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Litigation funding: calling for backup

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The costs of commercial litigation are tougher to finance post-Jackson. Alternative financing models

are coming to the market, but will they succeed in plugging the funding gap?

The UK economy may be returning to growth, but for some the effect of the recovery will not be felt for a while yet. Not least, litigation to recover the value of a loss involves a time-lag.

Meanwhile, under the reforms to civil litigation and costs heralded by Lord Justice Jackson, after-the-event (ATE) insurance premiums are no longer recoverable from the losing side, nor is the solicitors' uplift on basic costs in no win, no fee agreements. And unlike personal injury litigants, claimants in commercial litigation cannot benefit, for now at least, from qualified one-way costs shifting that caps the amount claimants may have to pay to defendants.

This all means that commercial litigants, particularly at the smaller end of the spectrum, are increasingly struggling to pay their legal bills. Alternative sources of finance are becoming available alongside ways of bringing legal insurance costs down. Can they fill the funding gap and allow claims to proceed?

Legitimacy

Third-party funders finance businesses involved in legal disputes in return for a portion of any damages awarded by the courts. James Blick, a director of risk broker TheJudge, notes that the number of third-party funders entering the UK market has been rising steadily over the past few years, and estimates that around a dozen or more such investors are operating in the UK. Blick says: 'We have seen a significant growth in demand for third-party funding (TPF) among clients. We see more law firms being more sophisticated in advising clients about their funding options.'

Blick has identified a notable increase in the market since 1 April 2013, when Jackson's reforms were implemented through the Legal Aid, Sentencing and Punishment of Offenders Act (LASPO). Transactions have also increased, with the number of cases receiving offers of funding, and the number of clients taking up those offers, both expanding.

One of the reasons for the expansion and uptake of TPF is that Jackson LJ, gave it his endorsement, affirming that it was valuable in boosting access to justice in view of other civil justice reforms.

Leslie Perrin, chairman of litigation funder Calunius Capital, says: 'The most important thing that Jackson did for us was to give us legitimacy.' Perrin, former managing partner of Osborne Clarke, is also chair of the Association of Litigation Funders of England and Wales (ALF), which introduced a code of conduct in 2011 that received Jackson's seal of approval. The code was amended in January to include a requirement that funder members (currently eight) maintain access to £2m of capital.

Perrin urges solicitors to get up to speed with TPF and learn to speak 'authoritatively' about it to clients. 'More and more lawyers are understanding that litigation funding is something that they simply have to get their heads around,' he says.

Calunius advises funds totalling £70m that invest in large-scale commercial litigation and

arbitration, and would normally only consider backing lawsuits where damages are no less than £10m. For example, Calunius is funding the Elvis Presley estate in its action against Sony interests, now in the Federal Supreme Court in Germany.

ALF member Harbour Litigation Funding runs two funds worth a combined £180m. Head of litigation Susan Dunn notes that since April 2013, the level of enquiries from prospective clients has gone up 'dramatically'. Last summer, Harbour received an average of 40 new enquiries a month, up from 25 in the summer of 2012; in the first three weeks of January, there were 45. Dunn says: 'Without doubt, Jackson's reforms have made people look at how they are going to cover the costs of litigation. Lawyers are having to revisit the way they litigate, and get their clients to pay their fees.'

Harbour will only consider a minimum claim value per case of £3m. Dunn says claims with an expectation of recovery less than that would not be financially viable, particularly in circumstances when the claimants cannot persuade their solicitors to enter into a conditional fee agreement (CFA): 'For a reasonably involved piece of commercial litigation it seems difficult to get anything done for less than £500,000 if you look at own-side and adverse costs, and that is what drives our minimum claim value of £3m.'

But Dunn sympathises with businesses which have less valuable claims. 'We say rather blithely £3m, but £2m, £1m, £500,000 and £100,000 – these are big sums of money,' she says. 'I feel desperately sorry for people in those circumstances. The defendants get away with bad behaviour because they know that it won't be economically viable for the claimant to pay for themselves or be able to find a funder.'

