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Litigation Funding in the Construction Industry

HOW TO MITIGATE RISKS AND PROTECT YOUR BUSINESS

Construction

Litigation funding has evolved into a common and controversial tool for backing expensive and lengthy legal disputes. According to reports, third-party litigation funders invested $15.2 billion in the US in 2023, a figure that could reach $31 billion in the next five years.[1]

The lack of regulatory controls on litigation funding practices has become a concern. Third-party funders face criticism for imposing unfairly high interest rates, prolonging cases to win massive awards, and influencing the attorney-client relationship behind the scenes.

In recent years, litigation funding has been gaining traction in the construction industry. The economic downturn, arbitration proceedings, and higher returns in litigation cases could also increase the number of disputes in the construction industry, making it attractive for litigation funders.

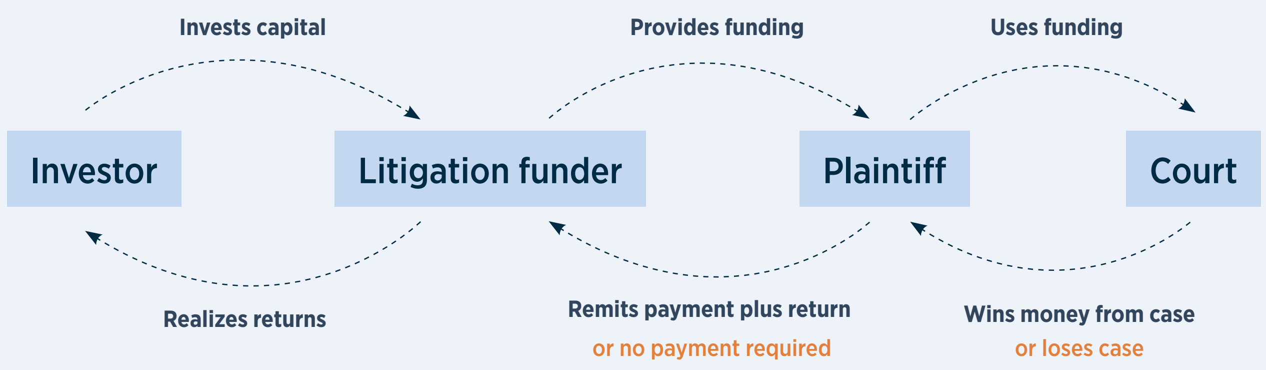
This paper will help you understand the growing influence of litigation funding and its impact on the construction industry.

What is litigation funding?

Litigation funding is a financial arrangement in which a third party provides funding to the plaintiff in a legal dispute. In return, the funder receives a share of the proceeds if the case is successful. The funding model enables plaintiffs to file lawsuits without bearing all the financial risks of litigation, clearing one of the traditional barriers to initiating a lawsuit.

Here's how it works

1. Investor provides capital to litigation funder.
2. Litigation funder provides funding to plaintiff.
3. Plaintiff uses funding for expenses while pursuing claim in court.



6. Investor realizes financial returns based on successful lawsuits.
5. Litigation funder recovers investment plus a return from the successful plaintiff.
4. If the plaintiff wins the lawsuit, the plaintiff recovers money from the defendant.

Source: GAO. | GAO-23-105210
Figure 1: Example of Third-party Litigation Financing for Plaintiffs

Impact of litigation funding on the construction industry

Higher fees

While litigation funding may, on its face, appear to resolve cash flow issues involved in lawsuits, the fees associated with the practice can ultimately be incredibly costly. Funders often take a large portion of the settlement or push for substantial settlements that could exceed the coverage limits. For construction companies already operating on tight margins, these additional expenses can be a heavy burden.

According to reports, funders typically leave the plaintiff with an average of just 43% of the settlement.[2]

During economic downturns, litigation funders may increase their interest rates in line with the action taken by central banks. This means the cost of capital for litigation funders is also rising.[3]

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> **43% OF THE SETTLEMENT**

Lengthy litigation process

Commercial litigation cases can often last around four years.[4] Instead of settling the case out of court, funders might push for longer legal battles with the hope of securing a larger payout. Prolonged legal battles could disrupt project schedules and affect business cash flow.

Loss of control over legal proceedings

In litigation funding, funders pay for the plaintiff's legal expenses with the understanding that they will receive some or all of the potential settlement. This arrangement can allow funders to influence decision-making processes, including pressuring for settlements that may not be in the plaintiff's best interests.

Potential conflict of interest

Third-party funders' primary goal is to maximize their return on investment, which may not always align with the construction company's objectives.

