ASSURED REPORT

The Role of Litigation Funding in P/C Insurance

Dai Wai Chin Feman is the managing director of commercial litigation at Parabellum Capital. Parabellum, in business for more than a decade, is a commercial litigation funder. Dai Wai didn't pull punches when, in the Spring of 2022, he penned an article for Carrier Management, arguing "…commercial funds are not driving the "nuclear trucking verdicts" oft cited by the insurance and defense lobbies as demonstrative of the dangers of litigation funding."

It's been over two years since that article was released, and with social inflation still problematic for most insurers, we thought it would be useful to see if Mr. Chin Feman would entertain our questions on litigation funding. He kindly agreed, and in this Assured Report we share his responses as part of a wide-ranging discussion on the topic.

Specifically, in this Report you'll find important distinctions between commercial and other forms of litigation funding as well as Dai Wai's strong convictions on matters pertaining to regulation and disclosure.

But wait…there will be more. In our November Assured Briefing we'll continue the dialogue with questions pertaining to claim dynamics when litigation funding is involved. We can also add that our November Briefing will include a financial analysis of law firm loans – possible through the public disclosures of one of the few banks in that business.

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Dai Wai Chin Feman is the managing director of commercial litigation at Parabellum Capital. Parabellum, in business for more than a decade, is a commercial litigation funder.

Dai Wai has earned many accolades within the legal and litigation funding industries. He also handles Parabellum's public policy initiatives and it is in that capacity that he has kindly agreed to entertain our questions.

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Dai Wai Chin Feman, the managing director of Parabellum Capital's commercial litigation group didn't pull punches in the Spring of 2022 when he penned an article for Carrier Management called Commercial Litigation Funding and Social Inflation: A Non-Sequitur. Regarding regulation of commercial litigation funding he wrote, "Such calls to action [regulation of commercial litigation funding] lack empirical support and fail to withstand even gentle scrutiny."

Elsewhere he argued, "While insurers regularly cover consumer claims, coverage is rare or non-existent for the majority of funded commercial cases in the United States. Consequently, commercial funds are not driving the "nuclear trucking verdicts" oft cited by the insurance and defense lobbies as demonstrative of the dangers of litigation funding."

It's been a few decades since we picked up a comic book, but as we reread the piece, we envisioned those descriptive bubbles over the text filled with words like "Pow!" or "Splat!"

Well, more than two years have passed since that article was published and it's hard to argue that social inflation is any better or that we, the insurance profession, fully comprehend its drivers. In a recent article summarizing a study on social inflation produced by RAND, Carrier Management wrote: "Those involved in the study say the increase of legal system abuse generated by billboard attorneys, combined with third-party litigation funding of lawsuits by dark money investors, are contributing factors to rising social inflation."

Dark money investors in our legal system? That sounds scary, so for insights and more straight talk we turned back to Dai Wai Chin Feman.

AR: *Thanks for doing this and we're going to assume readers understand the basics of commercial vs. consumer litigation funding [Note: skim the first linked article for a refresher]. Now, for a research note written in December, 2019 we interviewed the head of a trade group for consumer litigation funders (the American Legal Finance Association) and the perspective shared then was – social inflation isn't our fault! The argument offered was that the loans were too small (e.g., a few thousand $ for living expenses) and were only made after a plaintiff had already contacted an attorney.*

Our first question, if social inflation can't be pinned on commercial litigation funders, nor on consumer litigation funders, then who? And how do you respond to arguments that commercial litigation funding contributes to social inflation?

DWCF: Thanks so much for having me, Bill. I think social inflation should be debated on the basis of research rather than rhetoric. As your readers know, talk is cheap, and there is no shortage of suspected causes. RAND's recent research report on social inflation helps distinguish causation from conjecture. Notably, the report does not conclude that any type of litigation funding – or so-called "dark money" – causes social inflation. This is completely unsurprising for commercial litigation funding, which entails passive investment in commercial claims, *not* claims for personal injuries or catastrophes.

