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Arms Race: The Litigation Funding Boom

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Body

In November news came out in an employment lawsuit that Gerchen Keller Capital LLC, the nation's largest commercial litigation funder, had poured $93 million into a fly-speck of a Texas plaintiffs firm called AkinMears. Unlike the traditional funding of a single lawsuit, the cash infusion was structured as an advance on AkinMears' expected windfall on its docket of mass torts claims, including roughly 15,000 trans-vaginal mesh claims it would acquire using Gerchen Keller funds. The investment in a claims-bundling firm, known not for trial work but for multimillion-dollar TV blitzes aimed at potential mass tort claimants, was a far cry from the funder's usual customers: companies with big business disputes or their Am Law 200 firms. Equally unusual was the fact that this funding arrangement had become public at all.

Around the same time, two rival funders, Burford Capital Ltd and IMF Bentham Limited, were making their own big bets, both overseas. In November, Burford said it would commit $33 million to help Hausfeld LLP start up operations in Germany and to spearhead cartel suits; then, in December, Hausfeld and Burford unveiled a joint venture to bring thousands of consumer claims against Volkswagen AG stemming from the automaker's admission last fall that it had cheated on emissions tests. Bentham, meanwhile, retained Quinn Emanuel Urquhart & Sullivan to prepare a massive shareholder lawsuit against Volkswagen under Germany's Securities Trading Act.

Deals like these show the nascent commercial litigation finance industry flexing its financial muscle in unprecedented ways. Investor money is pouring into funders' coffers, drawn by better-than-private-equity returns unlinked to the economy. The new investments are quite different from the single-funded-case model upon which they were built.

The U.S. Chamber of Commerce says all the cash flowing into litigation will increase costs for American companies, by triggering an onslaught of frivolous filings, prolonging litigation and raising settlement costs to meet demands of third-party investors. "Let's not fool ourselves," says Lisa Rickard, president of the chamber's Institute for Legal Reform. "You pour more money in, you're going to get more lawsuits. If that doesn't scare American companies, I don't know what else would." The chamber is pushing for a ban on investor control of cases, required court disclosure of funding contracts and a prohibition on the use of third-party funding in class actions, among other restrictions.

Common sense suggests that an explosion of meritless litigation isn't likely, since outside investors have a financial interest in backing only the strongest claims. But some lawyers say the arrangements raise ethical red flags. They note the potential for third-party investors to exert influence in case strategy or settlement negotiations. Funders are increasingly encouraging plaintiffs to pick firms they approve of; other times, they team up with firms to fund portfolios of cases. As the law firm-funder relationship gets closer, some lawyers worry that the interests of a client and a firm could diverge.

"There has always been discomfort about the role of money in the profession," says Geoffrey Miller, co-director of New York University School of Law's Center for

Civil Justice. By adding investors to the litigation ecosystem, "are we losing something?" he asks. "Do we degrade our professionalism? Do we create in the public's mind the sense that law is all about the money?"

Global firms, in particular, are wondering whether they could be liable if a funded case goes awry. In December, Clifford Chance agreed to pay a confidential settlement to resolve a dispute with a hedge fund that had helped pay its fees in a disastrous suit in London's commercial court. That $1.65 billion suit, between an aspiring oil exploration company, Excalibur Ventures, and a group of oil industry majors, ended with a loss for Excalibur; in 2013, the funders were ordered to pay the defendants' costs. Then, one funder, a small hedge fund, went after Excalibur's law firm, Clifford Chance. The dispute "puts a chill on firms where a funder is paying their monthly invoices," says the leader of a top U.S.-based global firm. "Everyone knew that the client could go after you. But this is the first case where the funder has."

Despite the industry's lack of transparency, one thing is clear: More major law firms are taking advantage of litigation funding. The big winners include corporate clients, who can pursue business disputes at a lower cost, and their law firms, including Am Law 200 firms with the most active plaintiffs-side dockets. By offloading the risk of contingency work, these firms are taking on cases that they would have had to turn down, while retaining some of the contingency-fee upside. Defense firms are winners too; they're busy clocking hours against now equally well-lawyered opponents in cases that, without funding, might never have been pursued or have withered early.

