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Options for transferring litigation risk

By Fallon Turner

Little more than a decade since After the Event (ATE) Insurance first came into being, its existence in its current form is already under threat following Lord Justice Jackson's recent proposals for reform. The Government has gone full circle from the introduction in April 2000 of the Access to Justice Act 1999, which allowed for the recovery of Conditional Fee Agreement (CFA) success fees and ATE premiums from the unsuccessful party (a measure aimed at counterbalancing the restriction of legal aid), to the proposed Legal Aid, Sentencing and Punishment of Offenders Bill, which plans to end such recoverability and instead places an emphasis on the successful party's damages. Nevertheless, litigation funding does still have an important role to play and it is a market which is constantly evolving, both in reaction to the changing political landscape, as well as in response to the burgeoning need for parties to off-set their cost risks in areas where previously funding has been ill-utilised. This article will explore the various tools available, most notably ATE Insurance and Third Party Funding. It will focus on the benefits and the potential limitations of these means of funding and will provide a snapshot of the market today, as well as a look at what the future may hold in the wake of the Jackson reforms.

1. ATE Insurance

Perhaps the most widely-used method of litigation funding, ATE Insurance is, as the name suggests, available *after* a dispute has arisen and can on occasions be obtained a mere few weeks before trial is due to commence. In effect, the insurer agrees to indemnify the insured in respect of legal costs in the event that the claim does not succeed, subject to a specified limit of indemnity. The policy will typically provide cover for the potential liability for the opponent's costs or "adverse costs", the policyholder's own disbursements (including expert reports, Counsel's fees and court fees) and potentially some or all of the policyholder's own legal fees. However, ATE does not provide cover on an interim basis (with the possible exception of interim adverse costs awards) and consequently the client must be able to provide the necessary cash flow to finance the litigation until its conclusion, whether by funding the costs privately, reaching an agreement with their legal team regarding deferral of costs or entering into a funding agreement with a third party.

While ATE has historically been utilised hand-in-hand with lawyers' CFAs in personal injury and clinical negligence cases to remove all or nearly all of the client's costs exposure, it is now a well-established product through which high value commercial claims are funded. While as a general rule insurers like to see another party (either the client and/or the solicitor firm) carrying some part of the risk, it is understood that CFAs are far less common when dealing with the more complex, higher value cases, and as a result the market has now evolved to a point where the lack of such an agreement is by no means a bar to obtaining insurance. Furthermore, in circumstances where the solicitors are acting

on a partial or discounted CFA, or alternatively where there is no CFA in place, the insurance can cover either a portion or even potentially the entire element of the solicitors' fees. The possibility of insuring the policyholder's own solicitors' fees creates a range of different fee structure options for a client keen to manage risk. For example, the solicitor may be willing to defer payment of a proportion of base fees, which can then be insured, creating the effect of a more heavily discounted CFA, whilst guaranteeing a workable level of fee income for the law firm.

A crucial and interesting feature of the current ATE insurance market is the way in which the premium is typically charged. Payment of the ATE premium is generally deferred until the conclusion of the case and contingent upon success (or "self-insured"). Therefore, there is no premium to pay when the policy is taken out and no premium to pay if the case is lost. Furthermore, if a costs order is made in the insured's favour, under the current regime in England and Wales the premium can be recovered from the opponent[1], subject to assessment by the court of its reasonableness[2]. Additionally, ATE premiums are often structured so that the premium increases as the case progresses, commonly on a stepped or staged basis. The opponent must be notified of any premium increase 'trigger points' via the Notice of Funding (form N251). Notice of the insurance and premium stages under the current regime can often provide a tactical advantage, by encouraging the opponent to settle early to minimise their potential liability for the premium.

