Currency swing

Andrew Hogan asks if cryptocurrency could enable law firms to act as funders

In this article, I shall explore to what extent initial coin offerings (ICOs) of crypto tokens might be used to raise money for litigation funding, and facilitate a reduction in the market cost of litigation funding – whether through ICOs being adopted by established litigation funders, or through new entrants into the litigation funding market, such as funding vehicles established and controlled by solicitors' firms.

BACKGROUND

Litigation funding fees can be significant. Typically, a litigation funder will ask for a fee of 30% of the proceeds of the litigation upon a successful conclusion, or a fee calculated as a multiple of three times the amount of funds lent.

This might be thought by solicitors and their clients to be expensive: litigation funders can point instead to the speculative nature of their investment, and to the fact that all litigation funding is made on a non-recourse basis. They may also point to the profit levels of similarly risky businesses such as speculative land development, where sites are purchased without planning permission and only 'hope' value, to illustrate that they are operating within a particularly niche part of a particularly small market.

The prospect of significant profits by providing clients with litigation funding should make setting up and establishing a litigation funding arm a logical step for modern law firms with a decent book of big money cases to diversify their own risk; to establish a further profit centre for a diversified legal services group.

But, by and large, this has not happened. There may be several reasons for this. First, one should never discount lawyers' innate natural conservatism and resistance to change. If they are making decent profits from the case already through the fees they charge, there may be no desire to take on another aspect that might prove problematic.

Second, there may be well grounded fears of regulatory difficulties and conflicts of interest, as well as systemic risk, if the lawyers go beyond, for example, deferring or making contingent their fees, or providing credit to clients for their disbursements, as permitted by the Courts and Legal Services Act 1990. A non-party costs order against a law firm which has financially backed a case might be a very unattractive prospect for the owners of the firm.

But third, the most simple reason may be lack of access to capital. Partners at law firms dream of the rainmaker: the big case that will bring in so much money, that they can create a 'war chest' to enable them to take on other expensive litigation and so leverage their returns. But this in turn leads to the chicken-and-egg dilemma, of how the rainmaker itself is to be financed. To whiteboard a business model, capital must be found.

COST OF CAPITAL

Like any industry, litigation funding looks to minimise its costs – and the cost of capital is a major element of this. Moreover, the cheaper the capital, the more competitive a funder. The key to minimising costs is to reduce the cost of capital. To do that, there are various routes that might be considered.

As Beata Dunn of Aria Grace Law, in a recent, perceptive summary of emerging trends for sourcing capital, noted: 'Any investor will be first concerned with the scalability, time and costs it takes to raise funds, the nature of collateral and reliance on a regulated structure.

'This is why either crowd funding or bank deposit taking models, or other cash only funding from hedge funds and institutional investors, with the added bonus of non-correlated high-returns, remain still more price competitive. Give them a more reliable "store of value", a collateral pool with some degree of fiat (hard) currency, smart contracts or similar within the known regulatory framework, and you end up with cheaper future funding. It is an investor's appetite to look at new types of assets, new forms of money and engagement of fintech firms, which can tip the scales.'

> Crypto tokens could be a way to access either institutional or consumer capital for the purpose of raising money for litigation funding

But is there another way? Is it possible for a litigation funder or a solicitor's firm to both enable litigation and extract value from the funding of it, at a much lower cost than hitherto, through the use of modern technology, in particular through ICOs of crypto tokens to raise funds cheaply, leveraging the phenomenon known as blockchain, or to its adherents the more prosaically named distributed ledger technology?

