Facts and figures

Andrew Hogan analyses the economics of litigation risk

Do the shares of law firms and litigation funders make good investments? The cynic holding a large 'put' option on such shares would suggest that they are excellent investments. But given the performance in recent years of the share price of, for example, law firm Slater and Gordon, or before them, Quindell, it is far from clear that such stocks make comfortable investments for 'widows and orphans'.

On 18 November 2015, Juridica effectively closed to new litigation funding business. In a press release, the chairman Lord Brennan announced: 'Both the board of Juridica and its investment manager acknowledge that scale and diversity are now required in order to invest successfully in this asset class, which is not achievable under the company's existing structure.'

It can be no coincidence that this announcement came two days after an earlier announcement that, in a US case in which Juridica had invested $3.5m of funding, an American jury's award would mean a return to the company of only $2m. Contrary beasts, juries, as every barrister knows.

THE PROBLEM OF RISK

Leaving aside the fate of a single company, in the currently unregulated world of litigation funding, the problem of risk will resurface again. This is likely to prove true not just in relation to third-party funders, but also in relation to the risk posed by the valuations attributable to law firms, where those valuations are heavily dependent on contingencies such as the number of claims which will prove successful, or the return to be expected from each claim.

These firms are – and have been for many years – providers of capital to litigants, through making their own services contingent on success, or providing credit or carrying disbursements; or even in some cases, providing an indemnity for the costs of the other side, should the case be lost - though this latter aspect raises big questions about maintenance, champerty and compliance with the Solicitors Code of Conduct.

Capital, using this term in a broad sense, could be provided in a number of ways. In the closing years of the 20th century, and still more so in the first two decades of the 21st century, the state has lost interest in providing capital through a state-funded legal aid scheme. This source of capital was never available to small and medium-sized enterprises or any other business, and never pretended to provide comprehensive provision.

The effective abolition of legal aid has not caused the need for capital to diminish; but rather has required the provision of capital from the private sector. Enabling lawyers to fund (part) of the litigation through making their own fees deferred and conditional on success, is another crucial source of capital for litigation funding, where the lawyers effectively provide capital to an impecunious claimant.

In such circumstances, their own client can expect to pay an economic 'rent' by way of a success fee for providing the capital. From 2000 to 2013, this 'rent' could be externalised through the scheme of additional liabilities which existed under the Access to Justice Act 1999.

So I believe it is entirely possible to view the 'costs wars' of this period as a struggle by defendants – whether insurance companies, public authorities or private litigants – to exclude the introduction of capital into litigation by their opponents, using tools such as champerty, maintenance and consumer protection provisions, coupled with the indemnity principle, to achieve this end.

Even the mundane struggle to decrease levels of costs through, for example, the introduction of fixed costs, the Ministry of Justice Portal and more restrictive rules on the recovery of costs generally can be viewed as exercises both in capital conservation and capital restriction.

I would further suggest that each of the legislative developments from 1990 to 2012 (the Courts and Legal Services Act 1990, the Access to Justice Act 1999, the Legal Services Act 2007 and the Legal Aid, Sentencing and Punishment of Offenders Act 2012) can be characterised fundamentally as statutory interventions, with the effect (though possibly not the expressed purpose) of working either to liberate or constrict the free flow of capital for the purposes of funding litigation.

RISK MATTERS

So when litigation funders or law firms take on too much risk, this matters, for reasons which are systemic. With an involved and sophisticated system of law such as we have in England and Wales, a key problem in obtaining effective access to justice in litigation is the inequality of arms that will often exist between a well-funded defendant and an impecunious claimant. Or to put it another way, the imbalance of capital between two parties which enables the richer party to buy better lawyers, better experts and generally turn its financial advantage into strategic or tactical advantage within the litigation.

> The liberalisation of legal services will facilitate the introduction of capital into litigation funding

In England and Wales, which enjoys (by and large) costs shifting, whereby the loser pays for the costs of the litigation, an additional need for capital exists, to potentially defray the cost of losing.

