Have The States Properly Addressed The Evils Of Consumer Litigation Finance?

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Alternative litigation finance for consumers, sometimes referred to as "consumer legal funding," has been seen by some commentators as yet another example of predatory, subprime lending that preys upon the disadvantaged while they await the resolution of their personal injury cases. (FN 1). The consumer is vulnerable because many people that seek this type of financing need those advances in order to stop home foreclosures and to pay for various desperately needed personal items such as food, basic household needs as well as car and insurance payments. (FN 2). Like so many other industries with less than sterling reputations, the consumer legal funding industry has tried to improve its image through a combination of public relations initiatives (FN 3), self-regulation (FN4) and lobbying in order to implement state laws that regulate, but not prohibit, this niche financing (FN 5). Led by the American Legal Finance Association, or ALFA, a 31-member industry group that by some reports account for 90% of these loans (FN 6), the industry has successfully worked with the legislatures in Maine, Nebraska, Ohio and Oklahoma to enact legislation. (FN 7). The Alliance for Responsible Consumer Legal Funding is a similar trade group that advocates working "at the state level for rules containing appropriate pricing and a high degree of consumer protection – including adequate licensing and disclosure requirements, and suitable limitations on fees." (FN 8).

This preemptive and collaborative approach has produced two basic regulatory approaches: the so-called "Disclosure Only Model" and a combination of disclosure, registration and some post-registration compliance requirements, the so-called "Registration Model." These approaches have been adopted in order to provide some consumer protections in order to prevent a total prohibition of this type of consumer finance. (FN 9). In particular, this approach seems designed to address seven major concerns that are routinely voiced by opponents of this type of financing: (1) the consumer's lack of understanding of the terms and effect of such funding, (2) the risk of putting consumers in a cycle of debt beyond their means, (3) the possibility that the lack of wide-spread information about alternative consumer legal funding sources may lead consumers to accept unfavorable terms, (4) funding business models based upon excessive returns, (5) possible collusion between the consumer's lawyer and the funding source, (6) assuring proper execution of the consumer legal funding contract and (7) proper screening for unscrupulous potential funders. (FN 10). The underlying principle here seems to be that the combination of these measures will prevent this source of funding from becoming another type of predatory lending to the less fortunate. Reviewing the statutes enacted to date, it would seem that these four states and the industry groups have satisfied some of these concerns but not others, so the jury is still out on whether or not this type of consumer finance is predatory.

The attached State Requirements Exhibit summarizes key provisions enacted by the four states and thus the detail and scope of the resulting regimes. (FN 11). So far, only Ohio uses the Disclosure Only Model; the other three states adopted the Registration model. As one would expect, there are certainly structural differences between the Disclosure Only Model and the Registration Model as well as significant differences in the manner in which the Registration Model is put in effect. (FN 12). Nonetheless, some general observations can be made in describing the overall approach taken in addressing the concerns.

To prevent consumers from entering transactions they don't understand, the states generally require detailed disclosures of key financial terms, including the total amount to be advanced to the consumer, all of the fees assessed by the funder, imputed interest in the arrangement, the time period from the date of advance during which the funder's return increases and a mechanism to calculate the total amount recoverable by the funder over that term. The states typically require that the contract disclose the non-recourse nature of the advance and use clear disclaimers such as unequivocally underscoring the consumer's right of rescission. Some states also require that the consumer acknowledge having reviewed the entire contract. While some commentators have argued for the use of disclosures based upon the Federal Truth in Lending Act (FN 13), each state requires detailed disclosures that would properly inform a reasonably knowledgeable consumer that is under no financial distress to obtain such advances.

In reality however, it appears that some consumer legal funders do not comply with these requirements (FN 14) and that, even when followed, these broad and detailed disclosure requirements do not always lead to an informed decision by a consumer who needs the cash now. An out of work automotive worker in Detroit with a wife, three kids, a mortgage payment and an industrial injury, for example, may only want to know how much he can get and when without much concern about any future payments to which the funder is entitled under the funding agreement. Seen in this harsh light, no amount of disclosure can overcome the individual financial exigencies that consumers may face and upon which unscrupulous firms could prey.