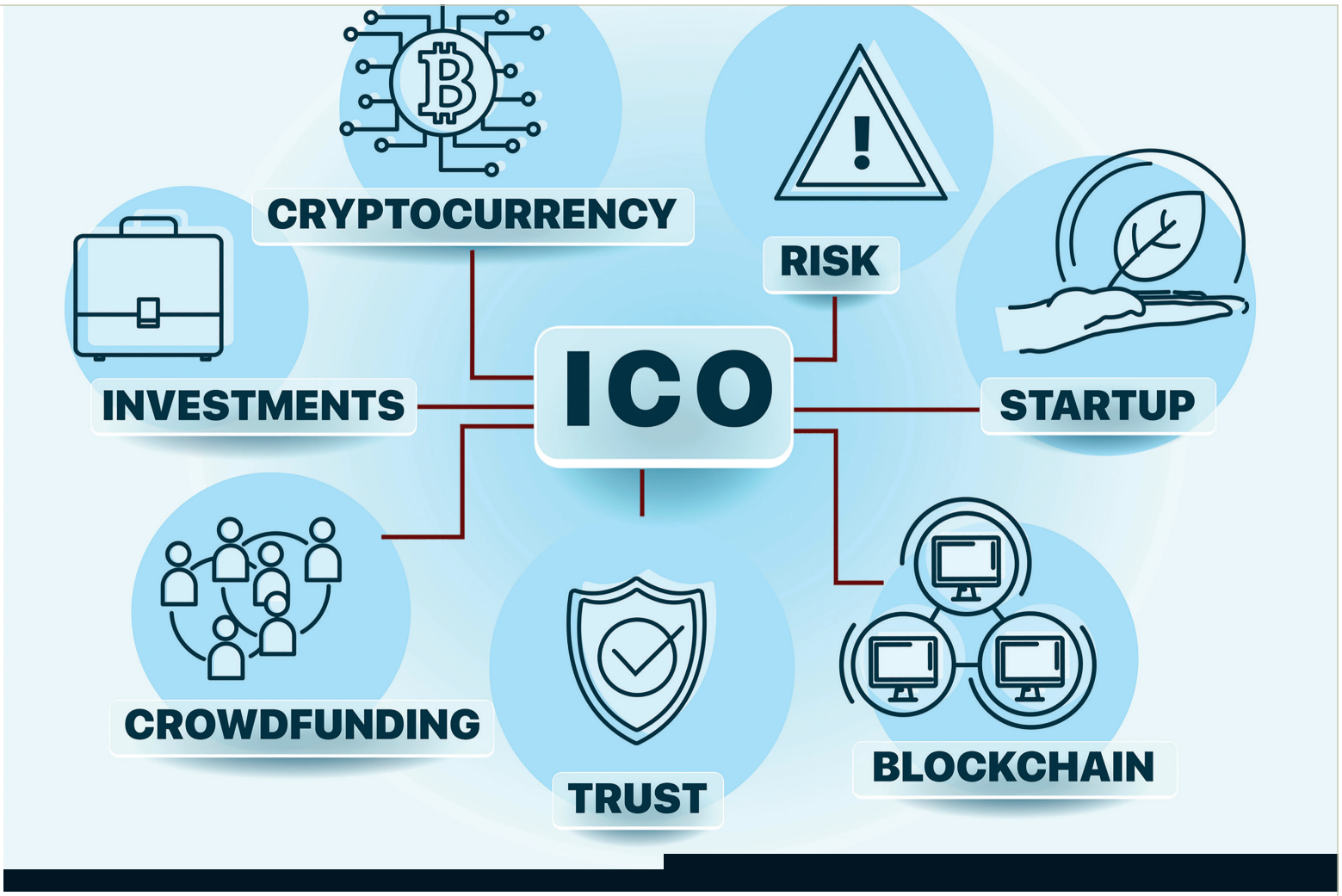
CRYPTO TOKENS AND BLOCK CHAIN

Blockchain is a special kind of database that was initially created to support a new digital currency called 'bitcoin' in the aftermath of the financial crash of 2008. There are now many different digital currencies: but they are all examples of what can be called crypto tokens. The blockchain that bitcoin is built on uses distributed ledger technology to keep track of the currency, with many copies that all update themselves, using blocks of transactions when people trade the currency to form an immutable record, a blockchain.

Bitcoins (and crypto tokens generally) do not have a physical existence: they exist as bits of computer code and can be traded digitally through exchanges. But the uses of blockchain technology go beyond creating digital currencies which can be used anonymously on the Dark Web. Crypto tokens are beginning to make an impact.

