

**RETHINKING REVENUE**

# Legal Financing

Can private capital unlock the hidden asset of local government affirmative litigation?

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**L**egal action is an important lever for local governments to achieve policy goals, enjoin harmful activity, and receive monetary compensation for damages suffered. However, the cost of litigation and greater legal resources available to well-funded defendants means that many local governments cannot realize the full potential of litigation. Legal financing is an established practice among private firms for financing and reducing the risk of litigation. Could it be time for local governments to start using legal financing to pursue lawsuits that seek to vindicate the public's interest ("affirmative litigation") and receive compensation that could be used to help address community problems? This article explores the potential of legal financing by asking and answering questions about this new-to-government tool.

## WHAT IS LEGAL FINANCING? WHY IS IT NEEDED?

Like any private entity, local governments exercise their right to sue in state and federal courts. In many cases, as exemplified by the tobacco and opioid litigation, this can result in a monetary award to the government by a court-ordered judgment or a settlement between the parties. Where these cases address a broader public interest and not just the local government's corporate interests, these actions are

known as "public sector affirmative litigation." Perhaps the most well-known example of public sector affirmative litigation is the tobacco litigation that led to the 1998 Tobacco Master Settlement Agreement, which yielded over \$200 billion for state and local governments. Currently pending are hundreds of cases relating to opioids, brought by states and thousands of local governments. In some instances, these cases have already settled for hundreds of millions of dollars. This illustrates the potential large financial impact of public sector affirmative litigation. In addition to opioids, other subject matters for affirmative litigation include:

- ➔ **Revenue recovery**—litigation against streaming television companies to recover franchise fees for use of public rights-of-way;
- ➔ **Vaping**—litigation against vaping manufacturers and retailers for misstatement of addictive potential and harms to underage consumers;
- ➔ **Environmental matters**—litigation against manufacturers and users of PFAS and PCB for water contamination, perchlorate run-off (usually related to agriculture), air pollution, and climate change;
- ➔ **False claims actions**—litigation against individuals and entities who cheat taxpayers and defraud the government by inflating charges for goods and services and falsely certify the completion or quality of work;
- ➔ **Data breach/electronic privacy**—litigation against government vendors who negligently permit data breaches and/or improperly use government and taxpayer data;

- ➔ **Antitrust/anticompetitive conduct**—litigation against social media platforms for monopolistic conduct, vendor collusion harming the government procurement pricing/process;
- ➔ **Consumer protection**—litigation to prevent and recover damages against companies that harm consumer health through failure to ensure proper food/drug safety; and
- ➔ **Medical services**—litigation to recover excessive pricing for drugs and medical services.

Local governments are taking on more responsibility to address issues, like the ones outlined above, that impact the communities they serve.<sup>1</sup> For some of these issues, the losses to local government are general and arise from injuries to members of the community that the local government must address; whereas for other issues, the damage to the government can be more direct. Whether direct or indirect, these issues affect the local government's fiscal resources. One way to address these issues is through the courts. However, access to the courts requires time, money, and resources that are often in short supply. In many instances, governments are opposed by well-funded defendants with large legal teams that seek to wear down their opponents. These barriers can prevent local governments from pursuing cases, even when those cases have great merit. However, a worthy legal claim is an asset, just like anything else, and it can be monetized and leveraged as such.

This is where legal financing (or "legal funding") comes into play. Legal financing refers to an outside

investor providing financing for attorneys' fees and litigation costs to bring litigation to resolution. This financing is "nonrecourse," which means that if the litigation is unsuccessful, then the entity that advanced the funds loses its invested capital, with no return, and the recipient of the funding has no further obligation to the funding entity. Legal financing is in common use by private firms and individuals, so much of the groundwork for local governments to use legal financing already exists.

With legal funding, the government does not lose money if there is no recovery. This is similar to the contingent fee model of litigation. If the litigation results in a recovery, the entity that provided the legal funding gets a share of the litigation proceeds. As we will discuss later in this article, legal financing can offer important advantages over traditional contingent fee litigation.

