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THIRD PARTY LITIGATION FUNDING: PURCHASING A CONTENTIOUS CLAIM AS A FORM OF INVESTMENT

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Abstract
This paper analyzes the institution of third party litigation funding, which is virtually unknown in Romanian law but is constantly evolving and frequently used in other states. This institution refers to cases in which a specialized funding company provides funds to a party that pursues a financial claim against another party in a national or cross-border litigation or arbitration case so that upon the successful conclusion of the case the funder gets a share of the damages awarded to the funded party. The issue of litigation funding is not a new one. However, using third parties to fund the pursuit of financial claims is a relatively new phenomenon, increasingly common in the world of litigation. This fast-paced growth – from a procedure specific only to certain areas of practice and certain jurisdictions to a phenomenon that has become a part of everyday activities – has motivated us to analyze and explore the way in which third party litigation funding works, focusing on elements related to the contentious claim as a financial asset and its purchasing by the professional funder as a form of investment, on the stages leading to the formation of the parties' – the funder and the beneficiary – binding decision, as well as on the actual content of the funding agreement. Among the issues debated in relation to this institution there stand out the recent European Parliament resolution of 13 September 2022 with recommendations to the Commission on Responsible private funding of litigation, as well as the draft Directive annexed to the Resolution, which could lead to a considerable increase in the use of third party litigation funding in Europe.
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1. THIRD PARTY LITIGATION FUNDING – THE CONCEPT, ITS LEGAL NATURE, AND THE STAGES LEADING TO THE CONCLUSION OF THE FUNDING AGREEMENT

Cash flow will always remain the driving force of a business. For any company, the decision to use significant resources to finance litigation is a difficult one. Despite being risky and undesirable, litigation is occasionally the only solution if a customer must be forced to pay a debt or if a supplier must be forced to compensate the firm for the losses it has caused.

These two basic factors, cost and risk, are the criteria most frequently cited by litigants as determining the decision to seek alternative methods of litigation funding (Rowles-Davies, 2014).

The issue of litigation funding is not a new one. However, turning to third parties to get funds is a relatively new phenomenon, increasingly common in the world of litigation.

Its rapid rise from a procedure specific only to certain areas of practice and certain jurisdictions to a phenomenon that has become a part of day-to-day activities motivated us to understand and explore, in the present paper, the way in which third party litigation funding works, focusing on elements related to the contentious claim viewed as a financial asset and its acquisition by the professional funder as a form of investment, on the stages that lead to the formation of the parties' - the financier and the beneficiary - binding decision, as well as on the actual content of the funding agreement.

Third party litigation funding is the process whereby an entity called the funder, which has no direct interest in a case, pays the costs of one of the litigating parties, receiving in return a portion of the funded party's award. In the most common form of litigation funding, the funder's earnings are contingent on the success of the case and are paid out of the litigation proceeds (Johnson Jr., 2009; de Morpurgo, 2011).

Most financiers will request an amount that will be a multiple of the investment made or a percentage of the compensation awarded in the case, which will cover their initial investment, and an additional amount that will be their profit. Thus, funders typically seek to get a share of the award won in the litigation, which ranges from 15% to 50% depending on the costs and risks associated with funding the dispute.

Most specialist institutional funders are based in jurisdictions with an established or rapidly growing TPLF industry, for example Australia, the USA, or the UK (Ungureanu, 2018).

The funded party is usually the party that files a complaint. For example, as a prudent claimant, a commercial organization will want to consider all the available means to protect its business from the financial risks it may be exposed to during the litigation. Various methods of funding the case will be discussed. Besides having to pay its own lawyers, the claimant will need to consider the risk of paying the defendant's costs if the litigation outcome is not the expected one (Rowles-Davies, 2014).

The funding process will essentially involve a detailed analysis of the case and of the claimant-client, with a special focus on whether the potential defendant possesses the means to pay the estimated award in the event of a resolution that favours the client (Xiao, 2015).

This stage will include an internal risk assessment procedure (Shannon, 2015), but external legal opinions may also be sought. If the initial analysis is positive as far as the merits and grounds of the case are concerned, the funder will make an indicative funding offer, establishing a series of indicative terms which do not imply any obligation for the parties. Based on this, the funder and the customer will negotiate the initial terms of the funding agreement, which will be subject to further due diligence (Abrams and Chen, 2013).

