CHAPTER 11. THIRD PARTY FUNDING

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1. INTRODUCTION

1.1 Background. The nature of third party funding, the manner in which funders operate and the legal background are set out in PR chapter 15.

1.2 Benefits of third party funding. In PR paragraph 15.1.1 I expressed the view that the institution of third party funding was beneficial in that it promoted access to justice.[94] The majority of contributors to the debate in Phase 2 of the Costs Review supported that view both at meetings and in written submissions.[95] I remain of the view that, in principle, third party funding is beneficial and should be supported, essentially for five reasons:

(i) Third party funding provides an additional means of funding litigation and, for some parties, the only means of funding litigation. Thus third party funding promotes access to justice.

(ii) Although a successful claimant with third party funding foregoes a percentage of his damages, it is better for him to recover a substantial part of his damages than to recover nothing at all.

(iii) The use of third party funding (unlike the use of conditional fee agreements ("CFAs")) does not impose additional financial burdens upon opposing parties.

(iv) Third party funding will become even more important as a means of financing litigation if success fees under CFAs become irrecoverable.

(v) Third party funding tends to filter out unmeritorious cases, because funders will not take on the risk of such cases. This benefits opposing parties.

1.3 Recent example. A recent and well known case in which, seemingly, third party funding operated satisfactorily is *Stone & Rolls Ltd (in Liquidation) v Moore Stephens* [2009] UKHL 39; [2009] 3 WLR 455. The claimant company brought a substantial claim for professional negligence against its former auditors, with the benefit of third party funding. The Court of Appeal, reversing Langley J, held that on

[94] The Civil Justice Council (the "CJC") has expressed a similar view: see the CJC report "*Improved Access to Justice – Funding Options and Proportionate Costs*", June 2007, recommendation 3 and chapter C.

[95] This view was not universal. In particular, the Young Barristers Committee argued that third party funding should be prohibited in all circumstances on public policy grounds.

the facts alleged the auditors had a defence of *ex turpi causa non oritur actio* and accordingly struck out the claim.[96] The House of Lords dismissed the claimant's appeal. According to press reports, the funder, which had stood to receive some 40% of the proceeds if the action succeeded, duly accepted liability for the auditors' costs. Those costs were reported as being in the region of £2.5 million. It was also reported that there was no after-the-event ("ATE") insurance. In an interview with the Law Society Gazette following the House of Lords decision a legal director of the funder said that the funder currently had a portfolio of 10 to 12 ongoing cases with a success rate of 80%. These facts illustrate that third party funders can operate satisfactorily in the absence of ATE insurance and they can accept liability for any adverse costs orders. The risk undertaken by the funder is reflected in the percentage of damages which the funder is entitled to receive in the event of success.

1.4 It should also be noted that third party funding is commonly used in some overseas jurisdictions: see PR chapters 55 to 61.

1.5 Limitations of third party funding. Although third party funding is beneficial, in that it promotes access to justice for certain litigants, its limitations must also be recognised. Third party funding is not usually feasible where non-monetary relief, such as an injunction or declaration, is the main remedy sought. Third party funding is most readily obtained for high value cases with good prospects of success.

1.6 Matters for consideration. The matters which arise for consideration now may be formulated as follows:

(i) Whether third party funders should be regulated or should subscribe to a voluntary code.

(ii) Measures to ensure the capital adequacy of third party funders.

(iii) Liability for adverse costs.

(iv) Maintenance and champerty.

2. SHOULD THIRD PARTY FUNDERS BE REGULATED OR SUBSCRIBE TO A VOLUNTARY CODE?

2.1 The general view (but not universal view) expressed during Phase 2 was that there should be some form of restriction upon the activities of third party funders. The central issue which emerged was whether a voluntary code would suffice or whether there should be statutory regulation.[97]

2.2 Law Society's comments. The Law Society believes that third party funding may well assist access to justice, but that proper regulation is required. The Law Society is particularly concerned about two matters:

(i) The litigation funding agreement is likely to allow the funder to withdraw funding in circumstances which would be contrary to the client's interest or unreasonable.

(ii) There is no guarantee against the funder becoming insolvent, with all the consequences which would flow from that.

[96] From a bad cause no action arises. This principle of public policy means that a claim cannot be based on the illegal actions or wrongful conduct of the claimant, nor can he benefit from his own wrongdoing.
[97] Both views were expressed in the written submissions. At the Commercial Litigation Funding Conference on 23rd June 2009, the majority of those present indicated support for regulation.

