# CHAPTER 11 ALTERNATIVE SOURCES OF FUNDING

1. In this Chapter we consider alternative mechanisms for funding litigation that have not been considered in earlier Chapters. These include third party funding, legal aid for family actions, self-funding schemes and *pro bono* funding.

## THIRD PARTY FUNDING

2. Third party funding refers to the provision of financial support for a litigation by individuals or companies with no pre-existing interest in the litigation. In this sense, the Legal Aid Fund, legal expenses insurance,[1] trade unions and professional associations all provide third party funding. Here we consider one particular type, where commercial investors provide financial support to litigants usually in return for an agreed share of any sum recovered. This is sometimes known simply as litigation funding.

3. Unlike legal expenses insurance, third party funding does not charge a premium. Nor does it charge interest, like a bank loan. Rather, it seeks to provide for the funder an appropriate return on investing in selected litigations. The return may be based on a multiplier of the investment or on a percentage of any monies received by the recipient of the funding.[2] Occasionally a fixed sum will be agreed. In addition, the agreement will often allow funders to retain any expenses recovered from the other party. The fee itself cannot be recovered as part of an award of expenses and is therefore payable by the funded party out of monies received.

4. Like speculative fee and damages based agreements, a third party funder is entitled to payment only if the action succeeds. Should the action fail, the funded party is not obliged to repay the funder. This reduces the financial risk to those individuals and companies wishing to embark on litigation. Whereas in speculative and contingency funding those who reap the rewards of success and bear the risks of failure are primarily the lawyers involved, in third party funding the reward and risk is assumed by the funder. The funder's involvement in the litigation is mainly financial, although this ultimately depends on the funding model.[3] The funder may agree to fund the litigation in whole or in part, for example, providing funding for outlays only, or taking over funding part way through a case. The funder will usually offer an indemnity, or pay for (or require the funded party to pay for) an After the Event ('ATE') insurance policy, against the risk of having to pay the other side's expenses.[4]

5. While third party funding may be available for a broad spectrum of commercial disputes, funders are typically willing to invest only where there are good prospects of success (often expressed in percentage terms), the defender is creditworthy (to ensure that

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[1] Before the Event insurance is discussed in Chapter 6 of this Report. After the Event insurance is discussed in Chapter 7.

[2] Civil Justice Council, *The Future of Litigation - Alternative Funding Structures* (2007), page 53

[3] Christopher Hodges, John Peysner and Angus Nurse, *Litigation Funding: Status and Issues* (2012), page 2

[4] One funder now established in England and Wales offers both ATE insurance and third party funding.

any award of damages can be enforced), and the ratio of the cost of financing to the action's value is sufficiently low to ensure an adequate return for the funder. Funders, who may themselves come from a legal services background, typically conduct a detailed assessment of the legal merits of a case prior to agreeing to fund it. It has been observed that some funders publicly advise that they reject over 85% of applications.[5]

6. There is no prohibition or restriction in Scots law on a litigation being funded wholly, or in part, by a third party. The prohibition on maintenance and champerty, discussed below, is not part of Scots law.

**England and Wales**

7. In England and Wales, the historical prohibition of maintenance and champerty hindered the development of third party funding.[6] In recent years the prohibition has been eroded by a series of decisions.[7] By 2009, Jackson LJ identified "a sea change" in the courts' approach to third party funding:

> *"It is now recognised that many claimants cannot afford to pursue valid claims without third party funding; that it is better for such claimants to forfeit a percentage of their damages than to recover nothing at all; and that third party funding has a part to play in promoting access to justice."*[8]

Further benefits observed by Jackson LJ include the filtering out of unmeritorious cases by third party funding, since funders will not take on the risk of such cases.[9]

8. Jackson LJ addressed third party funding by identifying the largest providers in the UK at the time and asking them to provide him with details of how they operate. They informed him that, given the commercial nature of their involvement, they required to generate a profit while at the same time covering their costs with respect to both 'won' cases (in so far as costs are not fully recoverable from the other side) and 'lost' cases. This meant that they selected cases with considerable care, which some quantified as having prospects of success of 70% or greater. They typically identified high value cases which, depending on the funder, meant a minimum value ranging from £150,000 to £25,000,000. Since funders were potentially liable for the other side's costs, they generally required funded parties to obtain ATE insurance cover. Some brokers specialised in packages comprising third party funding and ATE insurance cover.