If the result of the due diligence assessment (JDSUPRA, 2023) is positive, the next step involves finalizing the clauses of the actual litigation funding agreement.

We believe that most funders see themselves as investors, and given that litigation investment is a relatively new phenomenon, it is our opinion that recognizing and mentioning the funder's role and influence in the procedural rules applicable to commercial disputes is a step forward in ensuring that funders are constructive forces in the dispute resolution process.

At this point, we touch upon the issue of identifying the legal nature of the third party litigation funding agreement, as well as the economic nature of the third party litigation funding mechanism.

Thus, financial investments are inevitably transactional in nature because they involve from the start the investment of an amount of money by an investor who expects to receive back the amount invested, plus an additional amount, at some point in the future (Shannon, 2015). However, the same description applies to a loan, and in the latter case, interest rate regulations protect borrowers from excessive interest rate increases. The question naturally arises as to why third party funding is not viewed as a loan, but as an investment, and why are usury regulations not applicable to it?

There are several reasons. First, the funded litigant has no absolute obligation to reimburse the funder for the amount invested in the litigation (Shannon, 2015). If the client is the claimant, then the funder is repaid only if the claimant wins the case.

If the client is the defendant, the contingency fee is awarded as soon as the case is settled in favour of the defendant, and if the defendant loses, the funder will not receive the contingency fee at all (Cremades, 2011).

Second, litigation funding is non-recourse, which means that if the client loses the case, the funder cannot seize other assets of the client, unrelated to the litigation, in order to obtain benefits (Shannon, 2015).

Third, the litigation funder is looking for a much higher return rate than a traditional lender.

Fourth, further differentiating litigation funding from a loan, funders assume a greater risk than in the case of unsecured loans, because the loan agreement is a bilateral synallagmatic contract, while third party funding is a multilateral synallagmatic agreement. The lender and the borrower enter into an agreement based on a commitment by the borrower to repay the costs of the loan at regular intervals (Shannon, 2015), with no third party involved.

However, the funder and the client enter into an agreement based on an estimate of what a judge or an arbitrator might decide at an unknown future date, or an estimate of the settlement that the client and the opposing party might reach at an unknown future date. Thus, a litigation funding mechanism must rely on two additional actors (the judge or the arbitrator and the opposing party), which greatly increases the transaction’s risk.

Fifth, information is asymmetrical, because at the beginning of the funding procedure the funder and the client, as a rule, do not yet have access to documents or other evidence belonging to the other party, so they cannot foresee with sufficient certainty that they will win the case. Under these circumstances, we understand why it is not reasonable for third party litigation funding to be subject to the same restrictions as lending by traditional lenders (Steinitz and Field, 2014).

In fact, the funder and the client view the funder’s input as an investment and a variety of factors determine the rate of return on that investment. As such, unlike a loan agreement where the debtor knows at all times the value of the amount owed, the value of a litigation funding facility changes over time based on the actions taken and the information obtained during litigation or arbitration.

The funder buys the right to receive a share of the possible litigation award and continues to invest fuelled by the hope that the amount recovered will far exceed the initial investment in the future. Funders are not interested in getting only the amount they invested, therefore they will only invest if they assess that there is a real chance of multiplying their investment beyond the limit of their initial capital input. In fact, the funder often calculates the rate of return as a multiple of the amount invested rather than as a percentage of the amount recovered (Shannon, 2015).

From our point of view, it is certain that the funders’ expectations regarding their return on capital and profit are similar to the expectations that creditors have regarding their return of the initial loan and, additionally, the interest paid. On the other hand, the obligation of the third party funded client to repay the funds is contingent on the recovery of the claim upon the resolution of the litigation. Thus, unlike in the case of a loan, the client does not have an absolute obligation to repay the funds to the funder or to provide the funder with a profit, the obligation being conditional on obtaining the litigation award.

Considering all the preceding arguments, it is the author’s opinion that the legal nature of the third party litigation funding agreement is not that of a loan, but that the economic nature of the third party litigation funding procedure is that of investment.