The courts are prepared to find that bitcoins are property, the right to which can be protected in law. In *AA v Persons Unknown* [2019] EWHC 3556 (Comm) the High Court of England and Wales found:

'[58]. The difficulty identified in treating crypto currencies in property starts from the premise that the English law of property recognises no forms of property other than choses in possession and choses in action. As I have already identified, crypto currencies do not sit neatly within either category. However, on a more detailed analysis



I consider that it is fallacious to proceed on the basis that the English law of property recognises no forms of property other than choses in possession and choses in action. The reasons for this are set out between paragraphs 71 to 84 in the Legal Statement.

'[59]. The conclusion that was expressed was that a crypto asset might not be a thing in action on a narrow definition of that term, but that does not mean that it cannot be treated as property. Essentially, and for the reasons identified in that legal statement, I consider that a crypto asset such as bitcoin are property. They meet the four criteria set out in Lord Wilberforce's classic definition of property in *National Provincial Bank v Ainsworth* [1965] 1 AC 1175 as being definable, identifiable by third parties, capable in their nature of assumption by third parties, and having some degree of permanence. That too, was the conclusion of the *Singapore International Commercial Court in B2C2 Limited v Quoine PTC Limited* [2019] SGHC (I) 03 [142]'.

It follows that if a bitcoin or security token is property, that it can be traded and protected under law. With that essential status, the use and deployment of crypto tokens becomes possible.

Blockchain technology can be used wherever any form of trusted, secure, retention of information held on a distributed basis is involved. As blockchain was grounded in the invention of a new currency, the implications for financial services, including the securitisation of assets, are obvious.

Rather than issue shares or bonds through the equity or bond markets, it is possible to issue crypto tokens instead, which have the characteristics or properties of a conventional financial instrument, which are capable of being traded on digital exchanges.

If those are linked to an investment in funding litigation, whether that be an individual case or a firm's caseload, then the holder of the crypto token in exchange for his purchase of it, may derive an income from holding the token, or a capital gain pegged to the value of the proceeds of the litigation.

The crypto tokens could be made available to multiple investors. If 'floated' on a large digital exchange with interested investors and sufficient liquidity, the crypto tokens can be used to raise money.

The crypto tokens would be convertible by being capable of being traded on an exchange, and thus creating a secondary marketplace. Although it is not beyond the bounds of possibility to factor a litigation funding agreement, the nature of the investment is illiquid. Moreover,

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to ensure a greater take up than simple placing on an exchange might result in, the tokens could be marketed through crowdfunding marketplaces.

So in summary, crypto tokens could be a way to access either institutional or consumer capital for the purpose of raising money for litigation funding in several steps:

1. The creation of a scheme, whereby a firm's caseload or even an individual case is scoped for funding requirements, and the overall funding requirement collateralised by linking ownership of crypto tokens to a defined share in the profits of the litigation.

2. The scheme then must be prepared for a public offering: including the creation of a prospectus and any other requirements imposed by financial services regulators: of which more below.

3. The tokens are created. They are then presented for sale through markets and crowdfunding. Investors can purchase the tokens with digital wallets or escrow accounts.

4. The tokens will be freely tradeable: the value of the token will be pegged to the value of the underlying litigation serving as collateral, so might vary dramatically from time to time, as the fortunes of a case or a caseload rise and fall.

5. At the conclusion of the litigation, the tokens are paid out with the defined share of the proceeds, or if pegged to a dynamic caseload, receive a return based on the caseload's return. Conversely, there may be a 'nil' return.

So far so good, but there are several steps to putting together an ICO which can make it a costly process. Perhaps the one that will most immediately concern lawyers, are the regulatory considerations.

REGULATORY CONSIDERATIONS

Although the practice of litigation funding is not per se subject to regulation, once securities are offered for sale to the public, the regulatory regime which applies to the sale of financial products will apply to these activities.

Some litigation funders are already regulated by the Financial Conduct Authority because they choose to be. It may be that they are in an excellent position to revise or expand their funding business model and use ICOs to create a new market.

