



December 22, 2011

## **U.S. Chamber Institute for Legal Reform Comments on the Code of Conduct for Litigation Funders**

The Civil Justice Council (the “CJC”) has proposed a draft Code of Conduct to govern third-party litigation funding providers (“Litigation Funders”) under the auspices of a proposed voluntary association, the Association of Litigation Funders. The proposal for regulating Litigation Funders envisioned by the draft Code implicitly recognizes that third-party litigation funding threatens to undermine consumer interests and foster litigation abuse. The Code, however, is inadequate. As a threshold matter, it does not have the force of law. The only way to adequately safeguard the rights of consumers and defendants – and promote the orderly administration of civil justice – is to enact a statute that is binding on all Litigation Funders.

In addition, the self-regulatory code does not address the risks and concerns about litigation funding raised by the Right Honourable Lord Justice Jackson in his review of civil-litigation costs, which also examined an earlier draft of the CJC’s proposed self-regulations.

Of greatest concern, the Code: (1) contains a number of troubling provisions that would tolerate, if not promote, funding misconduct and incentivize lawsuit abuse; (2) does not address the unique dangers posed by litigation funding in collective proceedings, a practice that we strongly believe should be banned; and (3) does not contain adequate safeguards against litigation abuse. These concerns, which we discuss in more detail below, mirror the questions ILR raised in its October 25, 2011 letter to The Right Honorable Kenneth Clarke QC MP.<sup>1</sup>

---

<sup>1</sup> In its October 25, 2011, letter to Lord Chancellor Clarke, ILR expressed the concern, among others, that a self-regulatory code of conduct would be inadequate to safeguard against the serious dangers posed by litigation funding. *See* Letter from Lisa A. Rickard to The Rt. Hon Kenneth Clarke QC MP (Oct. 25, 2011).

## I. THE CODE CONTAINS A NUMBER OF TROUBLING PROVISIONS.

Litigation funding is a profit-motivated business, the goal of which is to maximize the Litigation Funder's return on any lawsuit investment. Because the primary objective of Litigation Funders is to protect their investments, they will inevitably seek to exert control over strategic decisions regarding prosecution of a claimant's case. This harms consumers and invites lawsuit abuse.

The Code contains a number of provisions that will invite such abuses.

**First**, section 1 of the Code provides that the Code sets forth the standards applicable to Litigation Funders who are members of the Association of Litigation Funders of England and Wales. This statement apparently means that funding providers who are not Association members will not be bound by the Code.<sup>2</sup> Permitting Litigation Funders to choose whether to comply with the Code will ensure that it is ineffectual. The only way to effectively regulate third-party litigation funding is to make it the law that *all* Litigation Funders must abide by a set of legal mandates that governs their behavior.

**Second**, the Code provides no mechanism for disciplining Association members who violate it. As such, it will not deter misconduct by Litigation Funders. The lack of any "teeth" to enforce compliance with the Code highlights the fundamental problem of self regulation. If the CJC's working group were serious about regulation, it would have adopted a meaningful mechanism for ensuring that it is followed.

**Third**, an additional problem with the Code is its inadequate definition of litigation funding, which makes unclear the sorts of transactions that the Code is intended to regulate. Section 2 of the Code provides, in its entirety:

A Funder has access to funds immediately within its control or acts as the exclusive investment advisor to an investment fund which has access to funds immediately within its control, such funds being invested pursuant to a Litigation Funding Agreement (LFA) to enable a Litigant

---

<sup>2</sup> ILR noted this deficiency in its comments to the previous version of the Code, which it submitted on September 3, 2010. See *Response of the U.S. Chamber Institute for Legal Reform to the Civil Justice Council's Consultation Paper regarding a Self-Regulatory Code of Conduct for Third-Party Funding Providers* ("ILR Response") at 8. The deficiency has not been corrected.

to meet the costs of resolving disputes by litigation or arbitration (including pre-action costs) in return for the Funder:

- (a) receiving a share of the proceeds if the claim is successful (as defined in the LFA); and
- (b) not seeking any payment from the Litigant in excess of the amount of the proceeds of the dispute that is being funded, unless the Litigant is in material breach of the provisions of the LFA.

This definition is unclear and risks omitting some types of funding transactions from the ambit of the Code.<sup>3</sup>

Once again, the fact that the working group is proposing such a narrowly-tailored definition illustrates the fundamental problem underlying the drafting process – i.e., that the Litigation Funders have every incentive to make the Code weak and ineffective. A code that lacks a true definition of litigation funding is inherently suspect. At a minimum, in order to be effective, any code or statute regulating litigation funding must include a definition of litigation funding that precisely and accurately describes the types of conduct at issue, such as the following:

A Funder is any person who engages in litigation funding.