## WHO ARE THE FINANCIERS? WHAT IS IN IT FOR THEM?

Think of legal financing like venture capital funding for lawsuits. Investors provide money to the legal financing fund, and the fund seeks out lawsuits that have a high chance of winning a sizable award. The return on the investment is tied back to the amount of money from the litigation recovery (either a settlement or award). The percentages vary, but where only a single case is financed, the amount is typically between 20% to 40% of the recovery. This is similar to contingent fee models of litigation, where fees are around 20% to 40%. Legal funds could accept lower percentages of a recovery if they are funding a portfolio of cases, which provides investors with diversification. This protects against the risk of a single case going badly and makes it more likely investors will get a consistent return. Portfolio funding of legal financing is becoming common and makes the investment attractive to institutional investors. To further diversify their portfolio,

legal funds have an interest in funding affirmative litigation on behalf of local government.

In the U.S., there are around 50 legal finance funds that invest in litigation. Private equity and hedge funds are growing their presence and competing with traditional legal funders as well. Assets under management are estimated to be around \$9 billion in the U.S.<sup>2</sup> However, the funding of public sector affirmative litigation is still small.

As "impact investing" or "ESG" (Environmental, Social, Governance) investing receives more attention, investment capital is finding its way to legal financing. According to the Global Impact Investing Network, assets under management with an impact focus total roughly \$715 billion. This is expected to increase over the next 10 years.<sup>3</sup> For institutional investors with ESG investing mandates, investing in legal finance funds that have an ESG investment mandate of their own present obvious synergies. The affirmative lawsuits that local governments could pursue might help fulfill these ESG mandates.

## WHAT IS THE BENEFIT TO LOCAL GOVERNMENT? WHY NOT CUT OUT THE FINANCIERS?

The economic logic is clear: All litigation consumes resources, and governments and their law departments are resource-constrained. Legal financing must be compared against the available alternatives. The current alternatives<sup>4</sup> are:

- ➔ Deferring or declining litigation;
- ➔ Appropriating funds for litigation, generating corresponding budgetary impacts; or
- ➔ Using a contingent fee arrangement.

The advantages of legal funding relative to the first two alternatives are clear. Deferring or avoiding litigation results in lost opportunities for monetary recovery. Appropriating funds (or borrowing, if feasible) strains the financial capacity of local government.

The costs of litigation are hard to predict and can last for multiple years—and a favorable outcome of litigation is not guaranteed. Legal financing means that local governments don't have to give up on a potential monetary recovery (alternative 1), but they also don't need to take on the risk of paying the cost of litigation on their own (alternative 2). Legal funding pays the cost of litigation and bears that cost even if the litigation is unsuccessful.

Let's turn to the third alternative: contingent fee arrangements with a private law firm. This is where a law firm is paid a percentage of the recovery, but not an hourly rate. It is not clear that either legal financing or a contingent fee model would have a consistent financial advantage over the other for local government. The percentage each takes of the recovery is comparable, though the specifics of each case will determine the percentage. However, legal financing can offer other important advantages over a contingent fee arrangement.

The most important of these is that legal financing can be used to fund any law firm to do the litigation, whereas the contingent fee model requires a law firm willing to handle a case on a contingent fee basis. Because the funds can be used to pay any firm's hourly rate, and because of the "portfolio effect" of the many cases a given financier is involved with,<sup>5</sup> the universe of legal capabilities that can be brought to bear on a case is greatly expanded. Many law firms are looking to develop new capabilities in affirmative litigation to grow their client base. However, the contingent fee model limits growth potential because law firms typically lack the ability to self-finance the cost of the litigation in hopes of a successful contingent recovery. Legal financing solves this problem, which will increase the number of law firm options available to governments for affirmative litigation.