2.3 Voluntary code. The draft voluntary code referred to in PR paragraph 15.4.3 was not in the public domain when I published my Preliminary Report. Now, however, the draft voluntary code is in the public domain and can be found upon the Civil Justice Council ("CJC") website.[98] It has been developed by the Third Party Litigation Funders Association in conjunction with the CJC. Support for this voluntary code was expressed by a number of respondents. The point was made that third party funding is still nascent in England and Wales at the moment and that nothing more formal is required. The point was also made that third party funding is not regulated in the overseas jurisdictions studied.[99]

2.4 I accept that third party funding is still nascent in England and Wales and that in the first instance what is required is a satisfactory voluntary code, to which all litigation funders subscribe. At the present time, parties who use third party funding are generally commercial or similar enterprises with access to full legal advice. In the future, however, if the use of third party funding expands, then full statutory regulation may well be required, as envisaged by the Law Society.

2.5 I turn now to the contents of the draft voluntary code. Section 1 is introductory. Section 2 sets out criteria for the selection of cases. Section 3 sets out what the funding agreement should contain. Section 4.1 sets out the funder's commitments of fair dealing. Section 5 sets out some key obligations of both parties, including the client's obligation to support the litigation and the funder's obligation to pay out adverse costs. Section 6 sets out the funder's entitlement to costs and a share of the proceeds in the event of success. Section 7 deals with the role of the client's solicitor. Section 8 protects confidential information. The remaining sections deal with disclosure of terms, complaints, enforcement of the code and so forth. The appendix to the draft code sets out key terms which should be included in any litigation funding agreement.

2.6 The detailed wording of the draft code is now the subject of debate under the aegis of the CJC and I do not enter into that debate, save in respect of two matters which I believe to be of particular concern.

2.7 Withdrawal by funder. Paragraph 2.7.1 of the appendix to the draft code proposes that the following key term be included in a litigation funding agreement:

> "The Funder may terminate the Litigation Funding Agreement at any time subject to paying all the accrued obligations. The Funder will give 21 days' notice of termination, unless agreed otherwise in the Litigation Funding Agreement. The Funder will terminate if it is no longer satisfied of the merits of your claim and/or has determined that the proceedings are no longer viable."

2.8 I do not regard this as satisfactory. In my view the funder should be obliged to continue to provide whatever funding it originally contracted to provide, unless there are proper grounds to withdraw. The precise definition of proper grounds for withdrawal will require some careful drafting.

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[98] Annex D to the CJC's submission to the Costs Review which can be found at http://www.civiljusticecouncil.gov.uk/files/Submission_to_the_Review_of_Civil_litigation_Costs.pdf.

[99] It should be noted, however, that in Australia a litigation funding agreement may be subject to regulation as a derivative under the Corporations Act 2001, in which case the funder must hold a financial services licence under the Act. In order to obtain such a licence the funder must satisfy capital adequacy requirements and similar matters. IMF (Australia) Ltd, the most well established funder in Australia, has obtained such a licence.

2.9 Section 4.2. Section 4.2 of the draft code deals with capital adequacy requirements. That section (in the version current at the time of drafting this chapter) provides:

> "4.2.1 A Member complies with the capital adequacy requirements under this Code, if the Member
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> (a) (i) is able to pay all its debts as and when they become due and payable;
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> (ii) has total assets that exceed total liabilities as shown in the most recent balance sheet of the Member;
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> (iii) has no reason to believe that its total assets would not exceed its total liabilities on a current balance sheet;
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> (iv) reasonably expects that it will have adequate resources of cash or cash equivalent (when needed) to meet its liabilities for at least the next three months (including any additional liabilities it might incur during that period), taking into account all commercial contingencies for which the Member should reasonably plan; and
>
> (v) has ensured that a responsible officer of the Member has documented that the officer has the reasonable expectation for at least the following three month period together with the reasons for forming that expectation, the contingencies for which the Member considers it is reasonable to plan, the assumptions made concerning the contingencies and the basis for selecting those assumptions; or
>
> (b) the Member is covered by an agreement for the current calendar year by virtue of which the Member's (ultimate) parent company shall compensate any annual net loss incurred by the Member during the term of the agreement to the extent that such loss is not compensated by withdrawing amounts from the profit reserves which were transferred to such reserves during the term of the agreement and the (ultimate) parent company is a regulated insurance company that is covered by EU capital adequacy requirements or is otherwise the holder of a financial services license issued by a national regulator approved by the Association."

2.10 Bearing in mind that litigation supported by a third party funder may last for years, section 4.2 of the draft code does not in my view afford adequate protection for the client. How such protection may be achieved is discussed in section 3 below.

