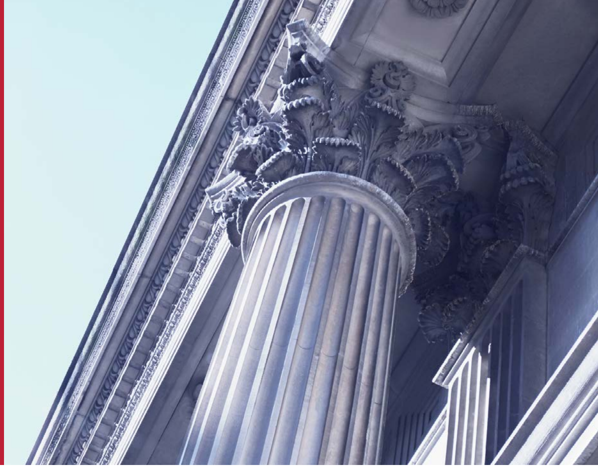
Backseat drivers of nuclear outcomes: litigation financing and letters of protection

By Melissa Hoffman-Schartel, Senior Director, Claims, and
Diane O'Neil, Director and Senior Counsel, Complex Claims



In today's litigation climate of ever-growing social inflation, plaintiffs are employing a number of tactics to argue for higher economic damages in the hopes of securing larger awards. Two such tactics are litigation financing and letters of protection. For defendants and their insurers, these tactics raise many challenges, including larger liens, lack of transparency, compounding interest rates, potential conflicts of interest, and the influence of non-parties over litigation strategies, to name just a few. In combination, these and other methods have had a negative impact on the ability of defendants and their insurers to dispose of cases for reasonable sums. This paper discusses these two tactics—and the challenges they present.

Part I: *Litigation financing*

Just a decade ago, litigation financing—investing in plaintiffs' legal expenses for a share of the returns from a trial or settlement—was a relatively unheard of and rarely used arrangement in the United States.[1] Today, it is a flourishing, multi-billion dollar industry that has reshaped litigation.[2] Touted as an equalizing mechanism that levels the playing field between well-heeled defendants and the "little guy"—think David and Goliath—it provides plaintiffs with a number of advantages. These include everything from a cash flow resource that allows them to replace income and living expenses while the litigation is pending to a full-fledged war chest. Using the added resources it provides, plaintiffs can exponentially increase the potential for favorable outcomes by funding additional surgeries and medical treatments and hiring expensive experts who work to inflate damage models.

As plaintiffs' law firms have sought additional sources of liquidity and funding over the last several years, litigation funders have seized the opportunity to profit from such an arrangement, made all the more attractive to law firms because risk is partly shifted to the funder. Further, certain states have greatly eased regulations on these kinds of non-lawyer investments in law firms.

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Litigation funders come in all shapes and sizes; some are self-financed, while others use hedge funds and institutional capital. But no matter the size, structure, or financial backing of the funder, two things have become crystal clear: These arrangements are here to stay for the foreseeable future, and they are making cases more difficult—and sometimes impossible—to resolve pre-trial.

Plaintiffs and law firms tend to find these arrangements attractive because if a recovery is not secured, there may be no obligation to repay the funder. Meanwhile, financial backing by the funder often emboldens the plaintiffs to secure larger settlements than would ordinarily be the case. Many funders also bring a staff of legal experts who review the claims and make a determination as to the merits of the case. In some instances, the funder even introduces a plaintiff to a law firm located in the jurisdiction at issue.

1 By contrast, the practice has been well established in other countries such as Australia and the United Kingdom for decades.

2 *Business Wire* reported in November 2019 that $2.3 billion of capital had been deployed over a 12-month period, and that $2.47 billion had been deployed in 2020 despite judicial disruptions caused by the COVID-19 pandemic. See *Business Wire*, "$2.3 billion of capital deployed over 12-month period across US commercial litigation finance industry, according to first-of-its-kind study" (November 19, 2019); and *Business Wire*, "$2.47 billion of capital deployed last year across US commercial litigation finance industry, as growing sector weathers pandemic storm" (January 27, 2021).

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Proponents of litigation funding argue that these arrangements help individual plaintiffs cover litigation costs, including attorneys' fees, expert witness fees, court costs, and other expenses associated with litigation. They further argue that these arrangements provide plaintiffs with increased access to the justice system by leveling the playing field and redress wrongs by providing support for an already filed legal matter. Litigation funding, they argue, also decreases the likelihood that plaintiffs' firms will run low on capital, preventing "low-ball" settlements that are far less than the original damages claimed.

Superficially, litigation funding has similarities to other types of loan transactions. There is financial investment by a third party (the litigation funder), which is secured by collateral (a portion of the award, whether by settlement or verdict), while the borrower (the plaintiff) pays interest for the privilege of borrowing money. But the similarities to standard loans end there. For one thing, the majority of states have no statutes or regulations directly applicable to third-party litigation funding. Though a few states have passed legislation aimed at capping the amount of interest that can be charged, the lawsuit finance industry is largely unsupervised and is not regulated at all at the federal level. There do not appear to be any explicit restrictions on fees and interest that funders can charge. Because litigation funding is typically on a non-recourse basis (meaning the lender can pursue the collateral but cannot seek damages from the borrower), state usury laws do not apply.