For example, if there is a legal dispute over a project delay, the construction company would likely want to settle the dispute quickly to avoid further delays and costs. However, the litigation funders might prefer to prolong the case, believing that a longer trial will result in a higher settlement amount. This difference in objectives creates a conflict of interest, leading to disagreements over case management and strategy and making it more difficult to pursue dispute resolution options, such as mediation and arbitration.

Reputational damage

Maintaining ethical standards in litigation funding can be challenging due to potential conflicts of interest and strong influence from third-party funders. Not all companies are open to accepting litigation funding, as some may see it as a sign of financial instability or an overly aggressive approach to disputes. This perception can have long-lasting effects on construction companies, where reputation and relationships are crucial.

Dip in the latest litigation funding deal commitments

New deal commitments for US litigation funding declined **14%** in 2023, dropping from **$3.2 billion in 2022 to $2.7 billion.** The decline is attributed to broader financial market trends, including higher interest rates. In addition, there were **39 active funders** in the US market in 2023, down from **44 in 2022.**[5]

However, the litigation funding industry remains optimistic about its business despite the overall reduction. With more difficulty raising new funds, litigation funding companies are being more careful about their capital and looking for targeted growth.[6] Meanwhile, critics argue that the growth and success of the US litigation funding industry over the past decade may promote unethical practices, undermine transparency in the legal system, and ultimately lead to tighter regulation.

Under the watchful eyes of the regulator

Bank loans and credit card debt are typically regulated by law in most states. However, litigation loans are treated differently. These loans are referred to as "non-recourse," which means that if the borrower does not win their case, they don't have to repay the loan to the funders.

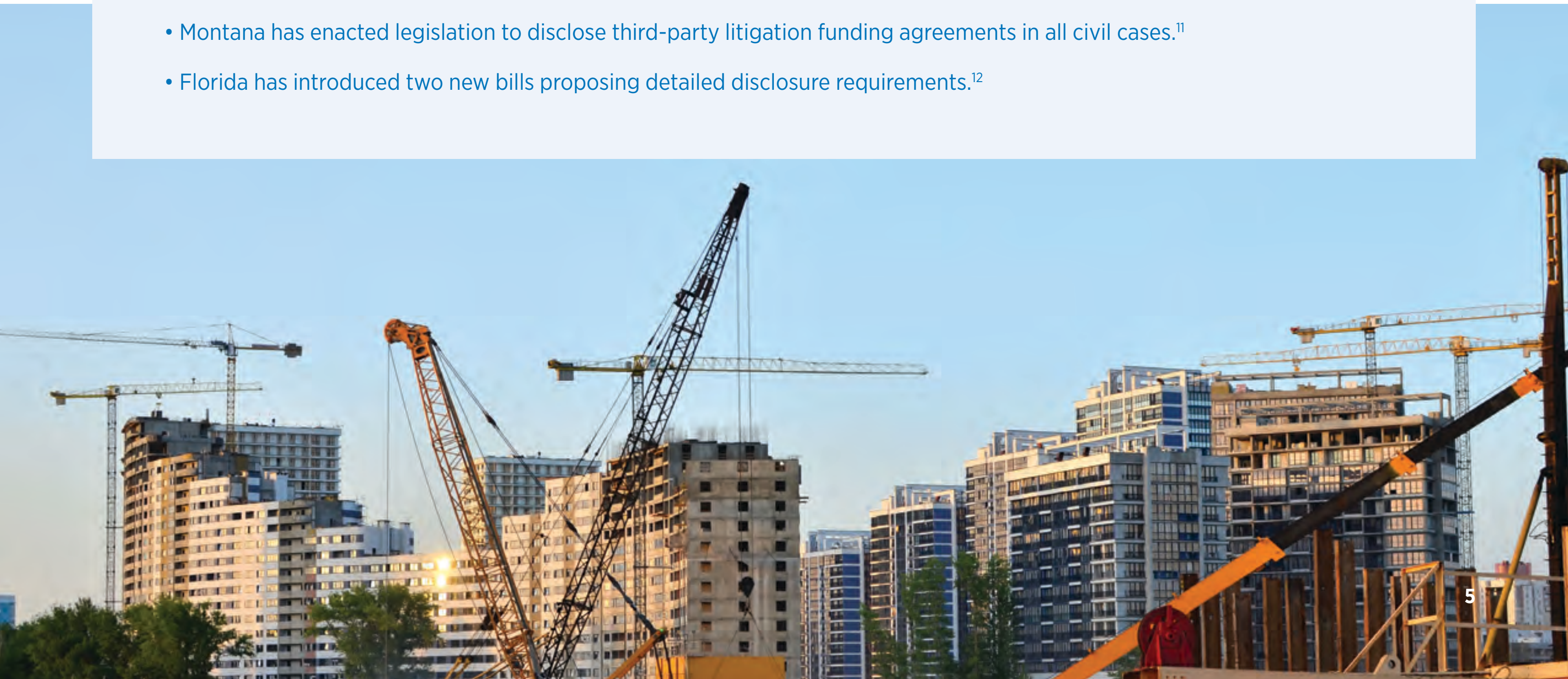
This difference in treatment has raised concern among lawmakers and has prompted increased scrutiny over conflicts of interest, influence from third-party funders, and the potential weakening of trust in the legal system.