2.11 One further point which merits mention concerns paragraph 7.3.2 of the draft code, which states: "*Whilst the Funder may assert some measure of control over the litigation funding, your solicitor must not cede control of his or her firm or the conduct of your case to the Funder.*" As presently drafted the phrase "*some measure of control*" is ambiguous and might benefit from clarification. In particular, the code might set out what rights the funder should have in relation to settlement negotiations.

2.12 Conclusion. I support the approach of the CJC in trying to establish, in the first instance, a voluntary code for third party funding. Provided that a satisfactory code is established and that all funders subscribe to that code, then at this stage, subject to my concern about capital adequacy requirements, I see no need for statutory regulation. However, if the use of third party funding expands, there may well be a need for full statutory regulation.

3. MEASURES TO ENSURE THE CAPITAL ADEQUACY OF THIRD PARTY FUNDERS

3.1 My initial view was that capital adequacy was matter of such pre-eminent importance that it should be the subject of statutory regulation. The natural body to undertake such regulation is the Financial Services Authority (the "FSA").

3.2 Indications from the FSA. I have made contact with the FSA to ascertain whether that body is the appropriate body to monitor the capital adequacy of third party funders. I understand that the FSA would not be able to deal with capital adequacy alone. If the FSA takes on a regulatory role, it would undertake full regulation of third party funders, the costs of which would need to be outweighed by the benefits. Hitherto the FSA, as a risk based regulator, has been holding a general watching brief in relation to this area and, on the basis of liaison with the Ministry of Justice, is not aware of any significant risk to consumers.

3.3 Given the low volume of third party funding at the moment and the fact that most clients are commercial parties with access to full legal and financial advice, I do not think it appropriate to recommend full regulation by the FSA at the present time. Also, I doubt that any such recommendation (involving substantial costs) would be accepted.

3.4 After some hesitation, in the short term I think that capital adequacy requirements are best dealt with by a substantial tightening up of section 4.2 of the draft code. In the long term, however, this matter must be revisited. Regard must be had to the nature of the funders entering the market. Also regard must be had to the nature of the cases and the nature of the claimants that they are funding. If funders are supporting group actions brought by consumers on any scale, then this would be a ground for seriously re-considering the question of statutory regulation of third party funders by the FSA.

4. LIABILITY FOR ADVERSE COSTS

4.1 *Arkin.* In *Arkin v Borchard Lines Ltd* [2005] EWCA Civ 655 Lord Phillips MR, delivering the judgment of the court, said this at [39] to [43]:

> "39 If a professional funder, who is contemplating funding a discrete part of an impecunious claimant's expenses, such as the cost of expert evidence, is to be potentially liable for the entirety of the defendant's costs should the claim fail, no professional funder will be likely to be prepared to provide the necessary funding. The exposure will be too great to render funding on a contingency basis of recovery a viable commercial transaction. Access to justice will be denied. We consider, however, that there is a solution that is practicable, just and that caters for some of the policy considerations that we have considered above.

…

41 We consider that a professional funder, who finances part of a claimant's costs of litigation, should be potentially liable for the costs of the opposing party to the extent of the funding provided. The effect of this will, of course, be that, if the funding is provided on a contingency basis of recovery, the funder will require, as the price of the funding, a greater share of the recovery should the claim succeed. In the individual case, the net recovery of a successful claimant will be diminished. While this is unfortunate, it seems to us that it is a cost that the impecunious claimant can reasonably be expected to bear. Overall justice will be better served than leaving defendants in a position where they have no right to recover any costs from a professional funder whose intervention has permitted the continuation of a claim which has ultimately proved to be without merit.

42 If the course which we have proposed becomes generally accepted, it is likely to have the following consequences. Professional funders are likely to cap the funds that they provide in order to limit their exposure to a reasonable amount. This should have a salutary effect in keeping costs proportionate. In the present case there was no such cap, and it is at least possible that the costs that MPC had agreed to fund grew to an extent where they ceased to be proportionate. Professional funders will also have to consider with even greater care whether the prospects of the litigation are sufficiently good to justify the support that they are asked to give. This also will be in the public interest.

43 In the present appeal we are concerned only with a professional funder who has contributed a part of a litigant's expenses through a non-champertous agreement in the expectation of reward if the litigant succeeds. We can see no reason in principle, however, why the solution we suggest should not also be applicable where the funder has similarly contributed the greater part, or all, of the expenses of the action. We have not, however, had to explore the ramifications of an extension of the solution we propose beyond the facts of the present case, where the funder merely covered the costs incurred by the claimant in instructing expert witnesses."