An interesting question is whether the common law torts/crimes of maintenance and champerty— recognized by some, but not all, states—prohibit litigation funding. In this context, maintenance is the support or promotion of another person's suit for personal gain, while champerty is the process whereby one person bargains with a party to a lawsuit to obtain a share in the proceeds of the suit.[3] While many jurisdictions do not explicitly prohibit champerty or recognize litigation funding as champerty,[4] other states do.[5] Whether a state court would find the third-party litigation funding model to be champerty would likely depend on the parties' intent and the manner in which the arrangements are structured.

Legal analysts predict that in states that still recognize champerty, such as New York, third-party funding would likely not qualify as such since the litigation funder does not bring the lawsuit in its own name; the funder is not controlling the litigation; and the funder's only interest is in the proceeds of the lawsuit rather than in the asset itself (think securities litigation).[6] Further, New York's champerty law has a safe harbor provision for assignments with a purchase price of at least $500,000. So the question of whether a particular state's champerty law prohibits third-party lawsuit funding may be academic—although it might be a worthwhile challenge in a given case.

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Further, the lack of transparency around litigation funding is a growing concern. When pressed, some courts require disclosure of at least some aspects of funding agreements; but more often than not, plaintiffs have successfully defended against revealing the terms or even the existence of the arrangement. As a general proposition, given that the loans are not relevant to the liability or damages issues in a lawsuit, they are technically not discoverable. However, they themselves are often cited by plaintiffs as justifying their inflated demands. Defendants often learn about the involvement of a litigation funder for the first time at a mediation or a settlement conference. At such times, plaintiffs often use the existence of these arrangements to justify the fact that their settlement demands are much greater than the injuries alleged. Defendants' counsel hear, time and again, that "my client has to be able to put some money in his pocket, after paying off the loan," or "the interest rate is compounding daily," as justifications why the demand is twice as high as the reported jury verdicts for the same injury. Such inflated demands are preventing cases from settling before trial, leading in turn to longer claim duration and higher allocated loss adjustment expenses. They also create the potential for larger verdicts since the funding allows plaintiffs to undergo additional (often unnecessary) surgeries and treatments and to stay out of work longer, thereby inflating the damages they put before juries.

[3] Champerty and Maintenance. (n.d.) *West's Encyclopedia of American Law, edition 2*. (2008). Retrieved August 2, 2021, from legal-dictionary.thefreedictionary.com/Champerty+and+Maintenance.

[4] E.g., Arizona, California, Louisiana, New Jersey and Texas; see "United States: A strategic look at champerty and third-party litigation financing" (2019), by Earl Mah and Charlene Morrow of Fenwick & West LLP.

[5] E.g., Alabama, Delaware, Georgia, Minnesota, Mississippi, New York, and Pennsylvania; Id.

[6] Id.

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The delays resulting from these tactics are increasing the backlog of cases; yet until such time as the judicial system feels the full effect that lawsuit financing is having on the backlog or the legislature addresses what would be considered predatory lending practices in any other context, we are stuck with litigation funding, and should use whatever resources are available to address it.

Part II: Letters of protection

In a related tactic, many plaintiffs claiming physical injury are being steered out of their existing health care networks into attorney-directed treatment, resulting in unnecessary and costly surgeries and procedures, often referred to as "phantom medicals." The added costs of these procedures are facilitated by a letter of protection (LoP), in which the plaintiff's attorney guarantees payment for the plaintiff's medical treatment from the future settlement or jury verdict.[7]

The existence of such arrangements is often shielded by the collateral source rule—a legal doctrine that prohibits the admission of evidence that a plaintiff has received compensation from a source other than the defendant.[8] Alternate sources of compensation include health insurance, workers compensation, life insurance, Social Security Disability, Medicaid, and Medicare. Simply put, a third-party payment cannot reduce what is owed by the defendant. The intent behind the doctrine is one of fundamental fairness: that a defendant should not benefit from the fact that the plaintiff has other available sources of recovery while waiting for the lawsuit to conclude. Plaintiffs argue that reducing what is owed by the defendant would shift the cost of negligent behavior away from the wrongdoer who should not benefit from insurance independently procured by the injured party.[9] For their part, critics of the doctrine argue that the rule allows for double recovery.

Posturing aside, this rule of law has long been recognized by our courts who are the gatekeepers of what jurors are allowed to hear and what they are not. A judge will usually apply a rule of evidence to determine the admissibility of a collateral source. For instance, Rule 403 of the Federal Rules of Evidence allows the court to exclude otherwise relevant evidence if its probative value is substantially outweighed by, among other things, unfair prejudice. Plaintiffs typically argue that they will be prejudiced—in the form of reduced verdicts—if jurors are told that they received benefits from some other source such as workers compensation or health insurance.