- (a) Litigation funding means:
  - (i) Providing to any person or group of persons who is or may become a party to any legal proceeding, or to a solicitor or barrister representing such person or group of persons, any money or its equivalent, with the repayment of such money or its equivalent conditioned upon and sourced from the person's or group's proceeds of the legal proceeding, by judgment or settlement or otherwise; or
  - (ii) Providing to any person or group of persons who is or may become a party to any legal proceeding, or to a solicitor or barrister representing such person or group of persons, any money or its equivalent, in exchange for a

---

<sup>3</sup> Despite the shortcomings of this definition, we note that, unlike the prior version of the Code, this version does not contemplate that Litigation Funders will be permitted to offer undefined “ancillary services,” which, as ILR previously noted, is an invitation to abusive practices. *See ILR Response* at 4.

right to receive any portion of any proceeds of the legal proceeding, by judgment or settlement or otherwise; or

(iii) Purchasing from any person or group of persons who is or may become a party to any legal proceeding, or from a solicitor or barrister representing such person or group of persons, or receiving an assignment from such person, group of persons, or solicitor or barrister of a contingent right to receive a share of the potential proceeds of such legal proceeding, by judgment or settlement or otherwise.

(b) Notwithstanding subsection (a) of this section, litigation funding does not include any extension of credit from any person to any solicitor or barrister where the solicitor's or barrister's obligation to repay the extension of credit is not contingent upon the outcome of a specified lawsuit or lawsuits in which the solicitor or barrister is representing a person other than the solicitor or barrister, whether or not the credit agreement provides the creditor a security interest in any proceeds of any lawsuit in which the solicitor or barrister is representing a person other than the solicitor or barrister.

**Fourth**, section 6 of the Code provides that an LFA is binding, but unlike the prior version of the Code, this draft does not require that LFAs be in writing. We do not understand why such an obvious requirement would have been deleted. It should be restored.

**Fifth**, section 7 of the Code provides that, before entering into an LFA with a borrower, a Litigation Funder must take "reasonable" steps to ensure that the borrower receives "independent" advice on the LFA. The Code does not require, however, that such advice come from a solicitor other than the borrower's trial counsel, who has an obvious pecuniary interest in whether or not the borrower has sufficient funds to pay trial counsel's fees.

**Sixth**, section 7 of the Code requires Litigation Funders to have adequate capital to cover their funding liabilities for 36 months. Given that complex cases may require funding over a period in excess of 36 months, particularly where funding is to be provided during the pre-action phase, for appeals and/or in support of enforcement proceedings, this obligation does not provide adequate protection for litigants.

**Seventh**, section 8 of the Code provides that an LFA must disclose whether the Litigation Funder will be liable for adverse costs. The Code does not, however, require that Litigation Funders agree to pay any opposing party's costs in the event the court issues an order for costs. This is not consistent with Jackson LJ's, recommendation that Litigation Funders should be liable for the full amount of any adverse cost orders, subject to the court's discretion. We agree with Jackson LJ's, recommendation and believe it should be reflected in the Code. Permitting Litigation Funders to decline to cover adverse costs orders against the litigants whose cases they fund could lead to consumers being pushed toward insolvency in the event their cases are not successful and opposing parties pursue *them* for adverse costs instead of their Funders (whose role in the case need not have been disclosed). The litigation funding industry's business model is to take a percentage of any damages awarded to their clients; in fairness, Funders must also accept the risk of paying adverse costs in the event their clients lose.<sup>4</sup>

**Eighth**, section 9 of the Code provides that an LFA may allow a Litigation Funder to terminate funding a case if it "reasonably ceases to be satisfied about the merits of the dispute" or if it "reasonably believes that the dispute is no longer commercially viable." But as with the Code's disclosure provisions regarding a Funder's liability for adverse cost awards, mere disclosure of these issues is inadequate. Rather, Funders should be required to continue funding disputes until they are finally resolved. Such a requirement will incentivize Litigation Funders to carefully research the claims they intend to fund. In addition, whether a claim is "commercially viable" may be a function of a claimant's trial or settlement strategy. Permitting a Litigation Funder to withdraw funding for commercial viability would give Funders inordinate control over litigation.<sup>5</sup>