Litigation finance is "not only good for the clients, who can get the certainty they want at a better cost, it's good for the outside lawyers who really believe in the case and want to take it on but aren't in a position to take on the risk," says Sidley Austin partner Robert Hochman, who has helped clients tap Gerchen Keller to fund several cases.

"My experience with funders is, all I've seen is growth," says Kirkland & Ellis partner Reed Oslan, on a break from a breach of contract trial against Caterpillar Inc. in Chicago, where his client, a small U.K.-based manufacturer, is backed by a funder. "More people are contacting me about funding, and bigger funds are being poured into cases," says Oslan, who heads Kirkland's committee in charge of alternative fee arrangements. But funders' increasingly high profile is now drawing congressional scrutiny. And some kind of regulation, ultimately, is likely.

An Evolving Business Model

Personal injury and divorce litigation funders have been around for decades, but specialized commercial funders arrived more recently, around 2000 in Australia and around 2005 in the United Kingdom. The funding of commercial suits in the United States dates back only to about 2006, when Credit Suisse Securities (USA) LLC formed a litigation risk strategies unit. Another funder, Juridica Investments Ltd, which focused on the U.S. litigation market, went public a year later, followed by Burford in 2009.

Credit Suisse's unit shut down, constrained by conflicts with its banking clients, but its former staffers now populate the top ranks at both Bentham's U.S. subsidiary, launched in 2011, and Parabellum Capital LLC, launched in 2012.

Originally, funders followed the same model, funding one-off suits with an expected recovery of at least $25 million. As a rule, funders don't invest more than 10 percent of an expected recovery. If the plaintiff loses, the funder gets nothing. The model remains the core of Bentham's business, says Ralph Sutton, the funder's chief investment officer. He says the traditional model helps ensure that cases will be adjudicated on their merits, rather than who can best afford to lawyer up- leveling the playing field in a David-and-Goliath scenario. The U.S. litigation system "is a Rolls-Royce, and no one can afford the gas," Sutton says. "The Fortune 1000, maybe, can, but most Americans work for small companies. What litigation funding does is give those small companies amazing firms."

The number and size of commercial investments are growing. Since 2013, Gerchen Keller's average investment in a new case has increased from $3.4 million to $10.7 million. But the docket of high-stakes commercial litigation remains limited. Sutton estimates that the industry collectively made 75-100 case investments in 2015. "It's extremely hard to find a good high-stakes contract dispute," says Oslan, noting that his firm has self-funded many cases that funders would love to get a piece of. "There just aren't that many great cases out there," he says. "And if we really believe in the case, we'd rather keep it and fund it ourselves."

But with investor dollars pouring in, funders need new places to deploy their capital. Gerchen Keller, for example, cut deals this fall with several Am Law 200 firms to provide up-front cash in exchange for a portion of the firm's year-end accounts receivable. If a firm expects $40 million in litigation fees, "we might purchase $20 million for $19 million," says founder Adam Gerchen. "We think of litigation finance not just as funding cases," says Ashley Keller, Gerchen's co-founder. "We view it as a one-stop, full-service capital provider where litigation is the underlying asset."

This year, Gerchen and Bentham both unveiled another new product: defense-side litigation finance. In this scenario, a funder agrees to cover a portion of a defendant's legal bills. The better the outcome, the more the defendant has to repay the funder above the amount funded. There have been relatively few takers so far. "Everybody says they're going to do it, but nobody actually does it," says Bentham's Sutton. "To define success on the defense side, you have to define the outside liability you are likely to suffer. And that's very hard to do."

Another push is into late-stage or postjudgment financing. The notion of striking deals with funders is particularly attractive to firms and their clients after a big verdict, when an appeal puts that recovery at risk. After years of parrying scorched-earth defense tactics in a major False Claims Act case and millions of dollars in unbilled time, lawyers at one Am Law 200 firm won a nine-figure jury verdict in June for a whistleblower client. Funders offered the firm a payment of about half what it would have earned in hourly fees. If the award is overturned, the payment is the firm's to keep; if it withstands appeal, the firm gets most of its

contingency fee, even after repaying double the advance.