The European Parliament Resolution of 13 September 2022 with recommendations to the Commission on Responsible private funding of litigation (2020/2130(INL)) itself refers to litigation funders as private investors, stating that commercial third party litigation funding (TPLF) is a growing practice whereby private investors (“litigation funders”) who are not a party to a dispute invest for profit in legal proceedings and pay legal and other expenses, in exchange for a share of any eventual award.

The European Parliament and the Council of the European Union have elaborated, annexed to this Resolution, a proposal for a Directive on the regulation of third party litigation funding, which supports an idea already advanced in legal literature, namely the introduction of regulatory standards by category: transactional (concerning the conclusion of the funding agreement), procedural (litigation in court) and ethical (Shannon, 2015).

This kind of model-regulation establishes guidelines upon which states could build and adapt their laws, using common, harmonized regulatory standards to foster transparency and safety in the third party funding industry, while removing the lack of trust and any concerns regarding the involvement of funders in the resolution of disputes.

Each jurisdiction and legal system could adapt each of these regulations to their own domestic needs, and cross-border collaboration to design the general principles governing third party funding would require jurisdictions to familiarize themselves with the rules of other jurisdictions. Moreover, local courts would learn the rules applicable to a case in order to recognize, enforce, dismiss, set aside, or invalidate the damages obtained in a case funded from another state (Shannon, 2015).

2. THE ADVANTAGES OF THIRD PARTY LITIGATION FUNDING

The rise of litigation funding in recent years is the result of several different factors, including its widespread availability and the unavailability of public funds in general.

Risk aversion, more than the inability to pay expenses, is also an important reason for the growing popularity of funding.

In what follows we will explore one of the outstanding advantages of using this procedure, i.e. maintaining the financial stability of the company that has decided to use this mechanism.

The potential impact on the company's economic and financial viability and stability may deter a party from taking its dispute to court.

Third party funding transfers the responsibility of covering legal expenses to the funder, thus giving more companies the opportunity to engage in litigation while giving them the security needed to maintain sufficient cash flow to avoid financial problems (Kirtley and Wietrzykowski, 2013). Thus, when pursuing a claim that meets all the conditions to be found meritorious, they can continue their usual activity or even invest in new activities. Companies could withdraw from litigations if their possible continuation would endanger their liquidity. At that moment, they will weigh up the factors that could lead to the biggest problems: lack of liquidity, which would translate into the stagnation of the business, or giving up the claim and stopping the litigation. Funding can be a solution to this dilemma, as it allows the party using it to remove the financial risk and the litigation cost from its financial situation, transferring them to the funder, while at the same time being able to continue its usual activity (de Boulle, 2014).

In many litigations, the main concern is the possible loss of the case, which would mean that the claimant would be liable not only for their own legal expenses, but also for the defendant's costs (de Boulle, 2014). The ability to disseminate and share these financial risks with a third party can be attractive even to clients with strong businesses and cash flows.

Below, we will examine how a company can benefit from the transfer of the risk associated with a litigation investment and why an entity that owns a portfolio of litigation claims is better able to bear and manage this risk.

Thus, from an economic point of view, legal actions based on monetary claims are regarded as patrimonial assets, being similar to bonds or other financial instruments; once a award is obtained through a court decision or through a judicial transaction, it gives the creditor of the claim the right to be paid under the stipulated conditions. Unlike a bond, however, it is uncertain whether the asset will actually mature. A bond entitles the holder to payment by itself. However, to become a value, a contentious claim must survive legal system proceedings.

Thus, an investment in a single legal claim carries substantial risk (Drucker, 2015).

Using litigation funding allows a company to better manage and fund its litigation claims and to improve the productivity of its resources overall.

As an illustration, let us imagine a company facing the prospect of having to take legal action to repair an injury and obtain damages.

As stated above, the legal claim (i.e., the litigious claim) can be viewed, from an economic point of view, as an asset, an asset that can be *monetized* (converted into money).

The company should take the following steps when considering whether to monetize the asset represented by the disputed claim: the first step is to estimate the litigation budget. The budget should include all the fees and expenses related to the litigation, at all its procedural stages (Drucker, 2015).

