MORETON & COMPANY

MUNICIPAL INSIGHTS

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Third-party Litigation Funding Explained

Third-party litigation funding (TPLF)—also known as legal funding, third-party litigation finance or alternative litigation financing—is when a third party invests in a lawsuit in exchange for a percentage of the proceeds if the lawsuit is successful. The recipients of TPLF can either be individual or corporate claimants.

Although exact figures are unknown due to the opacity of this practice, insurance company Swiss Re estimates that its worldwide market will reach $30 billion by 2028, with the United States representing the largest market. Swiss Re also notes that TPLF investments have recently produced internal rates of return of 25% or more. Due to the rising prevalence of TPLF, it is essential to be aware of this trend and its effects.

This month's Municipal Insights examines TPLF, including how it works, its different recipients and its impact on the insurance industry.

How TPLF Works

TPLF generally involves financers (e.g., Wall Street hedge funds) investing in ongoing litigation. This may be done by providing the funds directly to a plaintiff or law firm or through a broker or company that specializes in TPLF.

Investors engaging in TPLF typically provide nonrecourse loans against a case or a portfolio of cases in exchange for an equity-like stake in the financial outcome that may result. Funding can occur at all stages of a lawsuit and is not contingent on the plaintiff receiving a judgment or settlement. Litigation finance companies may also work to establish relationships with law firms or utilize search databases to find cases to finance.

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Different Recipients of TPLF

Investors may seek different types of cases to fund. How the money is used and dispersed depends on the type of claim that is financed.

Investors conduct extensive research before selecting a case or a portfolio of cases. The money typically goes to corporate plaintiffs or law firms that use it to fund various costs. These plaintiffs or firms generally receive funding no matter the case's outcome but agree to provide a portion of the monetary award to the investor. This amount has been reported to be as high as 50%.

Commercial litigation receives most TPLF, according to analysts. Money may be directed to various types of cases, including those involving intellectual property, arbitration, entity torts and contract breaches. Class-action suits may also be funded.

Personal or consumer litigation funding occurs when investors provide money to individuals to pay for living or medical expenses they may incur while a case is litigated. In some instances, and if local laws permit, the funds may be used to pay for legal expenses. Before providing money, funders analyze how much a case may be worth and often focus on personal injury cases.

As with commercial litigation, financial assistance is generally provided to personal and consumer litigation on a nonrecourse basis, with the investor only receiving money from awarded damages.

TPLF's Impact on the Insurance Industry

While advocates for TPLF state that it helps balance the scales of justice by allowing underfunded plaintiffs to pursue legal action against deep-pocketed industries, its critics proffer that the practice leads to increased insurance rates and less favorable policy terms and conditions. Because TPLF is generally not required to be disclosed, transparency as to whether a party has received it is lacking. This may make it hard for insurance companies to calculate associated costs and mitigate legal risks, which in turn could lead to an increase in insurance costs for consumers.

Additionally, opponents of TPLF state that it may disincentivize efficient litigation since law firms may receive payments regardless of the case's outcome, and funded claimants may alter their settlement strategy since part of their share may be eroded by paying back the investor. Moreover, juries may not receive the whole picture of who receives the money when they award damages, which may influence their decisions.

Data suggests that TPLF may be a driver of social inflation, a concept that refers to the increase of insurance claims' costs above that of the general economy's inflation rate. Swiss Re notes that there has been an increase of multimillion-dollar claims in the U.S. general liability and commercial auto areas and that TPLF incentivizes initiating and prolonging lawsuits while diverting a larger percentage of proceeds to the funder instead of the plaintiff. These expanded costs may be difficult for insurers to quantify and mitigate since they are hard to predict. Opponents of TPLF are pushing for more transparency and regulation of the practice.

Contact Moreton & Company today to learn more and speak with a qualified insurance broker.

For more risk management guidance, contact a member of Moreton & Company's Public Entity Team.

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