Second, because of the economies of scale involved in financing multiple



## Portfolio funding of legal financing provides diversification, making it more likely investors will get a consistent return.

cases, a legal financier may be able to negotiate lower rates from law firms and take on specialized or unusual cases that a single, contingent fee law firm would not. For example, because the legal financier is bearing the risk of losing the case, the legal firm working the case would not need to “price in” risk in the form of a contingent fee.

Also, legal financing opens the door to using capable internal legal teams. The legal financier directly funds the local government’s legal staff and associated litigation costs. Solvent, well-funded private sector corporations avail themselves of legal financing because of the benefits we described. Local governments could obtain similar advantages (though this particular advantage is probably only relevant to the largest local governments that maintain sizable in-house legal staffs).

### WHO ARE THE LAWYERS WHO PURSUE THE CASE ON BEHALF OF LOCAL GOVERNMENT?

Small- to medium-size governments (populations up to 500,000) usually

will file affirmative litigation with the aid of external counsel, although even the largest local government law departments have used external counsel for affirmative litigation. The most recognized law firm compensation arrangements are either: a) a full contingency fee model with the law firm incurring all attorneys’ fees and costs in exchange for a recovery percentage, or b) a billed hourly model that may have a retainer included with the incurred fees.

Legal financiers only want to finance cases with strong prospects of monetary recovery. With access to investment capital, governments have options for who provides legal representation. Financing could be used for a traditional municipal law firm that the government is familiar with; but as noted, financing can be used to access new law firms and legal staffing options that might have an advantage in the litigation in question. In some matters and in some cases, legal financing could be used to support the costs for internal legal staffing.

### HOW DO THE FINANCIERS DECIDE WHICH CASES TO MOVE FORWARD WITH?

Legal financiers consider the total return potential of any prospective case. Financiers typically seek a case that will generate \$10 for every \$1 spent on legal fees/court costs. This 10:1 ratio is an industry standard metric. The \$10 represents the opportunity cost to a potential financier, as this sum accounts for not only legal fees/costs but also the potential return to the financier (including the chance of a no recovery and total loss on invested capital) and the return to the local government. Litigation is an unpredictable risk, sometimes with a clear “winner” and a clear “loser” should a case go to trial and at other times an outcome with no clear winners or losers. Similar to how insurers underwrite potential litigation exposures, financiers do the same. A litigation funder

uses probabilistic evaluation and prediction tools to evaluate probable success and possible outcomes. Legal analytic tools help quantify what a case duration could be, the likelihood of a case being dismissed at any point along the way, and what a case settlement range could look like.

These data points are used to fix a certainty of return estimate. A 60% chance of a recovery is the lowest level of confidence most funders would be willing to proceed with. A higher chance, say in the 70% to 80% range, will give a prospective funder more confidence to proceed with a case. No reputable funder would assign greater than an 80% chance of prevailing because of the unpredictability of U.S. litigation. Other factors also inform a funder’s decision to underwrite a case, such as the subject matter of a case, the law firms on all sides of the case, the judge/venue hearing the matter, and who the defendant is.

### IF A CASE MOVES FORWARD WITH LEGAL FINANCING, HOW ARE THE RELATIONSHIPS STRUCTURED BETWEEN THE FUNDER, LOCAL GOVERNMENT, AND LEGAL REPRESENTATION?

The funder will typically contract directly with the local government as the “litigant” pursuant to a “Litigation Funding Agreement” (LFA). The LFA spells out the terms of the funding, including the amount, the duration, and the particulars of the monetary recovery. The LFA will also recite the legal and professional obligations of the parties, including that the litigant and its law firm retain decision-making authority over the litigation, not the funder. Under the LFA, the local government will remain the client in the attorney-client relationship, represented by its external counsel (or, perhaps, internal legal team), and will ensure that its preferences are carried out by its attorneys. If a local government and funder disagree on the strategy or resolution, the local



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government, as the client, has the final “say” and authority on how the case progresses to resolution, either by way of settlement or determination on the merits in a court or arbitration tribunal. However, if a funder disagrees with the case strategy and tactics undertaken by the government and its attorneys, it may retain the right to stop financing a case. A funder will typically preserve its right (as any investor would) to exit an investment relationship in the event of changed circumstances.