In a growing trend, plaintiffs are trying to stretch the collateral source rule beyond its intended limits. They essentially argue that jurors should also not be told about insurance and other benefits they could have used, but decided not to. For example, a plaintiff, while in the course and scope of her employment, is injured by an insured's driver and gets treated (at her counsel's recommendation) outside of workers' compensation. By not being treated under her workers' compensation coverage, the treatment is more expensive and costs are not legally capped as they would be under the workers' compensation coverage. This enables her to then blackboard larger medical costs at trial and thereby inflate her economic damages claim. The plaintiff's attorney in this example would use an LoP to guarantee payment for the plaintiff's medical treatment—again, from the future settlement or jury verdict.

The legislature in the plaintiff's home state more recently revised the collateral source rule, although an exception preserves the inequities caused by the use of LoPs. The new law states that where a plaintiff's medical expenses have been paid by a health insurer, recovery of past medicals is limited to the amounts actually paid to the medical provider (which are typically far lower than the amounts billed)[10] with some nuances not relevant here. However, where the plaintiff contracts with a legal finance company to pay his or her medical bills or contracts directly with the medical provider under an LoP, he or she may recover the full (and higher) amount billed by the provider. Furthermore, there is nothing prohibiting a plaintiff from negotiating a discounted rate with the doctor after the trial, after the jury has based its award on the higher amounts. As such, windfall damages, also known as "phantom damages," are still recoverable as long as they are contractually guaranteed.

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7 The LoP originated to provide medical treatment to plaintiffs who did not have insurance. The doctor agreed to treat, so long as the lawyer provided "protection" by way of a guarantee of payment from the proceeds of the lawsuit. Today, however, LoPs have become a vehicle to promote gross overbilling that goes beyond any reasonable standard of customary reimbursement, for the sole purpose of inflating claim value.

8 While each state has its own version of the collateral source rule, this article is concerned with instances where the courts enforce the rule in a manner in which plaintiff receives a windfall recovery, meaning the tort award and the collateral benefit.

9 An exception to the collateral source rule is an insurance company's subrogation rights.

10 Billed prices can be three to five times the negotiated, paid prices. See "Healthcare systems' billed v. paid disparity," APCIA Research Bulletin, April 6, 2021.

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We have seen this trend emerge in cases in other venues, and we suspect its popularity will continue to grow, particularly if litigation-funding companies are paying the medical providers. That is because the deep-pocket financing companies will pay the medical providers at their higher "retail" rates. Once the amounts billed equal the amounts paid, and the distinction between the two is blurred or even erased, plaintiffs will automatically be permitted to blackboard the inflated charges.

As noted in Part I of this paper, litigation financing is fairly new in the United States, so it's difficult to predict how such funding will impact the collateral source doctrine relative to medical bills. What we do know, however, is that many plaintiffs are being steered out of their medical networks into attorney-directed treatment, resulting in unnecessary and costly surgeries and procedures, or "phantom medicals." And the economics are not the only damages that are affected. When medical damages trend upward, the non-economic damages (pain and suffering) follow. The outcome is that higher indemnity dollars are required to dispose of the case, whether by settlement or by verdict.

For now, it would be prudent for defense counsel to vigorously cross-examine plaintiffs' medical providers on issues such as the necessity of, and reasonable value of, the medical services rendered; unreasonable current procedural terminology (CPT) code billing; financial bias; and the nature and extent of providers' relationships with the plaintiffs' bar. The ultimate objective is to develop evidence that enables juries to connect the dots on this widespread overreaching. Once the evidence is properly mined, it can be used to leverage reasonable settlement negotiations either before or during trial.

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In conclusion, while litigation financing and letters of protection both pose substantial challenges to defendants and their insurers, awareness of these tactics is a necessary first step to countering them successfully. Monitoring the discovery opportunities afforded by specific jurisdictions is clearly important, and there are opportunities to counter these methods. For example, one helpful point in the state of New York is that litigation funders are required to file a Uniform Commercial Code lien with the Department of State whenever a plaintiff takes out a loan for medical treatment. Although the particulars are not included, the filing does at least provide notice of the lien. Such developments, while limited, may assist defendants in individual cases and may also contain the seeds of a more equitable climate over time. In addition, while specific defenses continue to evolve, education about these tactics, in general terms, can potentially influence an evolution in public awareness that can offset their effectiveness.

Melissa Hoffman-Schartel is Senior Director, Casualty Claims, at Markel. She can be reached at +1.732.450.8723 or at Melissa.Hoffman-Schartel@Markel.com.

Diane O'Neil is Director and Senior Counsel, Complex Claims, at Markel. She can be reached at +1.732.450.8796 or at Diane.ONeil@Markel.com.