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[5] See http://www.thejudge.co.uk/index.php/third-party-funding

[6] 'Maintenance' has been defined as the support of litigation by a stranger without just cause. 'Champerty' is an aggravated form of maintenance and entails the support of litigation by a stranger with a financial interest in the outcome, such as a share of the proceeds. Section 14 of the Criminal Law Act 1967 c. 58 abolished criminal and tortious liability for maintenance and champerty but provided that such abolition "*shall not affect any rule of that law as to the cases in which a contract is to be treated as contrary to public policy or otherwise illegal*": *Blackstone's Civil Practice* (2013), paragraph 14.7.

[7] Summarised by Coulson J in *London & Regional (St George's Court) Ltd v Ministry of Defence* [2008] EWHC 526 TCC at paragraphs 102-103

[8] Jackson LJ, *Review of Civil Litigation Costs: Preliminary Report* (2009), Chapter 15 paragraph 1.1

[9] Jackson LJ, *Review of Civil Litigation Costs: Final Report* (2009), Chapter 11 paragraph 1.2

9. Jackson LJ found that third party funding was commonly used to fund insolvency cases. While it was reportedly still rare in commercial cases, it was becoming more common. Its use was also growing in professional negligence[10] and group actions. In personal injury cases its use was at that time prohibited by the solicitors' Code of Conduct.[11] It was not used in some other types of litigation for reasons including the perceived low rate of return (such as small business disputes), the technical and legal complexity (such as intellectual property or construction disputes), or the unpredictability of outcome (such as defamation actions).

10. Having affirmed that, in principle, third party funding was beneficial and should be supported,[12] Jackson LJ went on to consider whether third party funders should be regulated or should subscribe to a voluntary code. He also addressed measures to ensure the capital adequacy of third party funders, and liability for awards of costs. It has been suggested that other changes introduced following Jackson LJ's report, such as the non-recoverability of ATE insurance premiums, will lead to an expansion of alternative funding arrangements such as third party funding.[13]

**Consultation responses**

11. In the Consultation Paper we sought identification of the risks and potential abuses involved in third party funding and how might they be addressed. We asked if regulation was desirable and what form it should take; and whether a party to a litigation who has entered into a funding arrangement should be obliged to disclose details of that arrangement to any other party and, if so, in what circumstances.

12. There were 42 respondents to this section of the Consultation Paper. Many chose to respond to the questions more generally by providing general comments on the third party funding landscape in Scotland. Several respondents drew attention to the various forms that such funding may take and differentiated funding provided by membership organisations in the interests of their members from commercial funders, such as venture capitalists, where profit is the primary motive. The Law Society of Scotland also identified funding by debt factors and a party's creditors, both of which are in the party's interest but which, in its opinion, give rise to no concerns in the public interest.

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[10] For example, *Stone & Rolls Ltd (in liquidation) v Moore Stephens* [2009] UKHL 39. That claim was unsuccessful and the funder reportedly had to meet costs of £2.5 million. See Rachel Rothwell, 'Major third-party funding case fails in House of Lords', *Law Society Gazette* (6 August 2009)

[11] Rule 9.01(4) of the Solicitors' Code of Conduct 2007 prohibited a solicitor, in any personal injury claim, from acting in association with inter alia any person whose business was to support claims and who in the course of such business received contingency fees. This was replaced by 'outcomes-focussed regulation' in the Solicitors Regulation Authority Code of Conduct 2011. This is discussed in more detail elsewhere in this Report: in Chapter 9 ( Damages Based Agreements) and Chapter 10 (Referral Fees)

[12] Jackson LJ, *Review of Civil Litigation Costs: Final Report* (2009), Chapter 11, paragraph 1.2

[13] John Hyde, 'Jackson reforms will encourage third-party funding,' *Law Society Gazette* (15 December 2011)

***Risks and abuses***

*Principled objections*

13. A considerable number of respondents considered that third party funding was contrary to fundamental principles of law and justice. They argued that risks and abuses were inherent in its very nature. They were of the view that the legal system should never be a forum for commercial speculation, citing the banking industry as an example of what could happen if it became so.