Indeed such stark realities do lend credence to the argument that consumer legal funding places consumers in a state of indentured servitude in which they accept onerous terms simply because they have nowhere else to turn. Advocates of such financing counter by noting the non-recourse nature of the advances in order to point out that the consumer does not assume personal liability for repaying the initial advances from the funder. Indeed, this argument continues, if the dispute is resolved in the consumer's favor, the consumer may even receive a subsequent payment as well. While not noticeably present in the literature on point, one could also support this position by noting the requirement imposed by some of the states that have adopted the Registration Model that each subsequent consumer legal funder must pay off the position of any earlier funder to this consumer. Clearly, the greater bargaining position enjoyed by the funder enables it to extract a hefty return from successful cases, (FN15), but the consumer does receive much needed cash in her most desperate hour when no other funding sources appeared to be available.

Perhaps, argue the critics, if only the consumer knew about other consumer legal funders, she could have gotten a better deal since a more efficient market should generate the level of competition and transparency necessary in order to reduce the overall returns required by the funders. Regrettably, the states do not do much good on this point. To be sure, some states suggest that all consumers determine whether or not their potential funder is registered in the state and others require the delivery by the registered funders of detailed operating results to the appropriate oversight agencies. But such guidance and reporting requirements do not amount to an easy way for consumers to comparison shop for the best available deal. As any late night television aficionado can attest, lenders fill this gap by continually advertising their services in a manner to target the demographics of their typical consumers. While not perfect, this mechanism does more to inform consumers than the regulatory requirements, particularly in those states that expressly prohibit false or misleading advertising.

Well, the opponents argue, perhaps the consumer does get the needed cash but the returns to the consumer legal funder are unreasonably high, "generally unseemingly," unfair and should be regulated. In response, funding sources argue that their returns are reasonable given the level of risk they assume in their operations and the economic infeasibility of conducting any meaningful, detailed due diligence on cases with such small individual advances. In order to prevent predatory lending in this niche, the Registration Model couples the consumer protections discussed above with a series of restrictions on the operations of the funders. These restrictions range from prohibiting the use of false advertising as discussed above to prohibiting the consumer from using the advanced funds to pay legal fees or expenses. Some states also require that all lending be done from the location specified in the funder's application. Helpful to be sure, but these requirements – standing alone—are insufficient.

Of greater help are the restrictions placed by the states on the potential returns available to registered funders. For example, one state provides that the potential return to the funder cannot be based upon the actual recovery received by the consumer. In addition, the duration of the period during which the funder's potential return may increase and the manner in which interest on these advances are calculated are also frequently restricted. In some instances, the funder is expressly prohibited from determining its return based upon the amount that the consumer receives in a successful resolution of her dispute.

Let us assume that funders are permitted to receive an appropriate risk-adjusted return and that they can operate profitably under these constraints. Even assuming an appropriate level risk/return, the consumer does not seem to be sufficiently protected from predatory lending practices solely by these restrictions. Let me suggest that, while useful, the steps detailed above would be woefully inadequate if not coupled with substantial financial risk to the funder for loan operations that do not comply with the applicable state requirements. The key protection against such malevolent lending practices is the potentially disastrous results imposed on the funding source if the state requirements are not met. In Oklahoma, for example, a non-compliant funder may receive its advances upon a favorable resolution, but the funder loses its right to receive any additional payments. Further, an illegal funding contract may also subject the lender and its principals to other serious regulatory sanctions.

The conclusion that the consumer is still vulnerable to predatory lenders remains true even if you consider the additional requirements addressed at prohibiting collusion between the consumer's counsel and the funder. Generally, referral arrangements are prohibited as is funder participation in the underlying litigation. In Nebraska, counsel must disclose any financial interest she has in the funder. Counsel may not be required to assign to the funder any portion of her recovery from the underlying litigation in some situations. Frequently counsel must acknowledge her representation of the consumer and her review of the funding agreement (with special emphasis on the payments to the funding source) while confirming that counsel discussed these matters with her client prior to the client's execution of the funding agreement. As with the use of other detailed disclosures to promote consumer understanding, this approach seems to provide a reasonable amount of protection against collusion. However, with or without this type of express acknowledgement by counsel, the Code of Professional Responsibility to which the consumer's counsel is subject would either provide the lion's share of the real protection for the consumer in such matters or, at the very least, the specter of disciplinary actions proceedings for counsel's lack of competent and loyal representation would serve as a strong and ever-present adjunct in trying to achieve this objective.

On the other hand, these states seem to have done some or all of four things fairly well. First, all four of the states provide basic logistical precautions relating to contract execution such as requiring that the agreement must be in writing and use plain language, all disclaimers should be conspicuous and understandable, accommodations are frequently made for consumers for whom English is not their primary language, each page of the contract must be initialed by the consumer, and the consumer is admonished not to sign an incomplete agreement and to have the contract reviewed by counsel prior to execution.