Last year, Gerchen Keller rolled out a new $475 million fund focused on late-stage litigation, which it considers a lower-risk investment. One of its first investments was the $93 million advance to AkinMears.

Details of the arrangement came out in a breach of contract suit brought by a former AkinMears executive who arranged the Gerchen Keller advance but didn't get the commissions he claimed he was owed. The suit did not allege any misconduct by Gerchen Keller. "AkinMears is nothing more than a glorified claims processing center where the numbers are huge, the clients commodities and the paydays, when they come, stratospheric," the former employee wrote in a September complaint in state court in Houston.

Gerchen appeared eager to front AkinMears the money, taking a few weeks to negotiate a cash infusion. AkinMears then used both to refinance its debt to a law firm lender, Virage Capital Management LP. The funds also helped finance the acquisition of 15,000 more transvaginal mesh mass torts claims. AkinMears stands to collect perhaps $100-200 million on those and other mesh claims; Gerchen Keller, for its part, gets its advance back, plus a 16 percent interest rate, lower than the 24 percent loan Virage had offered.

Gerchen Keller wouldn't comment directly on the investment except to say that it works with firms that use a variety of business models. When litigation is at a very late stage, "as long as it meets our size threshold, we're relatively agnostic about the type of litigation," says Gerchen Keller managing director Travis Lenkner, a former Gibson, Dunn & Crutcher associate and senior counsel at The Boeing Company. "This is pure time-value of money. This isn't venture capital funding new mass torts." In October, in fact, Gerchen explicitly disavowed early-stage mass torts investment in its newest $400 million early-stage litigation fund.

Meanwhile, other financial institutions remain deeply invested in mass torts. They include AkinMears' original investment bank lender, Virage, which has a "strategic relationship" with J.P. Morgan Alternative Asset Management.

Like Gerchen Keller, Burford is moving away from funding single cases to a broader litigation-linked finance model. Last year, about 14 percent of Burford's capital was in "complex investments" and 50 percent in portfolios of cases. The one-off cases that originally made up all its business accounted for just 37 percent of investments. "This is, for us, a corporate finance company," says founder and CEO Christopher Bogart. Burford doesn't shy away from its interest in investing in U.S. mass torts. In October, it co-sponsored a popular plaintiffs-side conference, "Mass Torts Made Perfect," in Los Angeles. The same month, it announced its $33 million commitment to Hausfeld.

Bentham, staying closer to its roots, is now moving toward a closer relationship with a few firms. In late November, its U.S. unit announced that it had established formal ties with 10 law firms (though only two were identified) to fund portfolios of cases. Stephen Weisbrod, of Washington, D.C., litigation boutique Weisbrod Matteis & Copley, says Bentham's portfolio funding has allowed his firm to grow. "This is a pretty new field," he says, "so if you can come up with something that's logical for both sides, then there's a good chance a funder would do it."

Such diversification is critical for funders. One early entrant, BlackRobe Capital Partners LLC, shut its doors in May 2013, blaming internal disagreements and too little new outside capital. And in November, Juridica halted new investments after some litigation setbacks and constraints on its capital-raising. "Scale and diversity are now required in order to invest successfully in this asset class, which is not achievable under the company's existing structure," Juridica's chairman, Lord Daniel Brennan, said at the time.

Who's in Control?

Commercial funders generally ask that a funded law firm agree to underwrite some fees in exchange for a larger upside of a funded matter. They reason that this aligns the economic interests of the funder, the client and the firm.

But the incentives to clients and law firms are somewhat distinct. Companies like funders because outside funding allows them to bring strong claims and hire top-flight counsel without betting their operating funds on a win. Their counsel want to increase profitability while eliminating the downside risks of taking cases on contingency.