14. Secondly, they argued that since it takes a substantial percentage of the funded party's award, third party funding could be said to *"strike at the heart of the principle of compensation which underpins the legal system, viz. restitution."* They argued that it was a basic principle of justice for litigants to be entitled to recover as much as possible of any damages or other financial award that a court may make. The involvement of a third party, other than the 'not for profit' sector, was said to be an impediment to that principle.

15. Thirdly, some respondents referred to inherent conflicts of interest that were likely to arise wherever third party funders are both underwriting liability for judicial expenses and are reliant on a successful outcome for their income. This was unlike other funders, such as trade unions and professional associations, which were concerned with judicial expenses but not reliant on damages for their income. However, several respondents acknowledged that there was potential for a conflict of interests whenever third parties had a direct interest in the action, be they solicitors or commercial organisations.

*Control*

16. A number of respondents identified control over litigation, including withdrawal of support for it, as the primary risk associated with third party funding. However, one solicitor respondent noted that this was not restricted to 'for profit' third party funding and observed that no organisation was more insistent on being kept informed, and more likely to refuse an extension of funding, than the Scottish Legal Aid Board.

17. These respondents also identified conflicts of interest. Where a third party funder exercised control over the litigation, little regard may be paid to the pursuer's interests. This could work in several ways. Funders could pressurise pursuers to agree a lower but more immediate settlement figure. Alternatively, pursuers may be pressurised to wait for a higher offer. Pursuers who wished to accept a non-financial remedy could also come into conflict with the interests of funders.

18. Some considered that control exercised by third party funders could be detrimental to the lawyer/client relationship by exerting influence on funded parties to act contrary to their lawyer's advice. However, others observed that the potential for abuse existed with all funding arrangements. For example, when litigation was funded by an insurance policy, a solicitor's financial interests could conflict with those of the policy holder whenever the indemnity limit was approached.

19. Other potential risks included the withdrawal of – or refusal to continue – funding, possibly at short notice and/or in the absence of proper grounds. However, only one

respondent (a firm of solicitors) reported having had any direct experience of this during the course of a third party funded case.

*Capital adequacy and recovery of expenses*

20. A small number of respondents identified the risk of third party funders becoming insolvent, especially during a protracted litigation. This could impact on both parties, since the funder might be unable to fund the litigation and/or meet an award of expenses in favour of the other party.

21. More generally, a number of respondents referred to difficulties that successful parties might encounter in recovering expenses from a third party funded opponent. They observed that where funded parties did not have the financial means to meet an award of expenses, no mechanism was available by which the expenses could be recovered. It was observed that similar difficulties could arise where other funding mechanisms were used, specifically legal aid.

***Regulation***

22. Some respondents did not support regulation of third party funding, albeit for different reasons. Those who saw no place in the Scottish legal system for third party funding argued that regulation would appear to endorse it. In any case, they considered that regulation could not address adequately the inherent conflicts of interest. Others argued that since third party funding was rare in Scotland, there was no need for more regulation here.

23. However, most respondents did favour regulation, although what they meant by this varied as did the strength of their views. Several respondents stressed the need for careful definition of third party funding if regulation was to be effective.

24. Several respondents considered that it might be sufficient to have a standard form agreement, drawn up by an independent body such as the Law Society of Scotland, to regulate relations between the funded party and the funder (and possibly the solicitor) on matters such as when funding could be withdrawn. Some sought restrictions to prevent withdrawal of funding part way through a litigation. More generally, others thought that any agreement should specify the funder's and the solicitor's responsibilities. Others considered that such an agreement would not address certain risks, such as insolvency. One respondent, a financial institution, considered that third party funding should be subject to the same regulatory requirements as other financial products.[14]

25. Other respondents favoured a voluntary code of conduct, as has been developed in England and Wales. This did not preclude the reconsideration of statutory regulation should third party funding become more prevalent in the future. In the meantime, the Law Society of Scotland was of the view that if not already subject to the Financial Ombudsman

[14] Regulation of financial services was formerly carried out by the Financial Services Authority. This was abolished on 1st April 2013 and replaced by two new regulators: the Financial Conduct Authority and the Prudential Regulation Authority.