With the typical requirement that copy of the fully executed contract be delivered promptly to the consumer's counsel and/or the consumer, this objective appears to have been satisfied.

Second, these states have made efforts—at least in the text of the legislation—to address the final concern listed above, namely proper screening to weed out unsavory parties that could foist predatory loans on these consumers. Barriers to entry into this business are low, if not nonexistent. States adopting the Registration Model address this concern by requiring lenders to register with the state prior to making any consumer legal advances, and as part of the process, to make certain disclosures, some of more significance than others. For example, the application process either provides the overseeing agency the right to generally review the character, fitness and financial status of a potential lender or requires the disclosure by the lender and each of the funder's principals of all prior felonies, regulatory actions, monetary amounts owed to federal or state governmental agencies as a result of prior violations and the loss of any professional license. Annual renewals of the registered funders and the requirement in some states of annual reports of consumer legal funding activity to the state legislature provide some level of industry monitoring. However, application and registration is only as good as the operation of the registered lenders and the ability of the states to enforce the rules and punish lenders for violations. At present, it is unclear how well such enforcement activities will be funded or whether or not they will be effective. As a result, the satisfaction of this objective is still uncertain.

Third, some of these states provide an additional consumer protection that is related less to preventing predatory transactions directly as it is to ensuring courts will have the ability to examine the transaction if it is challenged. In these states, the funders cannot require that any dispute between themselves and the consumer be resolved through binding arbitration. The underlying rationale appears to be that the consumer's disputes should be subject to the harsh light of public disclosure to that same extent as any other litigation in order to assure a fair and impartial resolution. This laudable approach is further strengthened in those states that permit the prevailing party to be awarded attorneys' fees and expenses. Enabling an indigent consumer to receive the attorneys' fees and expenses she incurred in pursuing a meritorious claim against a predatory funder is clearly a positive step in overcoming any disparity in bargaining power between the consumer and the funder. All states would be well advised to include such a provision regardless of the extent to which they adopt the full gamut of protections afforded by the other states.

Fourth, we should also note that some of the states have also addressed key criticisms traditionally raised by opponents of any type of alternative litigation. Nebraska, for example, specifically states that the sharing of case-specific information by the consumer's counsel with the funder does not constitute a waiver of the consumer's rights under either the work-product doctrine or the attorney-client relationship with her counsel. Advocates of this type of funding can also argue that it will not lead to frivolous litigation since this type of funding is only available to support consumers that have already commenced the litigation process. Counsel's ethical concerns seem somewhat appeased by the provisions in Nebraska and Ohio that the involvement of counsel in this type of financing does not increase counsel's ethical obligations to the client beyond those obligations already imposed by that state's current Code of Professional Conduct.

Conclusion

With this detailed review as backdrop, it becomes quite clear that the ALFA's legislative philosophy relies upon various factors to overcome the overarching concern that consumer legal financing is predatory in nature, whether through the Disclosure Only or the Registration Model. Since the perceived need to protect individuals is greater than is the need to protect corporate entities, it is not surprising that the statutes enacted to date are generally only applicable to loans made to individuals although Ohio's extension of this consumer protection to "small businesses" may have merit as well (FN 16).

To have a chance at being effective, the anti-predatory lending statutes must require, as some states do, that loans made to plaintiffs not in compliance with these statutes be subject to additional, more restrictive statutes and potentially devastating results to the lenders as discussed above. These protections are further strengthened by the fact that counsel's continued right to practice law could be withdrawn if she colludes with the funder and thereby violates the applicable Code of Professional Responsibility. Concerns nonetheless remain as to the ultimate protection afforded to consumers for a variety of reasons, including the registration requirement in some states that the funder need only demonstrate a net worth of $25,000 and post a $50,000 bond. Thus even if the system "works" and the unscrupulous funder is discovered and punished, such low capital and bonding requirements gives one pause since the funder's victims, especially if numerous, are unlikely to be made whole. However, these statutes do represent an improvement over the current generally unregulated landscape and continue to permit the functioning of this vitally needed funding source to an underserved segment of our society, even over the continued objections of consumer advocates.