Increasingly, firms are testing the waters. Bentham's Sutton lists 18 big firms that are either participating in or seriously discussing funding relationships. They include Boies, Schiller & Flexner; Cadwalader, Wickersham & Taft; Cravath, Swaine & Moore; Hunton & Williams; Latham & Watkins; Jones Day; Katten Muchin Rosenman; King & Spalding; Kirkland; Kramer Levin Naftalis & Frankel; McDermott Will & Emery; Quinn Emanuel; Pillsbury Winthrop Shaw Pittman; Robins Kaplan; and Proskauer Rose. We contacted each of these firms. Several declined to comment, but none disputed that they had explored funding. Others acknowledged that they handle funded cases.

"We often advise clients about this option in contingency and noncontingency cases we are handling, such as when we have obtained a judgment for a client and that judgment is being appealed," says Pillsbury insurance recovery co-head Peter Gillon. McDermott trial practice head Lazar Raynal says that despite the fact that most of the firm's work is defense-side, "we certainly are exploring it, and have been for some time." It's particularly common in the restructuring area, where liquidation trustees don't have funds to pursue claims. "I think you're going to see more of that," he says. Crowell & Moring has openly talked about participating in funding arrangements. Former chair Kent Gardiner told the Wall Street Journal two years ago that the firm had participated in a dozen funded cases for large companies. Bogart, a former Cravath associate and Time Warner Inc. general counsel, says Burford has spoken with lawyers from most Am Law 100 firms, though he won't name them. In 2010, for example, now-retired Simpson Thacher & Bartlett trial veteran Barry Ostrager famously used Burford to help fund a real estate development litigation in which his client won $110 million.

"In our view, the risk of a case does depend on the quality of the lawyers pursuing it," says Burford chief investment officer Jonathan Molot. Like insurance contracts, Burford's agreements include a provision that, if a client replaces the lawyers on a funded case, they "can choose any firm [they] want among a certain set of top law firms," Molot says.

Boaz Weinstein, a cofounder of Lake Whillans, says that when a new case comes in without sufficient trial firepower, "we ask ourselves, 'Who's the right lawyer for [this] specific matter?' We have a roster, and are always adding new firms to it." Often, the lawyer getting that referral is one who has brought cases to the funder before, he says.

But the process of picking counsel raises questions, says John Desmarais, who left Kirkland in 2010 to form Desmarais LLP. "Is the law firm going to be more loyal to the funding company if they know they're going to get more business from it?" he asks. In a typical contingency relationship, firms and clients split the outcome, and everyone's interests are aligned. But in funding contracts, he says, the funder "takes the first dollars. So say you have a potential judgment of $50 million. The funder put in $5 million. The defendant offers to settle for $10 million to $15 million. But that $10 million to $15 million goes to pay the funder. [The funder] is really happy with an offer to settle at that level. And they are going to press that plaintiff to settle." Often, he says, there will be a clause that "if we recommend that you take a settlement and you refuse, that's your choice, but you will have a financial obligation to us of X dollars."

Critics cite a 2009 case involving Altitude Capital Partners, a private equity firm that invests in patent lawsuits. In 2007, it loaned $8 million to a startup, Deep Nines Inc., to fund an infringement suit it valued at $200 million. Deep Nines promised to repay the loan with interest and a stake in the recovery. But in the end, it settled for just $25 million. After Altitude recovered $10 million, Fish & Richardson was paid $11 million, local counsel $1 million, and expenses ate up $2 million, there was just $800,000 for Deep Nines.

Altitude isn't a big player in the current commercial litigation finance industry, note the specialized funders, who say that they won't get involved in a case unless their due diligence, often performed by former Am Law 200 lawyers, indicates a strong likelihood of a large return for the plaintiff.

Bentham, for example, won't provide funding unless its models predict that the plaintiff will receive at least 50-60 percent of a recovery. In 2014, the funder posted a "code of best practices" on its U.S. website. While the code promises overall fairness, transparency and accountability in its dealings with claimants, it can't quite conceal the fact that the funder, by providing risk capital, acquires a measure of control. The code notes that "the claimant, counsel and the funder shall consult in good faith as to the appropriate course of action to take in connection with all settlement demands or offers"; if there's a dispute, funders generally require that it be arbitrated.