**Ninth**, section 9 also explicitly provides that the LFA may allow the Funder to "provide input into the Litigant's decision in relation to settlements." We believe that Funders should not be permitted to influence settlement.<sup>6</sup> This is not a disclosure issue. It must be remembered that the interests of Funders and consumers are not necessarily aligned. Consumers seek redress for perceived injuries whereas Funders use consumers' cases to make a profit. Funders' incentives in relation to settlement may be influenced by the manner in which their fees are calculated. Accordingly, permitting Funders to have a say in whether a consumer settles a case risks creating a conflict of interest between Funders and consumers regarding how to prosecute cases. In this respect, it also bears noting that because Litigation Funders and attorneys are

---

<sup>4</sup> ILR made a similar argument in response to a similar provision in the prior version of the Code. See *ILR Response* at 6.

<sup>5</sup> The prior version of the Code contained a similar provision, which ILR criticized. See *ILR Response* at 4-5.

repeat players in the litigation marketplace, they can be expected to develop relationships over time, and an attorney being paid by a Litigation Funder would likely feel pressure to provide settlement advice reflecting that Funder's wishes. Thus, permitting a Litigation Funder to provide input regarding settlement decisions also threatens to undermine the relationship between the consumer and his or her attorney.

**Tenth**, section 11 of the Code provides that a Litigation Funder will continue to be liable for funding obligations of the claimant, even in the event the LFA is terminated, unless the LFA is terminated because of the borrower-claimant's breach of the LFA. As explained above, however, Litigation Funders must be obligated to cover adverse cost awards against claimants. That is primarily a protection for defendants who are wrongfully hauled into court. Funders must continue to have this obligation even if an LFA agreement is terminated, and even if it is terminated as a result of a borrower-claimant's breach. Again, the defendant must be protected against frivolous claims.

**Finally**, section 11 also provides that if a Litigation Funder and a borrower-claimant have a dispute over whether to settle a case, they must take their dispute to a binding opinion from a Queen's Counsel, i.e., the most senior grade of trial attorney under the English system, who will in most cases be independent rather than employed by a law firm. ILR does not question the inherent fairness of this procedure, since Queen's Counsel are required by their professional rules to avoid conflicts of interest and are accustomed to acting in an impartial manner when serving as arbitrators. However, the Code lacks the level of detail required to ensure that this method of resolution will work in practice. It does not specify, for example, whether Queen's Counsel will be asked merely to decide whether or not particular settlement offers are reasonable or, alternatively, will be required to evaluate the case and provide an opinion of the likely outcome should it go to trial. Nor does the Code specify which party will pay counsel's fees. In addition, the purported binding effects of this procedure may be illegal and unenforceable in some cases, as consumers may not be deprived by contract of their right to go to court (in this case against Funders) until after a dispute has arisen and they have had the opportunity to consider their legal options. This provision further illustrates the Funder-centric pre-occupations and origins of the Code. In any event, because we believe that Funders should not have any role in settlement, this procedure is unnecessary.

## **II. THE DRAFT CODE FAILS TO ADDRESS CONCERNS SPECIFIC TO COLLECTIVE ACTIONS.**

Like the prior version of the Code, the current draft also fails to protect consumers against the danger that litigation funding could lead to a rise in frivolous collective actions. Because collective actions can be especially profitable for Litigation Funders (given the number of claimants that may be involved), and also uniquely prone to abuse (given the potential for large damages awards), any regulation governing the litigation funding industry should prohibit funding of collective actions. The Code does not bar Litigation Funders from seeking out and contacting (either alone or in concert with an attorney) a potential representative claimant and encouraging him to file a collective action. Thus, the Code leaves Litigation Funders free to play a significant role in designing and initiating collective litigation.

Concerns about litigation abuse are especially acute in the context of collective litigation, because such cases are often controlled by claimants' counsel, and representatives often tend to be the friends, neighbors or employees of the lawyer. Adding a Litigation Funder to this mix increases the danger that a collective action will be prosecuted primarily for the benefit of attorneys and Funders – and not for the benefit of the class of claimants. The litigation-funding industry should come out strongly against this type of litigation scheme. Any regulation of the industry must include clear, direct language prohibiting the use of litigation funding in collective actions.