The position in relation to regulation within England and Wales of the use of blockchain-based crypto tokens is evolving and subject to development, as the technology is still new, if not novel. A useful starting point is the *Cryptoassets Taskforce: Final Report* published in October 2018, which provides an overview of the government's approach to policy as follows:

'The Cryptoassets Taskforce report lays out the UK's policy and regulatory approach to cryptoassets and distributed ledger technology in financial services.

'It provides an overview of cryptoassets and DLT, assesses the associated risks and potential benefits, and sets out the path forward with respect to regulation in the UK. 'The report commits the authorities to take forward actions that will:

'- maintain the UK's international reputation as a safe and transparent place to do business in financial services

'- ensure high regulatory standards in financial markets

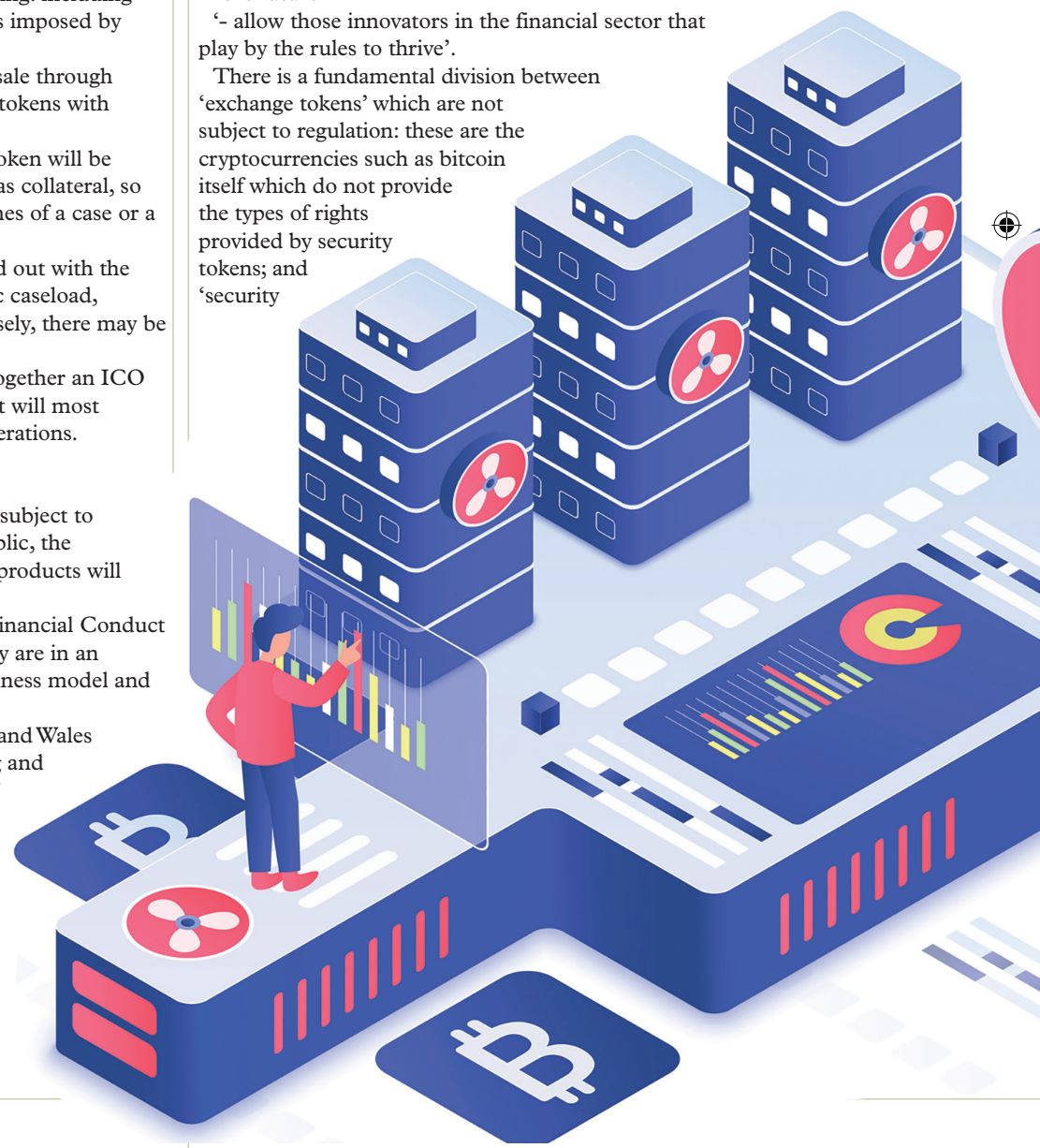
'- protect consumers

'- guard against threats to financial stability that could emerge in the future

'- allow those innovators in the financial sector that play by the rules to thrive'.

There is a fundamental division between 'exchange tokens' which are not subject to regulation: these are the cryptocurrencies such as bitcoin itself which do not provide the types of rights provided by security tokens; and 'security

The Financial Conduct Authority has issued Guidance indicating that only crypto tokens that are security tokens are transferrable securities



tokens', which do provide more extensive rights to their holders such as repayment of a specific sum of money, or an entitlement of a share in future profits.

Security tokens are specified investments subject to regulation through the Financial Services and Markets Act 2000 and the EU's Markets in Financial Instruments Directive II. Curiously, although bitcoin itself and its emulators are often used for speculative investment, with its dramatically changing price, they are not transferable securities, which are subject to regulation.

The Financial Conduct Authority has issued Guidance indicating that only crypto tokens that are security tokens are transferrable securities. Bitcoin and its competitors such as Litecoin and Ether are rather to be described as unregulated exchange tokens.

To be lawfully offered to the public, a detailed prospectus containing prescribed content would have to be drawn up and approved by the FCA. In addition, the restriction on financial promotion contained in the regulatory regime must be adhered to; in order to promote the sale of a security token, it must be approved by an appropriately authorised person, or some exemption must apply. Finally, the general regulatory provisions which apply to advertising, online or distance selling, and the protection of the consumer would need to be complied with.