Looking to the future, it would seem almost certain that the way in which premiums are currently recovered will come to an end. In the meantime, there is a degree of uncertainty in relation to premium recoverability. In an early decision, the courts expressed reluctance in interfering with the setting of premiums[3], although in light of Lord Justice Jackson's recommendations and the so-called "compensation culture" which provoked them, this attitude seems to be changing. Thus in subsequent cases, the courts have helped define the parameters of what constitutes a reasonable premium. For example, in *Jonathan Rogers v Merthyr Tydfil County Borough Council*[4] Lord Justice Brooke accepted that when testing the proportionality of the premium, the appropriate relationship is that between the premium and the costs exposure, not the premium and the financial value of the claim. The court suggested that several factors should be taken into account when making a decision on the reasonableness of the cost of insurance cover. These include:

- the level and extent of the cover provided.
- the availability of any pre-existing insurance cover[5].
- whether any part of the premium would be rebated in the event of early settlement (the general consensus being that a staged premium is more likely to be reasonable than a flat rate).
- the amount of commission payable to the receiving party or his legal representatives/agents.

Nevertheless, whilst willing to stamp some authority on this issue, the courts are still largely deferential. For instance, in *Kris Motor Spares Ltd v Fox Williams LLP,* the opponent (KMS) was served with a Notice of Funding on the first day of the Preliminary Issue hearing. The judgment was decided in Fox Williams' favour and KMS then sought to challenge the premium, which they believed Fox Williams had unreasonably taken out at such a late stage and which was in any event excessive (being approximately one third of the total costs sought by Fox Williams). The Court held that "there is no principle that the premium on a late incepting policy is irrecoverable as an unreasonable cost" and that "where the issue is raised as to the size of the premium there is an evidential burden on the paying party to advance at least some material in support of the contention that the premium is unreasonable"[6].

A final issue to consider in relation to recoverability is whether the cost of the work undertaken by the firm in setting up the insurance can also be recovered from the opponent in the event of a success. This was answered in the affirmative by the Court in *Motto and others v Trafigura Limited and another*, where it was held that this is work "properly undertaken by the solicitors, for which they are entitled to charge"[7].

It is generally advisable to shop around when trying to obtain ATE Insurance. A market search can be undertaken by an independent broker, by the prospective policyholder's solicitor or by the prospective policyholder themselves (although insurers will typically wish to liaise with the insured's legal team prior to making any offers of insurance).

The key reason for undertaking a market search is to maximise the chances of securing suitable insurance. If a single, preferred, insurer is approached but declines to offer terms for any reason (and the reasons can often be relatively subjective or linked to the insurer's specific appetites, rather than issues with the underlying case), the fact of this rejection will have to be disclosed to a subsequent insurer. A case which has been seen and rejected by other insurers will always appear less attractive to underwriters than a case which is presented 'afresh'.

Furthermore, evidence of market comparables (or indeed a lack of alternative options) obtained following a market search will generally provide compelling evidence of the reasonableness of any premium incurred, which may prove extremely useful should the paying party seek to challenge the level of premium at Detailed Assessment.

Defining 'success' in the litigation is of paramount importance to insurers when considering whether or not to provide cover, as the premium payment will generally be conditional upon achieving 'success'. Where the applicant is a claimant, the definition of success will frequently include either a settlement or a judgment/award whereby the opponent accepts a liability to pay or is ordered to pay a money sum to the claimant. However, this issue is much less straightforward when dealing with defendant cases as insurers will wish to avoid a potential moral hazard situation whereby the existence of ATE Insurance may impede nuisance or commercial settlement. For example, if 'success' were defined as the defendant's net liability to the claimant being below a certain sum, it

may be in the defendant's interest to pay slightly more than this amount to avoid a "success" and thereby avoid liability for the premium. Nevertheless, as the ATE market has evolved, various solutions have been formulated to get around these issues. Moreover, there are obviously a variety of circumstances, for instance where a claimant is seeking non-monetary relief, where the issue of a moral hazard does not arise and insurers are consequently willing to consider covering a defendant free of these concerns.

