two years, this business is not suitable for people after a quick buck. It doesn't attract back-street or rogue traders.'

Indeed, while there are many reservations about third-party funding for litigation, the industry has come a long way towards achieving respectability. Dr Blumenröder comments: 'A 30-40 per cent slice of proceeds seems extortionate at first, but once it is common practice and there are more players in the market to compare, it becomes more acceptable.'

But the main ammunition for supporters of third-party funding is their claim that it improves access to justice. 'Without these funding options, the impecunious client would get nothing,' Mr Eastwood points out. Or, alternatively, they would stand to lose more than they could ever contemplate.

Mr Amey admits: 'Certainly, some large corporations will benefit who don't need enhanced access to justice – but many companies do. Some who couldn't afford it will now be able to pursue litigation – albeit at a cost. In the end, although there are those who have seen third-party funding as an opportunity to make money, that's just the way it is. The fact is that it has nonetheless brought about access to justice.' ■