Calunius is equally focused on higher-value claims. 'We feel that big cases are more desirable because small cases are often just as complex as big ones,' Perrin says. 'The litigation funding industry does not see itself as the answer to the problem of how to fund small-scale commercial litigation.'

Indeed, there are no products in the market to help small and medium-sized enterprises (SMEs) with their 'modest claims' of between £250,000 to £2m, says Francesca Kaye, a litigation partner at Russell-Cooke, and current president of the London Solicitors Litigation Association. 'If you are trying to recover £250,000, and it's the difference between your company surviving or failing, you cannot afford to lose a huge chunk of that to funders, even if they are prepared to fund [your claim],' she says.

Richard Myrtle, managing director of ATE broker Universal Legal Protection, says: 'Lawyers are saying that it would be nice if clients looking to win £250,000 could obtain funding because they are struggling to pay their bills without it, but again it would be nice if the funder wasn't so expensive, because funders *are* expensive. For the funding to work at the moment you need to have a large quantum, and you need the costs of the funding not to eat up all that quantum.'

Funders typically expect a relatively high ratio between the expected damages in a case and the legal costs, ranging from 4:1 to 10:1, observers say.

But there may be hope for smaller-value claims, some practitioners suggest. David Greene, a commercial litigator and senior partner at Edwin Coe, says funders are now looking at

developing products that would see them invest in cases with potential damages of as little as £100,000.

AIM-quoted Burford Capital, with over $300m of capital, will consider a minimum investment of £250,000 in either individual cases (typically worth minimum damages of £1m) or in 'a book of cases'.

Chief investment officer Ross Clark explains: 'Ten cases of £100,000 each would be a typical example, but there is no reason why it couldn't be 30 cases of £50,000 each. We are saying to firms: if you are finding that you are blocked in that area, and you can actually bring a book of business or repeat business, then we can talk to you.' Burford has already financed a number of such portfolio cases and sees this approach yielding 'rapid' growth.

Others remain sceptical about rolling cases up into a package that is desirable for funders. Dunn says: 'The notion of portfolio financing is fine as a theory, but you actually find that firms don't really have a portfolio of cases. They have a number of cases that they'd like to have funded but they don't have common themes. Nobody has yet said to us: "Look, here's a dozen £500,000 claims, they are all surveyor-negligence claims, and we can come to an agreement about costs because they have got similar facts, and you can assess them as a group." That's just not what we are seeing in the market.'

This is not the only option for SMEs. Augusta Ventures, a specialist litigation funder launching later this month, has funded cases that required as little as £50,000, according to partner Robert Hanna: 'We don't really have a minimum. We have a model that is flexible and is designed to be able to accommodate pretty small commercial disputes, and we think the industry needed that.' Augusta, which Hanna says has 'a significant amount of capital' to invest, is backed by private equity group Metric Capital Partners.

Goliath v Goliath?

The Jackson reforms held out the promise of lower litigation costs. However, it certainly does not feel that way to clients. According to Tim Hardy, head of CMS Cameron McKenna's litigation department, while ATE insurance premiums have fallen since April, they are still 'incredibly expensive', at 18%-25% of the amount at risk.

Pre-LASPO, Greene argues, most of the firm's clients were financing litigation through a combination of ATE insurance and CFAs. He notes that while law firms 'can manage their own costs' and therefore cope with the loss of recoverability of the uplift, not being able to recoup the ATE premiums from the losing side is 'really quite determinative' for clients, he says.

Greene, who has worked on a number of high-profile cases such as the Railtrack shareholder action against the UK government and the Northern Rock investor case, says that collective actions, including consumer claims, where individual damages may be too small, and where claimants are also seeking non-monetary relief, will be more difficult to finance. 'You may not have substantial damages out of which to pay the [ATE] premium, and you can't do those cases unless you obtain ATE cover,' he says.

Edwin Coe is currently representing low-paid workers who have been sold personal accident insurance 'of doubtful worth' by temporary employment agencies. The firm contends that the sale of this policy breaks the law, and sometimes reduces workers' income below the minimum wage. Greene says: 'The individual losses are small but the numbers affected are substantial. It is difficult to obtain ATE cover for this type of claim.'