Service, third party funders should come within the remit of the Scottish Legal Complaints Commission and should be required to contribute to its running costs.

26. Only one respondent considered that individuals contemplating a third party funding agreement should first be obliged to take legal advice from an independent solicitor. Such advice would include consideration of alternative sources of funding. Another respondent considered that solicitors and counsel should be prohibited from being directors or shareholders of third party funders or, at the very least, from acting for clients funded by an entity in which they were so involved.

27. Several respondents suggested that potential conflicts of interest could be addressed by capping the amount which third party funders could deduct from a monetary award.

28. A number of respondents addressed the issue of capital adequacy and suggested that the funded party should require to find caution on commencing litigation. Others considered that the court should be entitled to award expenses against the funder. This would require disclosure of the funding mechanism and the funder's identity.

***Disclosing the funding mechanism***

29. A slight majority of respondents considered that the funded party should have an obligation to disclose the means of funding the litigation. Those respondents in favour of disclosure were often associated with defenders. They stressed the need for openness and transparency, and the potential for third party funding to impact on a party's willingness to proceed with litigation. Some specified, however, that the funded party should not be obliged to disclose details of the arrangement, such as the percentage of damages to be taken by the funder. One respondent, who considered that successful opponents should be entitled to enforce awards of expenses against the funders themselves, argued that identifying a funder by name was a necessary step towards this. More generally, several respondents considered that the obligation of disclosure should be extended to all litigation in which a funding arrangement was used, since this would allow the opponent to assess the financial risk of proceeding.

30. Those respondents opposed to disclosure – often solicitors or their representative associations – considered that funding was a private matter and that no change to the current law was required. As one respondent explained, an opponent is not entitled to this information because the fee paid to the funder is not recoverable from the opponent.

**Discussion**

31. There are no legal impediments to third party funding in Scotland, such as the prohibition on maintenance and champerty which has hindered its development in England and Wales. Thus far, however, there is little evidence of third party funding having found fertile ground in Scotland. Indeed, it has been represented to me that the issue of third party funding is thereby redundant and undeserving of treatment by this Review. I am not inclined to take this view.

32. The current paucity of third party funding in Scotland is indicative of market conditions, and may relate to supply factors, demand factors or both. With regard to the

supply side, I have been told that the value of claims raised in Scotland was unlikely to entice third party funders into the Scottish legal market. While this may be so at present, third party funders are reportedly looking for new markets and I am aware of several who are presently making tentative steps into the Scottish marketplace by making initial contact with a number of commercial firms. With a view to providing a precedent for third party funding in Scotland, I am aware of one funder that is seeking to fund several high value claims (over £750,000) with a 65% chance of success and is ready to consider cases that involve breach of contract, professional negligence, intellectual property, insolvency, and international arbitration and mediation.[15]

33. Cases which are likely to be funded are those where the potential for a financial return is significantly greater than the cost of recovery. One solicitor with whom the Review met observed that there would be *"little left on a £1 million claim,"* even if judicial expenses were recovered. If £200,000 were to be invested by a third party funder in addition to the cost of an ATE insurance policy, the funder will require a success fee of between £400,000 and £600,000, in addition to the return of the initial investment and repayment of the ATE insurance premium. In commercial cases, so I was told, the ATE premium itself could be as high as 30% of the value of the claim. Some have argued that by virtue of the infrequency of high value cases, third party funding was likely to remain in limited supply in Scotland.

34. Nevertheless, it may be unsafe to predict a limited supply of third party funding in Scotland in the long term. In discussions during the Consultation period, the potential impact of alternative business structures on the supply of third party funding in Scotland was frequently pointed out to me. One solicitor observed that law firms, with their traditional partnership arrangements, have until now been seen by third party funders as an unsuitable basis for investment. Alternative business structures, on the other hand, may present themselves as an opportunity for third party funder investment. The introduction of alternative business structures in Scotland could therefore draw more third party funders into the Scottish legal market, and there are indications that this is already beginning to happen.