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For any remaining skeptics out there, here are a few commonsense considerations to help understand commercial litigation funding in the broader context of the social inflation discussion:

(1) *Evidence*. If there were an actual link between commercial litigation funding and insurance premiums, it would have emerged. Instead, unsupported suppositions persist. Tellingly, as Bloomberg recently noted, "[t]en large insurers whose executives have referred to social inflation recently either didn't respond or declined to provide data about the effect of litigation on their business beyond what the executives have said publicly." (By the way, on the consumer side, I've yet to see meaningful evidence of litigation funding for nuclear trucking verdicts.)

(2) *Market Size*. Despite market maturation, commercial litigation funding remains relatively rare. Data from Westfleet Advisors shows that only approximately 120 commercial litigants received funding in 2023. Even assuming the data were off by tenfold, it is clear that funded cases are statistically insignificant relative to the overall number of P/C claims. And if this sounds like a small number of cases, note that the average reported investment commitment was $4.8 million. There is a limited universe of disputes with damages sufficient to support investments of that magnitude using a standard damages to investment ratio (or anything close to it). In fact, the average case exceeds $10 million in damages and is technically "nuclear" in size by definition. The commercial funding market is also extremely concentrated. This is likely due to high barriers to entry associated with the cost of financing diversified portfolios of big-ticket litigation.

(3) *Anti-Corporate Sentiment*. Funded commercial cases are predominantly business-to-business in nature. Unlike individuals, corporate plaintiffs do not benefit from shifts in jury attitudes that may result in higher verdicts or expanded liability.

(4) *Aberrational Verdicts*. Commercial claims seek compensation for economic damages and are largely ineligible for the aberrational verdicts fueling the social inflation debate. The only purported correlation between litigation funding and social inflation comes from Swiss Re's 2021 report, *US Litigation Funding and Social Inflation*, which is based on general liability, vehicular negligence, and other personal injury claim data. Applying Swiss Re's analysis to commercial litigation funding might make sense if those claims were "commercial" in nature. However, funded commercial claims rarely sound in tort or property damage, rendering them clearly distinguishable. Examples of the most commonly funded commercial claims include breach of contract, antitrust violations, and intellectual property infringement.

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(5) *Insurance Coverage*. Commercial claims seldom implicate insurance coverage. This means that the commercial litigation funding market isn't even a meaningful beneficiary of higher insurance payouts.

(6) *Class Actions*. Contrary to speculation, litigation funders cannot directly invest in class actions without court approval. That is because neither class counsel nor the representative plaintiffs have the authority to bind the absent members of the class to a contract with a litigation funder. There is little to no precedent for court approval of any class funding arrangement.

AR: *If the finger can reasonably be pointed at capital providers to plaintiff firms (here are a few we found: Advanced Legal Capital, Advocate Capital, and Counsel Financial) can you explain how their advances/working capital change the economics of a law firm in a way that could manifest as the impacts of social inflation observed by P/C insurers (to wit: rising frequency of litigated claims, severity that outstrips inflation)?*

DWCF: I don't think the law firm lending sector is responsible for recent inflationary effects experienced by P/C insurers. Plaintiffs' firms have had access to credit for decades (including through banks), so this is not a new phenomenon that would be responsible for recent trends. Also, most of the country still prohibits non-lawyer ownership of law firms, so lawyers already have fewer financing options available than other businesses.

Plaintiff firms have had access to private credit for decades. What has expanded is their access to non-recourse capital; for which law firms pay extra but avoid the need for a personal guarantee.

What we have seen in recent years is more entrants into the non-recourse lending space, including multi-strategy and credit funds seeking private credit-like returns. However, the main difference between recourse and non-recourse products is the cost of the capital, rather than a directional shift in firm economics. Non-recourse capital is riskier – the investor has more limited collateral – and therefore more expensive. Due to both market dynamics and ethical constraints on fee-sharing with non-lawyers, law firm lending arrangements are typically structured as lines of credit or interest-bearing loans. A law firm can generally expect to pay several additional percentage points in exchange for non-recourse capital that avoids the need for a personal guarantee. The interest will almost always compound over time, incentivizing firms to resolve cases early.