### HOW LONG WOULD IT TAKE TO REALIZE NEW REVENUES FROM LEGAL FINANCING?

Affirmative litigation typically plays out over several years. Therefore, the financial gains to a local government are normally a long-term prospect, as any financial settlement or award would need to await a final decision. However, the local government’s stake in a potential recovery is an asset that could be monetized and sold for revenues that could be received on a

shorter-term time horizon. Private corporations monetize judgments in a similar fashion.<sup>6</sup> There are many details that a local government would need to navigate to monetize its stake in a potential recovery. It is beyond the scope of this article to cover those details, but we can say that not only is it theoretically possible to monetize cases but that it is already being done in the private sector.<sup>7</sup>

### WHAT IS THE HISTORY OF LEGAL FINANCING? WHERE HAS IT BEEN USED SUCCESSFULLY?

Legal financing began in Australia and London in the mid-1990s, following legislative moves paving the way for legal financing in these countries. Legal finance companies did not appear in the U.S. until 2008. In the U.S., there are around 50 legal finance companies. Ancillary legal funding also comes from opaque capital sources such as hedge funds and private equity firms.

In Australia, legal financing is routinely used by state governments. The most recent example is the Victoria and Queensland governments opting into a major Australian class action against manufacturers of flammable building cladding materials. The litigation funder financing that action estimates recoverable damages to exceed \$450 million and has financed that matter for several years.<sup>8</sup>

Both the Australian and U.K. markets continue to grow, but the total number of claims financed in the U.S. now exceeds those countries. Financing is expanding into new areas, particularly Latin America, Europe, and India. Commentators and market participants agree that this market is still young and will continue to grow by several orders of magnitude.<sup>9</sup> Currently, the use of legal financing by private entities dwarfs the use by local governments, so it seems that local governments have an opportunity to join the trend.<sup>10</sup>

### WHAT ARE THE RISKS TO LOCAL GOVERNMENT FROM ENGAGING IN LEGAL FINANCING?

Legal financing is not without its concerns. These concerns would resemble objections against litigation and judicial action in general. Four common themes of objections are summarized below:

**Public perception.** Some constituencies may object to courts weighing in on issues that could impact public policy, particularly when the legal action is funded by private parties. However, in the U.S. legal system, litigation can sometimes achieve what law and regulation may not. Without litigation, some communities may continue to be adversely affected by an issue that could otherwise be addressed with litigation. Legal financing offers a way to address these harms without putting the government’s budget dollars on the line. Further, the monies available from a recovery could be directed to priorities valued by the community.

**Opposition by certain corporate interests.** Certain corporate interests may object to local government litigation generally. To the extent the legal financing makes litigation easier for local governments, those same interests could be expected to object to legal financing as well. Of course, private firms use the courts regularly, so legal financing can “level the playing field” by addressing asymmetrical funding between governments and corporate defendants. Irrespective of the merits of their defenses, many corporate entities in high-stakes affirmative litigation have the means, the money, and the motivation to hire the best legal talent money can buy to wear down their opponents.

Some might also argue that legal finance encourages more lawsuits to be brought, and such lawsuits constitute frivolous litigation. Legal financiers, though, reject cases that are not “investment grade.” A legal funder

that finances cases of dubious merit will find itself out of business as the losses quickly stack up. Hence, any case taken on by a legal funder is almost, by definition, not frivolous.

Finally, some corporate entities may be the same entities local governments have a potential case against. As such, their objections to legal financing are likely to be based more on self-interest than an objective view of the merits of legal financing.

**Costs to local government.** Even if a legally financed case is handled by outside counsel, the local government will still need to monitor the case and its progress. Hence, though legal financing makes new resources available for affirmative litigation, a local government's governing board and top decision-makers still have limited time. Time spent reviewing the results of affirmative litigation is time spent not doing other things. Each local government will need to judge for itself whether the potential benefits of legal financing of affirmative litigation outweigh this cost. That said, local governments should maintain control of the case with legal financing, thereby assuring measurable control over the pace and outcome of the litigation.