Law firms have the collateral, in the form of a profitable caseload, albeit one that requires litigation funding to unlock the value of it; they have a financial interest in gaining a further profit centre created by the fees that litigation funding can attract; they have the option to use blockchain technology to obtain capital through the issue of crypto tokens, where subject only to market constraints they can dictate the price of the tokens; and they can do all this without the involvement of 'traditional' litigation funders, who in truth can be viewed as simply expensive brokers of capital. It will be interesting to see whether this route is pursued in the coming years as an alternative to more conventional forms of litigation funding, or whether existing litigation funders will revise their business model to include it.

PROBLEMS

Of course, none of this is going to be plain sailing. The lack of clarity in the regulatory framework, investors' appetite for risks and scalability are real concerns. Moreover, a litigation funder needs to be able to offer certainty on both the amount of capital it can provide and the timescale.

The perceived lack of collateral in a currency pegged to an individual case or a caseload may also create problems, as may wild swings in valuation, for which crypto currencies are notorious. This could be poison for the growth of a secondary market in the token.

This could be mitigated to an extent by the use of 'stable coins', which are crypto tokens pegged or backed to some asset, in the way that fiat currencies still hark back to the gold standard. But this adds a further layer of complexity to any ICO. Moreover, it may be necessary to simply accept volatility: after all, at the end of the day, in the ruins of a trial, the value of the crypto token may represent a share in the proceeds of nothing.

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COSTS

But how much will a crypto token offering cost compared to the 30%-or-three-times-the value price of such funding? The answer can only be - it depends.

The following costs need to be borne in mind:

- Concept development
- Legal and regulatory advice
- Token architecture and issuance
- Marketing
- Broker engagement
- Transfer agent
- Exchange listing

Knowledge of how to make an ICO in this context is at a premium, and the number of exchanges which possess large amounts of liquidity are limited, and charge an economic rent in consequence. But if the costs are coming in at under £1m, that does not seem a high cost compared to the sums that might be at stake in the litigation, or might otherwise accrue to the litigation funding industry.

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