If the Jackson reforms have not delivered hoped-for cuts to the cost of litigation, the courts are also taking a more robust approach to proportionality of costs to damages, Blick points out. SMEs, lacking deep pockets, find themselves squeezed from all sides.

Despite this, businesses, and in particular SMEs, need to protect themselves against adverse costs, especially if they want opponents to take them seriously and settle their claims. 'You are both Goliath, because you can afford to lose once you are insured,' says Myrtle.

Fortunately, insurers are becoming 'more flexible and more creative', allowing litigants to buy insurance cover in the same way they do for other areas of insurance such as home or motor, Myrtle points out. For example, in order to reduce the premium it is now possible to insure an excess amount, instead of buying 100% protection as has traditionally been the case with ATE. Clients can, for instance, opt to buy insurance cover against the risk of losing between £100,000 and £500,000, bearing the risk themselves for the initial £100,000.

Instead of automatically buying a very large amount of cover from the outset, clients are now choosing to purchase a lower amount of cover to benefit from a lower premium, Blick says, adding: 'They can then review their position at a later stage, or look to structure the premium in different ways, such as paying some or all of the premium up front in order to make it more affordable in the context of the claim value.'

THIRD WAY

£2m

The access to capital that litigation funders must maintain under the Association of Litigation Funders code of conduct (England and Wales).

4:1 to 10:1

The relatively high ratio sought by litigation funders between the expected damages in a case and the legal costs.

$300m

AIM-quoted Burford Capital's investment capital. Burford considers a minimum investment of £250,000 in either individual cases (typically worth minimum damages of £1m) or in 'a book of cases'.

18%-25%

The typical range of ATE premiums since April 2013 relative to the amount at risk.

40

Number of enquiries received each month by Harbour Litigation Funding – up from 25 in 2012. The minimum claim value funded is £3m.

£250,000

The common lower limit of any claim size funded by a litigation funder.

£70m

Size of the total funds advised by funder Calunius Capital.

50%

The maximum percentage of the damages a lawyer can claim in most cases taken on a DBA (though it is 25% in personal injury and 35% in employment claims).

There is no clear picture of the degree of uptake of ATE insurance under the new costs regime. According to TheJudge, the volume of new applications increased 'very rapidly' post-summer 2013. Until then the market had been quiet, owing to the big rush to take out ATE policies before LASPO came into effect in April last year. Myrtle says he has observed a sharp fall in sales of ATE policies.

Law firms should also be aware that ATE insurance can be used as a way of 'unlocking' other types of litigation funding. Blick notes that there is now 'a wider litigation funding market' beyond ALF. 'We have seen examples of entities offering to lend money to clients and securing their loan by way of an ATE insurance policy taken out by the client.' This funding solution, he says, makes it viable to finance smaller-value claims of about £100,000.

For their part, ALF members are increasingly working with ATE insurers. Burford has its own ATE business, Firstassist, purchased in 2011 and whose primary focus is high-value cases. Harbour, which insures most cases it funds and pays the premium as part of the funding, now has its own dedicated syndicate of legal expenses insurers. Harbour offers adverse costs cover of up to £6.5m on each case it finances, Dunn says.

Before-the-event

Jackson's report recommended a much-expanded role for before-the-event (BTE) legal expenses insurance, particularly for SMEs. Perrin, who also acts part-time as senior independent director of legal expenses insurer DAS, points out that BTE insurance is of particular relevance to small-scale commercial litigation.

BTE insurance policies are typically sold as add-ons to household, public liability or employer's liability insurance, but only provide limited protection. Observers note that for BTE to provide adequate risk cover in litigation it would have to be sold as a separate product and the premium hiked. Myrtle is sceptical: 'As a standalone purchase for an individual business, [BTE] never really worked. Personally, I don't see it changing that much.'

However, Tim Oliver, CEO of Parabis Group, which provides claims management for insurance companies and defendant insurance work, is confident that the use of BTE insurance will expand, and says that legal expenses insurers will soon start advertising more widely the availability of standalone BTE products. 'The more people buy them, the lower the price will be,' Oliver says.