Further, one might question that, even if potential new affirmative litigation is not "frivolous," perhaps pursuing new litigation, whether on policy grounds or for financial recovery, might not be the best course of action for a local government. It is true that legal financing could open up possibilities for affirmative litigation that did not exist before. A core tenet of savvy financial thinking is that options have value! One option every local government has is not to pursue a given opportunity. But there may be cases where it is in the local government's best interest to pursue the option. Local governments could even develop formal policies that provide guidance on how to evaluate options for affirmative litigation, just like many financially savvy local governments have policies that provide

guidance on how to evaluate options for incurring debt or investing idle cash.

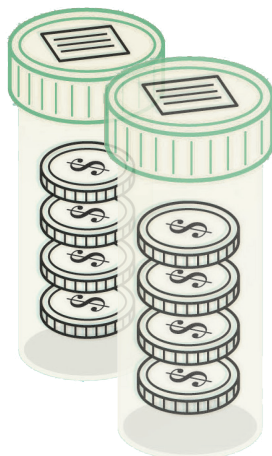
**Ethical considerations.** American jurisprudence has largely moved beyond historical common law prohibitions against "champerty"—the taking of financial interest in a legal dispute by a third party who funds the litigation. Some states have explicitly authorized legal financing arrangements, and others have implicitly done so; but in some states, the funding mechanism has not yet been authorized. Considerations of attorney-client privilege, the autonomy of the client to direct the litigation, and other traditional juridical principles remain paramount and may be heightened in the context of government clients. Lawyers for the local government may face challenges to the ethical propriety of the arrangement, and its details would need to be fleshed out to fall within the requirements of the Lawyers' Rules of Professional Conduct.

#### **WHAT STEPS ARE NEEDED TO PROCURE LEGAL FINANCE SERVICES? WHAT IS THE MARKET? HOW ESTABLISHED IS IT?**

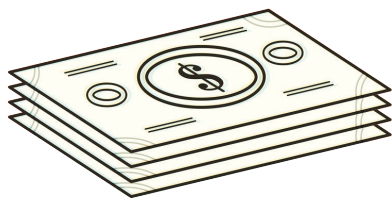
As referenced above, procuring legal services using legal financing will depend upon state and local laws, regulations, and applicable customs

and practices. Some states (e.g., Texas) require that the state attorney general's office review local government affirmative litigation before filing. As with anything having to do with litigation, consultation with your internal legal team is needed to get a picture of applicable rules and regulations informing any decision to go forward with legal financing.

Until now, legal financiers have largely not addressed the potential of the local government market. As the market evolves, new legal financiers with government legal expertise and experience are entering this space. Those financiers are engaging with governments and creating finance offerings for governments. To get a sense of the available market, one can look at opioid litigation, with cases being brought by about 3,500 governments. That litigation has a projected claim range valued between \$80 billion to \$100 billion, with just one component having a defined \$26 billion settlement value, as announced by certain claimants in July 2021. Depending on case volume and recovery potential, the government legal finance market could likely absorb at least \$200 million to \$400 million to finance legal fees/costs over the next two years.<sup>11</sup>



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## WHAT IS THE NEXT STEP?

Local government financial officers should discuss with their internal legal staff what potentially litigated matters have been deferred or avoided and are thus prospects for financing. A list of questions to discuss include:

- ➔ How many matters could be eligible to be financed?
- ➔ Will the matter(s) require external law firms, or can it be litigated in house?
- ➔ What is the expected duration of the claim(s)? How much time and resources do internal lawyers need to monitor matters and make sure that policymakers and other staff have the required information to make informed decisions?
- ➔ What are the potential cost and benefits of litigation? This includes the cost of litigation, recovery potential, and expected case duration. A local government's internal legal staff may have difficulty making precise estimates of these points, but even a rough estimate will help a local government understand which cases may have the most potential.
- ➔ What are similarly situated jurisdictions doing?
- ➔ Some jurisdictions, like the state of Ohio, have statutorily mandated fee schedules with a hard cap on recoveries paid to external law firms representing governmental entities. There could also be statutory or common law prohibitions that disallow legal financing. Do any of these apply in your jurisdiction?