4.2 The High Court of Australia has recently taken a different view concerning the liability of third party funders for adverse costs. See *Jeffery & Katauskas Pty Ltd v SST Consulting Pty Ltd* [2009] HCA 43 in which, by a majority, the funder was held not liable to pay adverse costs.

4.3 Comments during Phase 2. This reasoning of the Court of Appeal attracted some criticism during Phase 2. In their Response to the Preliminary Report the City of London Law Society's Litigation Committee wrote:

> "We consider that the court should have the ability to order the third party funder in an unsuccessful case to pay all of the successful defendant's costs (subject to assessment in the usual way) and its ability to do so should not be circumscribed by the principle in *Arkin*."

It should be noted that the facts of *Arkin* were unusual. MPC, the funder in that case, had funded only the claimant's expert evidence and the cost of organising the documents.

4.4 The Commercial Litigation Association commented that the *Arkin* approach creates an uneven playing field. The balance is tilted in favour of third party funding, in that the funder is only liable for costs up to the amount of its investment.

4.5 My view. In my view, the criticisms of *Arkin* are sound. There is no evidence that full liability for adverse costs would stifle third party funding or inhibit access to justice. No evidence to this effect is mentioned in the judgment. Experience in Australia is to the opposite effect. See, for example, the summary of my meeting with IMF on 1st April 2009.[100] IMF have funded approximately 200 cases in Australia. In approximately five of those cases costs orders were made against IMF's clients. IMF duly complied with those adverse costs orders. It is perfectly possible for litigation funders to have business models which encompass full liability for adverse costs. This will remain the case, even if ATE insurance premiums (in those cases where ATE insurance is taken out) cease to be recoverable under costs orders. This is illustrated by the *Stone & Rolls* case discussed in paragraph 1.3 above.

4.6 In my view, it is wrong in principle that a litigation funder, which stands to recover a share of damages in the event of success, should be able to escape part of the liability for costs in the event of defeat. This is unjust not only to the opposing party (who may be left with unrecovered costs)[101] but also to the client (who may be exposed to costs liabilities which it cannot meet).

4.7 I recommend that either by rule change or by legislation third party funders should be exposed to liability for adverse costs in respect of litigation which they fund. The extent of the funder's liability should be a matter for the discretion of the judge in the individual case. The funder's potential liability should not be limited by the extent of its investment in the case.

5. MAINTENANCE AND CHAMPERTY

5.1 The issue. The uncertain ambit of the law of maintenance and champerty has on occasions caused doubt as to the precise boundaries of proper conduct in relation to litigation funding.[102] In PR paragraph 15.4.2 I raised the question whether (provided that third party funding is satisfactorily controlled by other means) section 14(2) of the Criminal Law Act 1967 (the "1967 Act") should be repealed. A similar question has recently been raised in New Zealand: see PR paragraph 59.4.10.

5.2 Views expressed during Phase 2. Unsurprisingly, views differed on this question. A number of respondents pointed out that abolishing the common law doctrine of maintenance and champerty could have unintended consequences. Significantly, the Litigation Funders Alliance (the "LFA")[103] states in its comments on the Preliminary Report:

[100] See PR paragraph 58.4.6.
[101] It will inhibit access to justice for the defendant, if (a) it faces a claimant supported by third party funding and (b) the defendant is in the position that – win or lose – it will have to bear its own costs.
[102] The common law position is summarised in PR paragraph 15.1.2.
[103] The LFA states that its members include "*the main professional providers of third party funding in the UK*".

"We have no desire for the rule against champerty to be repealed. We feel that this is a useful mechanism to ensure the balance of power between claimant and professional funder remains appropriate."

5.3 My view. In my view, section 14(2) of the 1967 Act should not be repealed. It should, however, be made clear either by statute or by judicial decision that if third party funders comply with whatever system of regulation emerges from the current consultation process, then the funding agreements will not be overturned on grounds of maintenance and champerty. The law of maintenance and champerty has a wider impact, which goes beyond third party litigation funding of the kind discussed above. The abolition of this common law doctrine may have unforeseen and adverse consequences. Furthermore, such a drastic step is not necessary in order to protect the legitimate interests of third party funders.

6. RECOMMENDATIONS

6.1 I do not consider that full regulation of third party funding is presently required. I do, however, make the following recommendations:

(i) A satisfactory voluntary code, to which all litigation funders subscribe, should be drawn up. This code should contain effective capital adequacy requirements and should place appropriate restrictions upon funders' ability to withdraw support for ongoing litigation.

(ii) The question whether there should be statutory regulation of third party funders by the FSA ought to be re-visited if and when the third party funding market expands.

(iii) Third party funders should potentially be liable for the full amount of adverse costs, subject to the discretion of the judge.