## **III. ANY REGULATION OF LITIGATION FUNDING SHOULD INCLUDE SEVERAL OTHER IMPORTANT PROVISIONS.**

As set forth above, the Code does not impose meaningful safeguards to protect consumers from abusive litigation practices and deter lawsuit abuse. We reiterate our position that true regulation of litigation funding will come only through government-enforced mandates, which should include the following safeguards:

**First**, any regulation should require that in each case in which funding is provided, the LFA must set forth all terms and conditions, including a detailed explanation of the expenses that the claimant could be obligated to repay – and the Litigation Funder must disclose the terms of the arrangement to the opposing party and to the court. This rule would increase transparency and allow the court to satisfy itself that the funding arrangement does not pose any ethical problems.

**Second**, any regulation should prohibit Litigation Funders from selling any derivative interest or participation in any cases in which they have advanced funds to any other investor. Requiring Litigation Funders to keep their investments in their

own portfolio would incentivize them to carefully analyze any claim before agreeing to fund it, thus reducing the risk that litigation funding will increase frivolous lawsuits. Moreover, this rule would prevent Litigation Funders from pooling and securitizing their investments to offload risks on other investors.

**Third**, any regulation should ensure that Funders are not permitted to charge fees which would be unfair to litigants. In particular, a Funder should not be allowed to command a fee which is disproportionate in relation to the scale of its investment and/or the level of risk it is prepared to accept in respect of adverse costs (although, as stated above, Funders should be fully liable for adverse costs, subject to the court's discretion). In this respect, it should be recognized that LFAs are very similar to contingency-fee agreements insofar as both typically guarantee a non-party a percentage share of litigation proceeds. Because consumers often lack bargaining power and legal sophistication, countries that permit contingency fees normally impose a "cap" on such fees – a maximum allowable percentage. Any regulation should set a similar limit on the percentage of a litigation recovery that a Litigation Funder may obtain. That percentage should be relatively low to ensure that litigation remains a mechanism to redress grievances – rather than an investment tool for disinterested profit-seekers.

**Fourth**, any regulation should require that all LFAs be between the Litigation Funder and the consumer. The Litigation Funder should not have any contractual relationship with any consumer's attorney. By separating the Litigation Funders from the attorneys, this rule would reduce the risk that attorneys and Litigation Funders will engage in collusive conduct designed to maximize their own profits at the expense of consumers.

**Fifth**, any regulation should provide that it is within a consumer's sole discretion to determine whether his or her claim has become untenable, and whether he or she thus wishes to cease prosecution of his or her case. The Litigation Funder must respect that decision, and the LFA must provide that the consumer is not liable to the Litigation Funder for any of the funds advanced by the Litigation Funder that the consumer has already spent. This rule will diminish the pressure on litigants to continue prosecuting a case merely because they feel obligated to refund amounts advanced by the Litigation Funder.

**Sixth**, any regulation should prohibit Litigation Funders from accepting referrals of potential consumers from attorneys, or at the very least should prohibit referral fees between Funders and attorneys. The failure of the Code to address these problematic practices is troubling because attorneys and Litigation Funders will inevitably develop various relationships and alliances. Absent regulation, attorneys can be expected to "steer" clients to favored financing firms, even if the client's

particular circumstances suggest that a different firm may be more appropriate, and vice versa.

**Seventh**, any regulation should prohibit Litigation Funders from owning law firms or being owned by law firms. Although alternative business structures and publicly held firms are generally permitted in England & Wales, allowing a law firm to be affiliated with a Litigation Funder would create a significant conflict of interest for the firm's lawyers because the affiliated Litigation Funders would be focused only on their own profit and not on the firm's clients' interests or the advancement of the legal profession (of which the Litigation Funders are not a part).

#### **IV. CONCLUSION**

Lawsuit abuse is driven largely by financial incentives. Because litigation funding increases the amount of money available to pursue litigation – and because Litigation Funders are exclusively driven by financial incentives – this growing practice carries substantial risks of lawsuit abuse. For these reasons, we continue to believe that litigation funding should be discouraged in all circumstances. Absent a complete ban, however, the most effective way to minimize these risks is to adopt enforceable, statutory safeguards that discourage litigation abuse by raising the cost of, or reducing the potential return from, unethical or improper behavior by Litigation Funders. While a code of conduct governing litigation funding can contain bright-line rules and safeguards that clearly establish what conduct is permitted and what conduct is impermissible, those rules will be wasted effort unless they carry the force of law. Thus, the Code should be replaced by – or supplemented with – a robust regulatory regime that incorporates the measures and improvements discussed above. Such a regime is the only way to protect consumers from the risks of abuse that flow from litigation funding.