Also, consider past history with potential litigation. The potential cost of pursuing legal action may have created an internal bias against litigation. Legal financing opens up new options, so it might be wise to revisit prior decisions about affirmative litigation. Litigation that seemed too costly before may now be feasible.

Finally, consider if your government has been impacted by issues that could be litigated by many governments, either regionally or nationally. Scale will be more attractive to legal funders because the case could be brought on behalf of many jurisdictions, and the potential pool of recovery is greater. Scale will also benefit local governments, as more resources will be put toward winning. An example is litigation regarding "PFAS" chemicals, which infiltrate aquifers and require costly water treatment. Local government environmental litigation involving these "forever chemicals" (which was the subject of the 2019 motion picture "Dark Waters") is increasing across the U.S.

Taking the steps outlined in this article can start to unlock legal financing's potential for increasing the resources available to local governments and making use of the court system to address issues that impact the health, safety, and welfare of their constituents. ■

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<sup>1</sup> Books like Benjamin Barber's *If Mayors Ruled the World: Dysfunctional Nations, Rising Cities* and Bruce Katz and Jeremy Nowak's *The New Localism: How Cities Can Thrive in the Age of Populism* describe the trend of local governments taking on big problems and why that trend has developed.

<sup>2</sup> Westfleet Advisors (November 19, 2019). \$2.3 billion of capital deployed over 12-month period across U.S. commercial litigation finance industry, according to first-of-its-kind study. *Litigation Finance Journal*. <https://litigationfinancejournal.com/tag/westfleet-advisors>

<sup>3</sup> Lamy, Yasemin Saltuk; Leijonhufvud, Christina; O'Donohoe, Nick (March 16, 2021). The next 10 years of impact investment. *Stanford Social Innovation Review*. <https://doi.org/10.48558/XFK2-6N65>

<sup>4</sup> Another possibility suggested by some litigation funders is local government borrowing to fund specific litigation. This mechanism (which would repay lenders solely from proceeds of given lawsuits if successful and similar in some respects to the repayment of revenue bonds from the operation of a funded facility or service) would be subject to a range of statutory limitations that vary by state and require further consideration.

<sup>5</sup> This refers to financial diversification, where the financier is likely to achieve their financial objectives over a large number of cases, so they can absorb a loss on any single case.

<sup>6</sup> Brass, Justin (March 13, 2017). Litigation finance can optimize deal value in private equity. *PE Hub*.

<sup>7</sup> A legal claim is a form of property known as a "chose in action," so one consideration is whether the litigation financing relationship could be construed as the local government's transfer or encumbrance of a chose in action, which may be prohibited or regulated under state law, especially where the claim is sold to the financier or encumbered by a lien.

<sup>8</sup> Litigation Funding Insights, Omni Bridgeway (June 10, 2020).

<sup>9</sup> Westfleet Advisors (November 19, 2019). \$2.3 billion of capital deployed over 12-month period across U.S. commercial litigation finance industry, according to first-of-its-kind study. *Litigation Finance Journal*. <https://litigationfinancejournal.com/tag/westfleet-advisors>

<sup>10</sup> Pavia, Annie (November 16, 2020). Analysis: For litigation finance, new heights are within reach. *Litigation Finance Survey 2020*. *Bloomberg Law*. <https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-for-litigation-finance-new-heights-are-within-reach>

<sup>11</sup> This figure is extrapolated by looking at the estimated volume of financed matters in the private sector legal market, as reported by Westfleet Advisors and Bloomberg Law, and comparing it to the smaller public sector legal market. By then applying an industry standard that 2%–4% of legal spend is suitable for legal funding, this estimated total addressable market represents a conservative projected baseline sum.