Bentham, Gerchen and Lake Whillans directed us to some clients and counsel they have worked with. Those clients insisted that the funders take a hands-off approach. "One of the big misconceptions out there is they want to manage your litigation for you," says Swanson, Martin & Bell partner William Patterson. As an in-house counsel at Business Logic Holding Corp., a financial software company, Patterson chose Lake Whillans to help fund a trade secrets case against Morningstar Inc. That case, in which Lake Whillans invested $3 million to $5 million, ultimately resulted in a $61 million verdict, about 95 percent of what Business Logic had sought. Business Logic also selected a Houston trial boutique at Lake Whillans' urging. "They want to find good cases with good lawyers working on them and then get out of the way," Patterson says.

King & Spalding Silicon Valley managing partner Timothy Scott, whose tech clients have used funders four times, also says he hasn't felt pressure to accept lowball settlements. "They didn't exercise one whit of control," Scott says. "They did not attend the mediations. We called them to bounce ideas off of them, but we made our own decisions."

The Regulation Question

So far, the industry has operated in a relative vacuum of disclosure and without regulation. Despite tacit approval from courts and the American Bar Association, that may soon change.

The ABA examined the issue of litigation finance in 2011 in a widely circulated white paper, but was unable to conclude whether regulation was needed. "It is difficult to generalize about the ethical issues ... 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," wrote the authors, who included judges, academics and private practitioners. But the authors advised lawyers to approach third-party funding carefully, to be mindful of their obligations to their clients and to "not permit a third party to interfere with the exercise of independent professional judgment." The Advisory Committee on the Federal Rules of Civil Procedure has also declined to amend Rule 26(a) to require disclosure of third-party investors, noting that judges have the power to obtain funding information if they feel it is relevant.

Meanwhile, federal and state judges have generally ruled that the arrangements need not be disclosed to jurors. In a widely cited decision last year, the judge overseeing discovery in Oslan's trade secrets case against Caterpillar ruled that Caterpillar couldn't compel release of the deal documents between the plaintiff and funder. The judge rejected the notion advanced by the defense that the funder was the "real" interested party. "A shared rooting interest in the 'successful outcome of a case,'" wrote U.S. Magistrate Judge Jeffrey Cole, "is not a common legal interest."

Now, it's Congress' turn to weigh in. "Litigation speculation is expanding at an alarming rate," Senate Judiciary Committee chairman Charles Grassley (R-Iowa) said in announcing a probe of the industry in August. Because "these arrangements lack transparency, the impact they are having on our civil justice system is not fully known." The committee asked Burford, Bentham and Juridica for details on their investments, clients and contracts.

"I completely reject the accusation of secrecy here," says Bogart, of Burford. "We publish significantly more about our financial performance and what we do than any hedge fund or average private equity firm." As of mid-December, the three had resisted handing over the materials, citing nondisclosure agreements and arguing that the contracts are proprietary. A hearing on the issue hadn't been scheduled.

Some kind of regulation appears likely, says University of Iowa College of Law professor Maya Steinitz, who has studied the industry. Rather than restricting plaintiffs' access to capital, she favors regulating it as just another form of corporate finance. Doing so, she says, would make regulation more straightforward; it might include capitalization requirements, so that funders keep skin in the game. As a baseline, she says, the process "should be profitable for funders, otherwise they won't do it."

And what about law firms? As clients increasingly demand outside funding, firms will need to adapt-and some will win new business because of it. "How can any law firm come out against the concept when multiple bar associations have held public debates and concluded otherwise?" says Latham & Watkins chair William Voge, adding that, in the end, "the decision on whether to use litigation funding firms is for the client-not the law firm."

Correction: An earlier version of this story incorrectly identified Burford Capital Ltd CEO Christopher Bogart as a former partner at Cravath, Swaine & Moore. He was a litigation associate at the firm. Also, the story has been revised to clarify that a breach of contract suit filed against AkinMears by a former employee did not allege misconduct by litigation funder Gerchen Keller.

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