35. I have been told that some solicitor firms in Scotland are now being invited by their clients to enter into novel fee or profit sharing arrangements which probably have their origins in alternative business structures. We know that a number of legal firms are being taken over by insurers in England and Wales. There are indications of a similar trend in Scotland. So, for example, Parabis, which was the first private equity-backed alternative business structures to be licensed by the Solicitors Regulation Authority in England and Wales in August 2012, has recently been launched in Scotland as Parabis Scotland, offering pursuer and defender insurance law services.[16]

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[15] The value of case should also be at least 5 times the likely costs of running the case. The funder will provide initial funding in return for a 2 to 3 times multiplier of the fees or a percentage of the damages/value, whichever is higher. It expects ATE insurance to be put in place and will fund that cost, though it will be paid for out of damages if the ATE is not recoverable.

[16] Sam Chadderton, 'Parabis Marches North With Launch in Scotland,' *The Lawyer* (6 November 2012)

36. At the same time, third party funders with an interest in funding lower value claims have recently entered the market in England and Wales. So, for example, a new fund was launched in May 2012 by Novitas, which had previously dealt with high value divorce cases with an average loan of £50,000 but which is now offering loans from £3,000 to fund divorce cases.[17] There is no reason to believe that third party funder entry into low value cases will be restricted to England and Wales. Supply may not depend exclusively upon the availability of high value cases. I am therefore unwilling to follow the advice of at least one response to the Consultation which recommended that since third party funding was not active in Scotland, I could well avoid dealing with it.

37. On the demand side, some respondents observed that demand for third party funding, as demonstrated in England and Wales, was also unlikely to develop in Scotland. They argued that Jackson LJ's encouragement of third party funding was a response to significant changes that he recommended should be introduced into the costs regime in England and Wales, such as the non-recoverability of success fees and ATE premiums. A 'mischief based analysis' suggested that demand for third party funding will remain limited in Scotland.

38. This was by no means a unanimous view. For example, an association of solicitors representing pursuers in personal injury claims considered that third party funding may well address funding gaps in Scotland. They observed that it could provide an option where no other funding is available, for example, in multi-party litigation and clinical negligence actions. Other solicitors with whom I met were of the view that third party funding may be particularly attractive in certain areas such as insolvency, and especially with regard to complex high value cases where solicitors may wish to share the risk with a third party funder rather than enter into an SFA, as they frequently do in lower value work. This could equally apply to a broader field of cases and circumstances. It has been suggested that the demand for third party funding, which can meet the cost of counsel's fees, outlays, insurance premiums and other fees as the case progresses in return for either a multiple of the amount invested or a percentage of the damages, is likely to increase in England and Wales following the introduction of damages based agreements in April 2013.[18] There is no reason why the same may not apply to cases in Scotland funded by 'no win no fee' arrangements, whether they are damages based agreements or speculative fee agreements ('SFAs').

39. Demand for third party funding may also arise because of the tactical advantages that it offers. It has been represented to me, just as it was to Jackson LJ, that third party funding provides a clear message to the opposing side that a party with no interest in the litigation other than its profitability has confidence in the case. The decision of third party funders to invest in the litigation is made only after a detailed assessment of the legal and factual matrix of the case, its prospects of success and the qualities of the legal team.[19] Since the case is assessed by an independent party for its prospects for success, this may serve the

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[17] Rachel Rothwell, 'Is it wrong to profit from divorce litigation?' *Law Society Gazette* (28 May 2012)
[18] Rachel Rothwell, 'Litigation Funder Targets Case "Portfolios,"' *Law Society Gazette* (25 October 2012)
[19] Hodges et al, *op cit* (2012), pages 2 and 102

public interest by promoting settlement. Where pursuers are pitted against a stronger party, it may also promote access to justice. As one representative of third party funders argued in the Law Society Gazette, *"Large firms often find it preferable to bury claimants under excessive costs, rather than settle genuine claims....Funding removes this weapon from their armoury and puts previously weak claimants on a level playing field."*[20]

40. This view is not restricted to funders. Empirical research in England and Wales found that many of the cases suitable for third party funding were of a David vs. Goliath nature and would never have proceeded without it.[21] Indeed, the funding for commercial litigation which third party funding offered small and medium sized enterprises in England and Wales was found to represent *"a significant extension in access to justice in an area that has been consistently overlooked by commentators, lawyers and policy makers, who have concentrated concern and analysis almost exclusively on low value claims by consumers and individuals."*[22]