The second step involves approximating the duration of the litigation, and the third step, determining the estimated return on the company's investment.

In the fourth stage, the company carries out a cost analysis of the opportunity to promote the legal action, by summing up the costs of the litigation itself and the opportunity cost of giving up other operational uses of the capital (business operations, for example, marketing, capital expenditure, research and development, etc.).

The maximum return comes from investing monetary funds in litigation (proceeding with the legal action) because the return profile of litigation investment is binary [1], while the return profile of business investment has a wide range of likely outcomes.

The use of third party litigation funding is advantageous to the company, as it creates the highest expected return and the narrowest range of potential outcomes. The company can monetize its litigious claim and invest in its business. Similarly, by using the third party litigation funding mechanism, a company that defends itself in a dispute can optimally protect its own capital by continuing to invest in business-related projects (Drucker, 2015).

Many of the companies that benefit the most from third party litigation funding are in the growth phase of their life cycle, and many of these companies seek to generate profits by rapidly increasing their company valuation. In a favourable economic environment, companies can reach valuations that exceed their revenues by as much as 20 times.

Litigation income is considered non-operating income, being reported on an income statement separated from operating income, and is generally viewed as a one-time gain rather than recurring profit (basis of valuation). This means that when considering the impact of an investment on the value of a company, the return generated by an investment in the company whose litigation requires funding will be given a greater weight and thus the value of the company's return is maximized by its use of litigation funding; the company's valuation is superior when using this mechanism compared to business-only investments or litigation-only investments (Drucker, 2015).

Let us now answer the question of why a litigation funder has a greater ability to support and manage the risk associated with monetizing a legal claim.

As shown above, litigation funding can help a company to optimally allocate its resources. This is possible because the litigation funder places a higher value on the disputed claim than the company.

In other words, the litigation funder is willing to invest the necessary amount in the litigating company, in exchange for (i) the return of its capital and (ii) a fraction or percentage of the remaining revenues obtained in the litigation, while the economic director of the company may have difficulties in making the same investment in exchange of the full amount obtained after winning the litigation.

But why does the litigation funder place a higher value on the litigious claim than the company? The answer is that out of the two potential investors in the asset represented by the disputed claim the litigation funder incurs a lower capital cost (Drucker, 2015).

The cost of capital is the level of profit required to own an asset. In general, investors must be compensated for both the time value of the money invested and the risk that the return on an asset (in this case, the disputed claim) will be less than the expected return (i.e., the return of the investment plus profit, from the award received after winning the claim in court). The assets that hold a higher risk require higher returns and involve a higher capital cost (Drucker, 2016).

To conclude, holding a diversified portfolio of litigation claims reduces abruptly the risk associated with investing in a single legal claim and therefore allows an investor to invest in the litigious claim for a substantially lower compensation.

Since a funder holding a portfolio of assets consisting of legal claims requires less compensation for investing in the contentious claim (having a lower capital cost because the risk is lower), the same asset is worth more to the funder than to a company that has only one (or a few) litigious claim(s).

3. CONCLUSIONS. CREATING A SECONDARY MARKET FOR LEGAL CLAIMS

The rise of the third party litigation funding sector - representing the primary market for legal claims - has also had collateral effects. Thus, in recent years, a secondary market for legal claims has also developed. More often than not, this secondary market takes the form of litigation funding companies that begin to sell shares and go public (Stenitz, 2011).

In the future we may also see the creation of a new type of securities, legal-claim-backed securities.

The literature provides several examples of creditors specialized in litigation funding who already use the aggregation (pooling) of the legal claims they agreed to fund [2], and sell shares issued on the receivables represented by these legal claims (Stenitz, 2011).

The idea that the securitization of this new class of assets, i.e., legal claims, could become a reality in the near future is further supported by the observation that the first wave of third party litigation funding as a primary market also generated a series of secondary transactions based on legal claims. Thus, some litigations were financed by trading (i.e., selling shares issued based on claims), and there are even some cases when the shares issued based on claims subject to future court decisions were traded on Nasdaq (Stenitz, 2011).

NOTES

[1] Win or lose.
[2] *Aggregate claims* refer to the total value of receivables based on legal claims.

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