The jury is still out on whether or not either the Disclosure Only Model or the Registration Model, with all of its permutations, have been successful in achieving the goals listed above or whether additional, and possibly significant concessions must be made to the opponents of this type of funding. Regardless of the preferred approach in any statehouse, the remaining states may wish to monitor both the reports of progress and the required enforcement against both registered and non-registered consumer legal funding sources in order to determine how best to prohibit an additional predatory lending practice in their jurisdictions.

FOOTNOTES

Footnote 1 S. Meade, “The Litigation Finance Industry: The Wild West of Finance Should be Tamed Not Outlawed,” X Fordham Journal of Corporate and Financial Law 55, at pages 63-64 (2004) (hereinafter “*Wild West*”); Steve Garber, “Alternative Litigation Financing in the United States – Issues, Knowns, and Unknowns” at page 9 (Rand Institute for Civil Justice Program 2010) (hereinafter “*Garber*”) available at .http://www.americanlegalfin.com/press/RAND%20Alternative%20Litigation%20Financing.pdf; Harvey Hirscheld, Chairman, American Legal Finance Association. “Commercial Legal Funding in the US” at pages 7 – 9 (RAND Corporation, Rand Institute for Civil Justice Conference available athttp://www.americanlegalfin.com/press/RAND%20Consumer%20Legal%20Funding.pdf (hereinafter “*Hirscheld*”).

Footnote 2 *Hirsche*ld at pages 8 and 9,

Footnote 3. See, e.g., “American Legal Finance Association Helps Fund Rebuilding of Church Damaged by Explosion” (August 4, 2005) available athttp://www.americanlegalfin.com/PressReleases.asp; *Wild West* at page 73.

Footnote 4: “American Legal Finance Association is Established: Will Set Up the Highest Standards for the Non Recourse Funding Industry” (March 10, 2005) available athttp://www.americanlegalfin.com/press/ALFA_formation.jpg.

Footnote 5 *Wild West* at page 77; Note, Access to Justice with Protection: Improving Alternative Litigation Financing with Consumer Protections at pages 24 and 39 (2011 -2012 events), available athttp://www.law.gwu.edu/News/20112012events/Documents/ALF_ConferenceNote.pdf(hereinafter "*Justice with Protection*").

Footnote 6 "Facts About ALFA," available athttp://www.americanlegalfin.com/FactsAboutALFA.asp

Footnote 7: Me. Rev. Stat. tit. 9-A, §§ 12-101 to -107; Ohio Rev. Code Ann. § 1349.55; Neb. Rev. Stat. §§ 25-3301 to -3309; Okla 14A O.S. 3-801-3-817.

Footnote 8 Letter dated May 5, 2011 from Amy M. Au, President of the Alliance for Responsible Consumer Legal Funding to the Working Group on Alternative Litigation Financing, ABA Commission on Ethics 2020, American Bar Association at page 2, available athttp://www.americanbar.org/content/dam/aba/administrative/ethics_2020/ethics_20_20_comments/arc_alfissuespaper.authcheckdam.pdf(hereinafter "*ARC Policy Statement*").

Footnote 9 *ARC Policy Statement* at page 3; J. Lyon, Revolution in Progress: Third-Party Funding of American Litigation, 58 UCLA L. Rev. 571 at pages 608-609 (2011)

Footnote 10: *ARC Policy Statement* at page 3; *Garber* at pages 12 and 42-43; *Justice with Protection* at page 1; Wild West at pages 64, 67 – 68 and 74; See "Industry Best Practices – ALFA's Code of Conduct" available athttp://www.americanlegalfin.com/IndustryBestPractices.asp

Footnote 11. The summaries contained in the article are designed to give the reader an overview of the manner in which the states have addressed the applicable issue. Not all of the states have taken the protection as far as described. For the approach taken in a particular state, the reader should review the Exhibit A in detail.

FN 12 *ARC Policy Statement* at page 3; *Justice with Protection* at page 22.

FN 13 *Justice with Protection* at page 1.

FN 14 John P. Barylick & Jenna Wims Hashway, Litigation Financing: Preying on Plaintiffs, 59 R.R. Bar J.5 at pages 7, 9, 34, 35 (2011) (hereinafter "*Preying on Plaintiffs*") noting that the language in the funding agreement is far from clear, annual percentage rates are not always disclosed or are impossible to calculate, the ban against mandatory arbitration is not universally followed while the use of in terrorem clauses limiting the consumers remedies upon dispute are prevalent,

FN 15 *Access with Protection* at page 26.

FN 16 *Access with Protection* at page 43.