41. The research also demonstrated that demand for third party funding in England and Wales far outstripped supply, so that funders were able to select meritorious cases that offered the best returns. These were frequently high value cases. Hence, the availability of high value cases may not be a necessary condition of supply. Rather, it may be that the present restriction of funding to very high value cases is a consequence of high demand, which allows funders to take their pick of cases. As the market for third party funding matures, and supply increases, investors may choose to support cases with higher risk and lower value.[23]

**Regulation**

42. The question that must now be addressed is whether regulation of third party funding is necessary in Scotland and, if so, what form it should take.

43. There is currently a voluntary code of conduct for members of the Association of Litigation Funders of England and Wales, which is reproduced at Annex 1. The Association was founded in 2011 with the stated aim of ensuring that the code's legal and ethical standards are met by all its members. Its website (as of July 2013) lists ten funder members (including one overseas member), almost all of whom are limited companies or limited liability partnerships; three broker members; one law firm member and; two academic members. The code of conduct sets out the standards by which members must abide. It requires funders to maintain at all times financial resources adequate to enable them to meet their obligations to fund all of the disputes they have agreed to fund. It provides that funders must behave reasonably and may only withdraw from funding in specific circumstances. Where there is a dispute about termination or settlement, a binding opinion must be obtained from senior counsel. Funders are not to seek to influence the funded party's lawyer to cede control of the litigation to the funder, or cause the lawyer to act in

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[20] John Hyde, 'US Plea to Curb Third-Party Funding,' *Law Society Gazette* (31 October 2012)
[21] Hodges et al, *op cit* (2012), page 105
[22] *ibid*, page 104
[23] *ibid*, page 103

breach of professional duties. In practice, because of their financial interest, funders will ask to be kept informed as the case progresses.

44. Jackson LJ considered that since third party funding was in its infancy in England and Wales, and since parties presently using it were commercial enterprises with access to full legal advice, a voluntary code would suffice until third party funding expanded, when it may be necessary to revisit the issue of full statutory regulation. The same position could be taken here, particularly given the low prevalence of third party funding in Scotland at present. In Jackson LJ's view, however, much also depended on the nature of the investors entering the market place and the nature of the claims and claimants that they are funding. If third party funders were to support group actions brought by consumers, for example, he observed that the issue of statutory regulation may have to be reconsidered.

45. Recent evidence suggests that the market is not only expanding in England and Wales but that funders are planning to extend into new markets, such as multi-party actions and divorce. This extension into cases involving ordinary citizens may mean that the case for transparency and regulation is stronger now than in 2009 when Jackson LJ was writing. A number of respondents to the Consultation identified clinical negligence and multi-party litigation as potential markets for third party funding in Scotland. Protection would be required since individuals are not 'repeat players' and do not have access to the financial and legal advice resources normally available to commercial parties.

46. Statutory regulation was considered during the passage of the Legal Aid, Sentencing and Punishment of Offenders Act 2012[24] but was not implemented. The Minister stated that the Lord Chancellor would be reviewing the operation of the voluntary code, leaving open the possibility that the Government may need to return to the issue in the future.[25]

47. Formal regulation has also been supported by academic legal commentators. It has been argued that a voluntary scheme does not address the requirements of a developing market and *"any potential harm caused by the emergence of new funders who may develop new litigation funding products and alternative business models that fall outside the scope of the code."*[26] The writers considered that third party funding in England and Wales had already expanded to the point where regulation by the Ministry of Justice, the Legal Services Ombudsman or a financial regulator should be considered. They doubted whether a voluntary code would provide sanctions adequate to deal with rogue funders and bad practice.[27]

48. Self-regulation of the industry, as is presently in place in England and Wales, may be sufficient to delineate core elements of the funder-client-lawyer relationship. At present, litigants funded by third party funding will have the protection of independent advice from their own lawyers before entering a funding agreement and also during the resulting litigation. However the legal landscape is rapidly changing, not least due to the advent of

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[24] c. 10

[25] HL Deb 14 March 2012, vol 736, cols 368-369, per the Minister of State for Justice (Lord McNally)

[26] Hodges et al, *op cit* (2012), page 148

[27] *ibid*, page 149

law firms being able to access external capital. Should a third party funder in the future acquire an interest in a legal firm and offer a 'one stop shop,' a completely new set of risks will be presented and will require to be addressed. At this stage in the evolution of third party funding and in the current legal landscape, I consider that I should adopt the solution adopted in England and Wales, where it appears to be working satisfactorily. Third party funding is very much in its infancy in Scotland. It may not reach adolescence.