There are a few further factors that need to be considered when making an application for ATE Insurance. For example, where there is a question mark over the financial stability of the opponent, insurers may be unwilling to offer terms due to concerns over recovering their premium, or may require comfort that the policyholder will assume responsibility for the premium to the extent that it cannot be recovered. Another important point to note is that an ATE insurance policy is unlikely to provide adequate security for costs[8]. However, certain insurance providers have the capacity to provide a bond or Deed of Indemnity, which effectively guarantees payment of the Defendant's costs. Insurers will typically charge an additional fee for providing a bond. A final point to bear in mind is the potential requirement to disclose the ATE policy (although the amount of the premium should not be disclosed[9]). Whilst there is conflicting authority on this point[10], it may be preferable to provide voluntary disclosure of the policy terms in certain circumstances.

2. Third Party Funding

Third Party Funding is procured via a professional investor (often a bank or hedge fund), who in return for funding the litigation will demand a success fee or contingency fee to be paid out of the "proceeds" of the claim. Because this fee cannot be recovered as part of costs, it will be taken from the client's damages (in the event of a successful outcome) and it is therefore crucial to have a sufficient margin between the level of funding required and the expected level of damages. However, should the claim be unsuccessful, the funder will simply lose their investment and no payment is due. As with ATE, the funder's success fee is determined on a case-by-case basis, however it is generally expressed either as a multiple of the investment or an agreed percentage of the damage recovered, or more commonly a combination of the two.

Funded cases will generally have certain key features, which limit the availability of funding to a relatively small pool of cases. The following criteria provide a general guide:

- strong prospects of success
- substantial (monetary) claim
- a credit worthy defendant (i.e. no issues as to recovering damages and costs from the opponent)
- an understanding about how any potential adverse costs exposure is going to be paid, typically requiring the involvement of ATE Insurance

It is also worth noting that where there are numerous stakeholders involved in the litigation, a Deed of Priority may be drafted to cater for a situation where the client's recovery is insufficient to discharge all of its liabilities.

The concept of third party funding would historically have been unlawful due to the doctrine of maintenance and champerty - a concept which was introduced in the medieval period to prevent those who do not have an interest in a claim from interfering in the court process. Champerty and maintenance were decriminalised and eliminated as torts in the Criminal Law Act 1967, however even today a champertous agreement can be declared unlawful and therefore unenforceable by the courts. In *R (Factortame Ltd) v Secretary of State for Transport Local Government and the Regions (no. 8)* [2003] QB 381[11] and the later case of *Arkin v Borchard Lines Ltd & Ors* [2005] EWCA Civ 655[12], the courts were prepared to recognise the legitimacy of third party funding, provided that the funder does not unduly seek to interfere with or control the litigation.

3. Litigation Buyout Insurance

A third way of managing litigation risk is Litigation Buyout Insurance (LBI) (sometimes known as "defendant outcome hedging"), which provides an alternative option for a Defendant facing the possibility of a substantial claim. This is effectively a stop loss insurance policy which caps the Defendant's potential liability at a certain level. LBI is not legal expenses insurance and can therefore cover both damages and legal defence costs. The insured must retain an element of risk (i.e. an excess or retention) and the insurer will provide cover for any liability over this excess, up to a specified limit of liability.

This form of insurance is most commonly used in the context of mergers and acquisitions where pending or threatened litigation presents a barrier to completion of the transaction or creates valuation difficulties. However, it can also be used to cover ongoing litigation (subject to the proviso that if the litigation is advanced, insurers may consider the level of risk to be substantial, which may inflate the excess and premium or make it more difficult to secure commercially viable terms), or to "top up" existing insurance arrangements. Unlike ATE Insurance, premium payment is made on inception of the policy and the premium is not conditional upon success, nor is it recoverable under s.29 Access to Justice Act 1999. In high risk scenarios, the premium can be substantial and LBI is therefore typically used where there is a commercial reason to cap litigation risk.

4. The Future of Litigation Funding

Looking forward, the form that litigation funding takes in the future will undoubtedly be irrevocably altered following Lord Justice Jackson's 2010 Review of Civil Litigation Costs and its prospective implementation via the Legal Aid, Sentencing and Punishment of Offenders Bill. The draft legislation seeks to end the recoverability of CFA success fees and ATE premiums from the losing party. While limited concessions have been made, such as

allowing solicitors to enter into "damages-based agreements" and potentially the ability to recover ATE premiums in clinical negligence cases where policies are limited to covering the client's own disbursements (i.e. medical reports), in reality the impact of the reforms, if implemented in full, will be far-reaching, with several personal injury ATE providers already hinting that they may withdraw from the market post-implementation.