From this perspective, the key to enhancing access to justice is to facilitate access to capital for the purposes of the litigation by the economically weaker party. This should enable them to pay for lawyers, pay for experts, pay court fees, and make provision for funding any adverse costs consequences which might follow from an unsuccessful court case.

There can then be a reasonable prospect that the provision of capital will remove the inequality of arms and produce a more 'just' result. Thus those who provide capital – whether by means of funding litigation or acting on a contingent basis – are actually providing a public service, although their own motives for doing so will be far from altruistic, and driven by the prospect of profit.

Although the above analysis is unashamedly economically determinative (positively Marxist in fact), it does shed light on why 700 years of prohibition on contingency fee arrangements was discarded within the span of a single generation of lawyers: the urgent and pressing need to introduce a source of capital into the system that was readily to hand. This was an inevitable result of the state being unwilling to provide litigants with the capital they needed to access a sophisticated

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and complex system of laws through appropriately skilled lawyers.

THE FUTURE

Looking to the future, one can predict that litigation funding from third-party funders will undoubtedly increase in terms of its availability and the frequency of its use. Furthermore, it will evolve, moving from funding individual cases into funding or buying 'books' of cases, with an increasingly porous dividing line between third-party funders and legal expenses insurers.

But perhaps the most far-reaching development of all is the market liberalisation of legal services, which will facilitate the introduction of capital into litigation funding on an unprecedented scale. Thus the LSA 2007 and the market liberalisation changes it has introduced will prove extremely far reaching, perhaps far more so than the removal of the prohibition on contingency agreements.

But with memory of the 2008 financial meltdown fresh in the collective consciousness, it should be readily apparent that the issue of risk is one that is all too easily discounted – even by giant financial institutions - until it is too late.

To avoid a fate similar to the financial services industry, the litigation funding and legal services industries will need to produce models of risk evaluation of a magnitude of sophistication far beyond those that operate today. If they do not, there will be further failures in balancing the risks posed by litigation funding, and ascribing a fair value to law firms' work in progress; to the general detriment of increasing access to justice.

LESSONS FROM INSURANCE

There is a useful parallel to be drawn from the insurance industry. In 1744, two Church of Scotland ministers invented the first true insurance fund. It had a degree of sophistication that went beyond the 'pay-as-you-go' financial arrangements which pertained in Lloyds, where the aim was simply to collect enough premiums in any given year to cover the payments out and leave a margin of profit.

Instead, the two ministers took six mathematical breakthroughs: Pascal's observations on probability; Edmond Halley's life tables; Bernoulli's 'law of large numbers'; de Moivre's work on distributions and the bell curve; the principle of utility; and Bayes' work on inference, to devise a scheme whereby widows and orphans of Scottish ministers would receive financial benefits in the event of the minister's death, in return for an annual premium.

What made the scheme different to previous insurance schemes was that the premium was calculated to create a fund that could be invested, so that the benefits were paid out of the returns on the investment. All that was needed were precise calculations using the mathematical breakthroughs noted, as to how many recipients there would be, and how much money they needed for their support. The scheme was remarkably successful. Scottish Widows is, of course, a well-recognised brand today.

Coming back to the legal world, what this means for any law firm that undertakes work on a contingency fee basis, is contemplating listing, or is looking to attract equity investment, is that the quality of the data that it has gathered historically will be absolutely key in demonstrating and justifying a fair price for such external investment as it may seek - but will not be a sufficient requirement. It can only be the basis on which a sophisticated model of risk is built. Otherwise, who would invest capital in a law firm when such an investment might be built on sand?

For litigation funders, the move to an insurance model based on claims data and other statistics to determine the likelihood of a payout; capital adequacy to ensure that payouts can be met from investments as well as fees; increased certainty on expenditures through the introduction of fixed fees for lawyers, and the preservation or strengthening of the *Arkin* principle will become priorities. These would go some way to reducing risk, perhaps even making the shares in these companies more of an option for 'widows and orphans' than they might be thought to be today.

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