Currently, there is no significant regulation of the litigation funding industry. Furthermore, the lack of disclosure requirements allows foreign investors to invest in US lawsuits, potentially influencing the litigation process.[7] Florida's tort reform bill, introduced last year, is a model that may be more widely adopted as policymakers seek to come to grips with the spiraling costs associated with the private funding of lawsuits.

In response to the growing prominence of third-party litigation funding, judges and policymakers in the US have begun addressing the associated challenges and risks.[8] Courts now require disclosure of third-party funders' identities and details of the funding agreements.

> "Implementing some form of regulation would be highly beneficial. Increased awareness will prompt more states to mandate disclosures."
>
> **Jackie Robinson, Managing Director of Operations, US Construction, Gallagher**

- In 2021, the US District Court of New Jersey ordered funders to disclose their identities.[9]
- Senator Anna Caballero recently sponsored the Litigation Funding Act in California. The Act, known as the Predatory Lawsuit Lending Prevention Act (SB 581), requires disclosure of litigation financing for a plaintiff if ordered by a judge.[10]
- Several states in the US have enacted legislation to regulate or restrict third-party litigation practices.
- Indiana's HB 1160, recently signed into law, aims to prevent foreign adversaries from influencing the litigation process. It prohibits funders from accessing proprietary data and from influencing or controlling lawsuits. Additionally, the law requires funding to be disclosed during litigation.[7]
- West Virginia's Senate Bill 850 expands the scope of an existing law regarding consumer litigation finance.[7]
- Montana has enacted legislation to disclose third-party litigation funding agreements in all civil cases.[11]
- Florida has introduced two new bills proposing detailed disclosure requirements.[12]



Litigation funding: a key driver of nuclear verdicts

Nuclear verdicts are exceptionally high jury awards, typically exceeding $10 million. According to a US Chamber of Commerce Institute of Legal Reform report on nuclear verdicts, third-party litigation funding is one of the key drivers of nuclear verdict size and frequency.[13]

When an external funder gets involved, a standard negotiation between two opposing parties can become more complex, often including undisclosed individuals working behind the scenes and focused solely on maximizing their investment returns.

With financial support from third parties, plaintiffs can hire top-tier legal teams, significantly improving their chances of achieving large awards. Moreover, funders may encourage plaintiffs to reject settlement offers and push for a trial to pursue higher payouts. In recent years, the phenomenon described as 'social inflation' by the insurance industry has seen juries increasingly likely to award headline-grabbing nuclear settlements.[14]

“Many significant losses and claims often involve some form of litigation funding. It may not always result in a nuclear verdict, but it could lead to a substantial settlement.”

Brian Cooper, Senior Managing Director, US Construction, Gallagher

Safeguarding your business against litigation funding exposures

- Invest in comprehensive insurance policies that cover a broad range of risks, including general liability insurance, professional liability insurance, and workers' compensation. Adequate coverage is there to help manage the financial risks associated with litigation, especially in cases where litigation funding might lead to larger settlements.
- Ensure that all contracts with subcontractors, suppliers, and clients are drafted and reviewed by legal professionals. It will help mitigate risks associated with ambiguous terms that could lead to disputes and a weak bargaining position should a dispute arise.
- Implement training programs for employees regarding safety protocols and operational procedures to reduce the likelihood of accidents that may lead to litigation. It will help construction companies defend against claims of negligence and reduce exposure to litigation.

In the absence of regulatory control, third-party funders are likely to continue to charge unfairly high fees for their financial support. In the event of large settlements or nuclear verdicts, insureds usually do not have enough coverage to handle these large payouts. This puts the onus on insurance carriers to support the insured individuals involved in these complex, expensive, and prolonged cases. The result is that carriers may seek to charge more premium and introduce tighter policy terms and conditions.

The growing trend of litigation funding is making it more difficult for construction companies to ensure adequate coverage for properties, projects, and other key areas of their business. Insurance carriers are responding to the risk of large payouts by seeking reinsurance, which is expensive and leads to higher premium expenses, affecting everyone involved in the insurance value chain.

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