Nevertheless, while some ATE providers may exit the market, the use of ATE Insurance in relation to civil and commercial cases is likely to continue to grow, albeit in an adapted form. Though premiums will have to be drawn from damages (and will thus be problematic for clients with smaller value claims where the costs to damages ratio is narrow), this will inevitably put a downward pressure on price and in many cases will still provide a more attractive option than pursuing a claim uninsured. Third Party Funding, on the other hand, has been left relatively unscathed. The primary changes suggested in this arena include a voluntary code of regulation (already acknowledged by the industry as a welcome modification), which will include limited capital adequacy requirements. As with ATE, market forces and the growing number of providers in this space are likely to bring with them an increasing pressure to decrease pricing, although it may be some time before Third Party Funding becomes a viable solution for small and medium-sized claims.

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Endnotes

1 s.29 Access to Justice Act 1999

2 Practice Direction 44.4 Civil Procedure Rules.

3 *Callery v Gray* [2002] UKHL 28. It was also held in this case that it is reasonable to take out insurance on day one bearing in mind that it may not otherwise be available further down the line or if insurance is offered at a later stage the premium is likely to be substantially more expensive.

4 paras 105-106; [2006] EWCA Civ 1134

5 The existence of Before the Event (BTE) Insurance does not necessarily render an ATE premium unreasonable, and while enquiries into the existence of BTE cover should be made, "The solicitor is not obliged to embark on a treasure hunt": *Sarwar v Alam* [2001] EWCA Civ 1401 at para 46

6 Paras 41 and 44 [2010] EWHC 1008 (QB). This does not, however, reverse the burden of proof and if there is any doubt as to the reasonableness, that doubt should be resolved in favour of the paying party.

7 Para 463 in [2011] EWHC 90201 (Costs)

8 At paras 35-36 in *Al-Koronky and another v Time-Life Entertainment Group Limited and another* [2006] EWCA Civ 1123 it was held that while in some circumstances an ATE policy might provide adequate security for costs, where a case (as it did here) depends entirely on which side is telling the truth and the policy is rendered void in the event that the insured has brought a fraudulent or dishonest claim, then clearly the policy will be inadequate as a method of security.

The Court went one step further in *Michael Phillips Architects Limited v Riklin and another* [2010] EWHC 834 (TCC) in deciding that because the insurer was able to cancel the policy if in good faith it forms the view at any time that the Claimant's claim is unlikely to be successful, the policy was consequently inadequate security, despite an endorsement confirming that the insurer "will not refuse to pay on a claim which is found to be fraudulent or false".

[9] Coulson J at paras 48 and 52 in *Barr and others v Biffa Waste Services Ltd* [2009] EWHC 1033 (TCC) held that while the ATE policy itself was a disclosable document and was not covered by litigation privilege, the amounts of the premiums should be redacted for fear that they could be said to reflect the legal advice as to the Claimants' prospects of success.

[10] In *Arroyo v BP (the Ocensa Pipeline Group Litigation)* [2010] EWHC 1643 (QB) it was held that the Claimants did not have a duty to disclose their ATE policy. Special weight was given to the fact that it was a bespoke policy and the very fact that the terms of the policy were negotiated suggested that it took into account specific litigation risk factors as well as the views and tactics of Claimants' lawyers.

[11] At para 36 the Court emphasised that it was necessary in each case to decide whether the agreement "might tempt the alleged champertous maintainer for his personal gain, to inflame the damages, to suppress evidence, to suborn witnesses or otherwise to undermine the ends of justice".

[12] In this case, the Court discussed the funder's potential liability for adverse costs and concluded, at para 41, that "a professional funder, who finances part of a claimant's costs of litigation, should be potentially liable for the costs of the opposing party *to the extent of the funding provided."*