With regard to the capital providers, they are not in privity with law firms' clients, cannot control litigation, and do not receive outsized returns from aberrational verdicts. Investment returns are calculated as interest rates or multiples of invested capital as opposed to a percentage of attorneys' fees from a specific case. Accordingly, capital providers are neither capable of causing, nor inclined to favor, an increased frequency of litigated claims. To the contrary, they philosophically prefer economically rational settlements that mitigate the risks of binary outcomes, increased duration/tenor, and high costs inherent in non-settled claims.

AR: *We gather you have strong opinions on views on enhanced regulation and disclosure requirements; outcomes often sought by insurers and in some state legislatures. In your Carrier Management note you wrote "Implementing disclosure regimes would actually increase defense costs and prolong case durations." Can you expand on that and has your thinking changed since 2022?*

DWCF: With limited exceptions, courts continue to deny funding disclosure on the grounds of relevance and work product. That unfortunately doesn't stop defendants from routinely trying, whether through document requests, interrogatories, deposition questions, and/or subpoenas to funders and/or potential funders. These new pages in the defense playbook cause unnecessary discovery and motion practice that only add delay and expense – an effective tax on plaintiffs, defendants, and courts.

Litigation funders have primarily opposed disclosure on the ground that it creates material potential for prejudice.

The excuse that disclosure is necessary because "we don't know what we don't know" doesn't last forever and doesn't hold up. Not only is this the epitome of a solution in search of a problem, but there are now numerous examples of commercial litigation funding agreements in the public domain (for example, on EDGAR and PACER), as well as provided to the judiciary under local rules and individual practice rules. There have also been active disclosure regimes in Wisconsin, West Virginia, and the federal District Court in New Jersey for years. And the U.S. Government Accountability Office issued a 46-page report on litigation funding in 2022 after conducting an extensive study. Yet there is no evidence that problematic control provisions are present in any standard funding agreements, let alone common. Instead, disclosure proponents fixate on anomalous examples, some of which I've written about, that are in no way representative of the broader commercial funding market.

Over the past few years, I've found it helpful to explain that litigation funders do not oppose disclosure because we have something to hide; it's because we have something to protect. It would be foolish for funders to publicly portray ourselves as passive, all while secretly conspiring with claimants and counsel to control litigation. Doing so would require the contravention of legal rules, ethical rules, and protective orders – pretty far-fetched for a handful of investment funds run by a bunch of lawyers. As we have pointed out in opposing certain disclosure regulations, courts have the inherent authority to order disclosure, so funders are always at least prepared for the prospect of *in camera* review (which Judge Polster ordered in the Opioids MDL, after which time there were no reports of foul play).

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Litigation funders have mainly opposed disclosure on the ground that it creates material potential for prejudice. The defense and insurance lobbies perennially propose broad, forced disclosure requirements based on transparently pro-defendant rationales. Litigation funding is meant to help plaintiffs, not be used as a guise for new defenses and strategies that enable defendants to continue exploiting an uneven playing field. I don't deny that our industry can sound opaque. Until defendants stop pushing for substantive disclosure, litigation funders will be forced to fight for the confidentiality of potentially prejudicial information. Our investments – and more importantly the claims we're backing – could otherwise be unfairly impacted.

I think there would be more potential for consensus if disclosure proponents narrowly tailored their requests for legitimate purposes rather than litigation advantage. For instance, the disclosure of a funder's identity to clear judicial conflicts is not inherently prejudicial or controversial. Nor is confirmation that a funder lacks control rights or isn't clandestinely controlled by a hostile foreign sovereign. But any disclosure regime actually intended to open the door to further discovery – including the production to defendants of funding agreements and underwriting communications – will continue to be a non-starter.

