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Is a hedge fund behind that plaintiff?

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Many legal claims - both legitimate and frivolous - never make it to the court room simply because of the expense of litigation. But a new trend in third-party litigation financing is changing that for some commercial plaintiffs by providing a funding source to assist with litigation expenses in exchange for a cut of a successful award or settlement. The principle source of this money is hedge funds, as they are finding certain litigation to be an attractive investment in this altered investment environment.

Litigation financing agreements provide that the investor hedge fund will pay for the plaintiff's attorneys' fees and litigation costs. In exchange for funding the litigation, the investor charges a multiple of its investment - usually two to five times the investment - but only if the litigation returns to the plaintiff enough money to cover the fee.

The plaintiff enjoys zero risk; it owes nothing if the litigation results in no recovery. The fund protects against its risk of loss with thorough pre-funding due diligence of the claim. Following due diligence of the claim (and of the lawyers litigating the claim), if the hedge fund decides to invest, it and the litigant enter into a detailed business agreement. The agreement allows the plaintiff to shift the financial burdens of litigation to the hedge fund for the price of sharing its benefits. But are such arrangements ethical and legal? And if they are, what are the pros and cons?

Increasingly, lawyers encourage these agreements and refer clients to potential investor funds. The promised funding is appealing, for obvious reasons. That being said, lawyers must evaluate these opportunities both financially and ethically. If the investment is approved by the plaintiffs and hedge fund counsel, a contract is negotiated that satisfies the ethical and legal requirements of the jurisdiction or jurisdictions in which the claims are purchased and in which the claims are pending.

For example, to comply with ethical rules prohibiting a non-lawyer from associating with or directing litigation counsel, the contract contains non-interference clauses. These provisions require the investor to renounce any right to direct the litigant, or the litigant's counsel, regarding the conduct of litigation. In addition, the funding is paid directly to the litigant, who, in turn, uses those funds to pay counsel fees.

On the litigant side, counsel and his/her client must be cautious about sharing information with the investor. This is a serious issue, because, prior to making an investment decision, the investor conducts several months of due diligence on the claim and the parties. In the course of that due diligence, the investor seeks access to factual information, the litigant's legal strategy, and the support for the alleged damage claim.

Investors will also evaluate the lawyer who is litigating the case and his/her experience with the type of litigation in question, as well as the political and social implications of the case. Cases with multiple defendants are viewed as more attractive, because they increase the potential for early settlement with one or more defendants, thereby generating income for the investor and decreasing the risk.

As a general rule, hedge funds are attracted to antitrust, intellectual property, securities, and commercial contract claims. Untested, controversial, and unpredictable claims are generally declined.

To avoid waiver of protective privileges, investors do not ask potential clients and counsel for work product or attorney-client privileged information. Considering the necessity of thorough due diligence, however, it is

unclear how funds evaluate claims subject to this limitation. The litigating attorney should consider, and explain to his client, the potential effect of due diligence on work product and attorney-client privilege. Litigation counsel must take steps to prevent waiver, and he or she should obtain the client's permission before sharing any non-public information.

The enforceability of third-party funding agreements varies by state. Attacks on these agreements in some states have revived the doctrines of champerty and maintenance -- laws prohibiting the sharing of litigation proceeds between the party owning the claim and a third-party financier.

These doctrines evolved from ancient public policy principles holding that litigation is personal and that less litigation is socially preferable to more litigation. Investors avoid the reach of these laws by structuring recovery as a multiple of their initial investment rather than a percentage of the total recovery, such as contingency fee arrangements. They avoid predatory lending laws by agreeing that no payment is due if the claim is unsuccessful.

Because of the novelty of third-party financing, there are relatively few cases discussing the issue. One such case is Anglo-Dutch Petroleum Int'l, Inc. v. Haskell. In Anglo-Dutch, the court evaluated several agreements that provided financing to litigation asserting claims for misappropriation of trade secrets and breach of contract.

Although the plaintiffs won at trial, they refused to pay their investors the promised return. The investors sued for breach of contract. Reviewing a trial court's grant of summary judgment for the investor, the Texas appellate court found the contracts to be bargained-for agreements that allowed the plaintiffs to pursue their claims and avoid bankruptcy. Accordingly, the court affirmed the trial court's ruling in favor of the investors.

Assuming compliance with laws and ethics rules, both investors and litigants can benefit greatly from third-party financing agreements. A commercial plaintiff's claims are marketable company assets: the more attractive the claim, the more likely a third-party will invest. Two major litigation market funds, Juridica Investments and Juris Capital, claim returns in excess of 20 percent. Juridica reported a success ratio of 100 percent over 17 months, although the fund is still in its early stages. It is noteworthy that Juridica focuses on cases in which the amount in controversy exceeds $25 million and that its average exposure per case is $8 million.

Plaintiffs need be mindful, however, of the restraints that accompany third-party financing. Standard contracts include mandatory arbitration, indemnification, and release clauses. Further, plaintiffs must provide investors with status updates, including material changes or negative developments that would affect the investment value or potential recovery. But assuming a satisfactory arrangement is reached, funds will provide anywhere from $100,000 to $10 million in cash to finance litigation.

Businesses should approach these opportunities as they would any other decision -- by determining the contract's value and weighing that against its disadvantages. With the emergence of third-party financing, a cash-strapped commercial plaintiff now has a way of financing litigation. In addition to a possible contingency arrangement with counsel, claimants can turn to third-party funding to provide the resources needed to fund litigation that, otherwise, was too expensive to pursue. So long as such arrangements are carefully reviewed and drafted, to avoid the legal and ethical problems described above, they are likely to be enforced and to become an accepted way to fund litigation.

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