DBAs or 'don't bother agreements'

CFAs have been the cornerstone of civil litigation since their introduction in 1998, but Hardy, who focuses on high-value corporate disputes, says that CFAs have been 'killed off' by Jackson's reforms. 'CFAs are pretty much out of favour,' he says.

'Although we were using them a lot before Jackson, we are not so much now.' CMS Cameron McKenna is working on a straight fee basis with clients – importantly many of these are large banks and corporations – who bear the risk of losing in court but also maximise gains if they win. For clients without deep pockets, CFAs remain the only option, but this means either lawyers take a hit on the uplift or clients receive less if successful.

Meanwhile, damages-based agreements (DBAs), or as one lawyer dubbed them 'don't bother agreements', which were introduced in April as an alternative to CFAs, are not being embraced by lawyers. 'We can certainly see the attraction to ourselves in doing them if you are able to take a contingency fee out of [clients'] net proceeds. We are happy with that type of idea,' Hardy says.

However, he is concerned about the lack of flexibility in the DBA regulations that do not permit what are termed 'hybrid' or partial DBAs, where the solicitor can also draw on other methods of funding or payment, including reduced hourly fees, in addition to a contingency fee if the case is successful.

Greene, who is a past president of the London Solicitors Litigation Association, explains that under a DBA a lawyer can take up to 50% of the damages (although in personal injury cases and employment cases it is 25% and 35% respectively). On the one hand there is the risk of not getting a suitable return, and on the other solicitors would probably be uncomfortable taking half of their clients' damages, he argues.

Hence solicitors' preference for partial DBAs. As they stand, DBAs, like TPF, probably work best in the bigger claims. The Ministry of Justice has not ruled out revising the regulations – described as 'obscure' and 'hopeless' by Perrin – but any redrafting is not going to happen soon, he says.

Meanwhile, Burford has launched a product which it says will ensure law firms do not fall foul of the current rules. This is a risk-sharing agreement between a law firm and Burford that sees the

firm share in the damages award with the funder in exchange for taking on some of the litigation risk.

'That's gone down very well across the board,' Clark says, adding that Burford is talking to 'dozens of firms who have indicated interest in it'. The product, somewhat confusingly dubbed 'Hybrid DBA', is designed for cases with an expectation of recovery of £4m and more, although Burford will consider smaller size cases if the damages to costs ratio makes them attractive. This should typically be 5:1.

So what does the future hold? It is still early days to tell what shape litigation funding will take in the years to come. Firms frenetically signed up clients to no win, no fee agreements in the run-up to the implementation of LASPO, so most lawyers are still busy working their way through cases under the old regime. However, it seems that new models are slowly beginning to emerge. The challenge will be to ensure there is one for every pocket.

The last word must go to Rachel Rothwell, editor of *Gazette* sister magazine *Litigation Funding* and an expert on the fast-mutating legal costs sphere.

She observes: 'There is no doubt that third-party funding is going to get more and more mainstream in the next few years. The entrance of Burford into the UK market in 2012 has already done a lot to increase the industry's profile among lawyers, and I can only see the funding market getting bigger – indeed I have been told that at least one new entrant is going to be coming into the market this year.'

She adds: 'What will make the biggest difference for funders will be if they can succeed in convincing general counsel – or indeed finance directors – at the big corporates that third-party funding is a sensible way of getting litigation risk off the balance sheet. That is a growth area that some funders are really targeting.'

Rothwell echoes the views of others when she acknowledges that the 'big limiting factor' for third-party funding is that it really only works for the very large cases.

She concludes: 'Most of the players listed in *Litigation Funding*'s table of third-party funders are putting their minimum value of dispute down as at least £3m. The economics just don't work for the funders where the dispute value is only in the tens or even hundreds of thousands, even though the merits of the case may be fantastic.

'There has been a lot of discussion over how funding could be made to work at the lower end of the market – for example, by investing in a portfolio of a law firm's cases – but frankly that is one area where I am not optimistic.'

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