Unfortunately, it doesn't look like we're anywhere close to a reasonable compromise on disclosure. As recently as last week, Lawyers for Civil Justice and the U.S. Chamber of Commerce Institute for Legal Reform continued their insistence on forced disclosure of funding agreements in a submission to the federal Advisory Committee on Civil Rules. The same is true of pending federal legislation. By the way, neither is supported by anything more than sparse, anecdotal examples of bad actors, despite the mountains of available data now available in the public domain, particularly in the District of New Jersey, where parties must indicate control provisions under its mandatory disclosure rule.

This all obviously casts doubt upon disclosure proponents' true intentions. The Chamber is well aware of our prejudice concerns. Instead of proposing solutions that are limited to addressing non-controversial issues (such as conflicts, control, and hostile foreign influence) or based upon data, they persist in seeking full disclosure of funding agreements without good cause and without addressing the lack of data supporting their position.

AR: *Insurance policies can be subject to initial disclosure requirements in many courts. Shouldn't litigation funding agreements also be subject to mandatory disclosure?*

I'm glad you asked this, because it's an important argument to debunk. Here are several simple and I hope relatable distinctions that demonstrate why this isn't a rational comparison:

(1) *Potential for Prejudice*. I doubt insurers would be comfortable revealing the defense budget, case strategy, or defendant's actual ability to satisfy a judgment. Yet that is the effective equivalent of funding agreement disclosure. A defendant's insurance policy is almost always procured "before-the-event," whereas a funding agreement is always "after-the-event." This means that insurance policies do not contain information specific to the insured dispute at hand that could be used by the plaintiff for strategic advantage. Instead, insurance policies are of limited utility on their own, only somewhat helping plaintiffs avoid pyrrhic victories against uncollectible defendants. The opposite is true for funding agreements. Litigation funding terms are customized for each investment and can vary widely. Accordingly, they contain sensitive work product – such as case budgets, attorney risk-sharing terms, economic returns, and representations and warranties – that could be strategically exploited by deep-pocketed defendants. As a

result, the information contained in funding agreements bears more similarity to details of the insurer/insured relationship after the claim has been filed. Importantly, this information is typically protected from disclosure on the defense side.

(2) *Control*. It is a given that insurers have control rights, including with respect to settlement. Funders do not for various reasons, both legal and ethical, and also depending on state law. I've also heard the argument that funders should be disclosed so they can be included in settlement talks. Funders would probably be happy to be disclosed if it meant they could be at the settlement table without injecting risk of prejudicial disclosure. But that's never been on the table. (By the way, it's a bit paradoxical for defendants and insurers to claim to want funders included in settlement talks, while also claiming disclosure is needed to ensure funders do not control settlement.)

(3) *Purpose*. The goals of disclosure are different. The production of insurance policies is intended to help avoid unnecessary litigation. The production of funding agreements has nothing to do that. If anything, it would enable defendants to prolong litigation until the plaintiff runs out of funding. Any potentially legitimate disclosure issues – such as conflicts and control – can be addressed via less intrusive means, such as representations to the court (e.g., per the District of New Jersey's local rule) and/or *in camera* review.

(4) *Parity*. As I mentioned earlier, insurance is rarely present for funded commercial claims. Funding agreements would therefore be produced in circumstances where the defendant does not have an insurance policy. Also, not every state requires the production of insurance policies.

But wait…there's more! In our November Assured Briefing we'll continue the conversations and ask questions including:

Does the use of litigation funding make defendants more likely to settle rather than go to verdict?
Does the use of litigation funding extend the time to settlement or trial?
Is the legal business model behind today's mass tort actions congruent with the investment parameters of litigation funders?
How has AI impacted litigation funders?

And don't forget Dai Wai's kind offer: If anyone out there wants to have an honest dialog about any of these issues, here's how to contact me. I'm eager to set the record straight and have the receipts to do so.