49. **I therefore recommend that there should, in the first instance, be a voluntary Code of Practice to which third party funders should conform.** It is beyond the remit of this Review to draft codes of practice or similar. That is a task for the new Scottish Civil Justice Council to oversee. However, this is a dynamic arena. I do not have a crystal ball to enable me to predict how, for example, alternative business structures will impact upon present practices and values. It may be that, in the future, a voluntary code will be insufficient to protect individuals who make use of third party funding and that statutory regulation will be required.

### *Capital adequacy*

50. Capital adequacy has implications for both the funded party and the successful opponent of a funded party. Several respondents observed that there was a risk of funders becoming insolvent, particularly during a protracted litigation. This raises the question of what can be done to ensure that funders have sufficient capital to fulfil their obligations to the litigants that they have funded.

51. In England and Wales the voluntary code of conduct requires a funder to maintain at all times adequate financial resources to meet its obligations to fund all of the disputes that it has agreed to fund.[28] While the code does not currently specify a minimum amount, it has been reported that the ALF intends to introduce more rigorous rules which will require funder members to have capital of at least £2 million. This figure will be reviewed annually. Members will also require to be audited annually.[29]

52. I consider that similar provision to that made by the ALF code should be included in the voluntary Code of Practice for third party funders operating in Scotland.

### *Recovery of expenses*

53. Several respondents referred to the difficulties of recovering expenses awarded against funded parties where the third party funder had insufficient capital to meet the award. This may be addressed under existing procedures by which the court can require parties to find caution. So, for example, in *Gaelic Seafoods (Ireland) Ltd v Ewos Ltd*,[30] the defenders were entitled to an order for caution despite the fact that the pursuers, a company in liquidation, had the benefit of legal expenses insurance.

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[28] Rule 7(d)

[29] Rachel Rothwell, 'Third-party funders face tougher rules,' *Law Society Gazette* (8 February 2013)

[30] 2009 SCLR 417

54. In Scotland the courts can impose liability for judicial expenses on a person who, though not a party to the action, has control of the litigation and an interest in its subject matter.[31] Such a person is known as a *dominus litus*. It is, however, rare for such a finding in expenses to be made.[32] In England and Wales the courts also have the power to award costs against a body which is not a party to the proceedings.[33] Such an order will be 'exceptional,'[34] for example, where non-parties pursue or defend claims for their own benefit and at their own expense. The Privy Council has held that where the non-party not only funds the proceedings but substantially controls or at any rate is to benefit from them, justice will ordinarily require that, if the proceedings fail, the non-party will pay the successful party's costs.[35]

55. As far as third party funders are concerned, the Court of Appeal in England and Wales has attempted to strike a balance between the need to preserve the expectation that costs follow success while avoiding the discouragement of professional funding of claims brought by litigants who would otherwise be unable to afford litigation. In *Arkin v Borchard Lines Ltd and others*[36] the Court of Appeal held that third party funders should potentially be liable for costs, but only up to the value of their investment. Giving the judgment of the Court, Lord Phillips MR said:

> *"If a professional funder, who is contemplating funding a discrete part of an impecunious claimant's expenses, such as the cost of expert evidence, is to be potentially liable for the entirety of the defendant's costs should the claim fail, no professional funder will be likely to be prepared to provide the necessary funding. The exposure will be too great to render funding on a contingency basis of recovery a viable commercial transaction. Access to justice will be denied. We consider, however, that there is a solution that is practicable, just and that caters for some of the policy considerations that we have considered above. We consider 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. The effect of this will, of course, be that, if the funding is provided on a contingency basis of recovery, the funder will require, as the price of the funding, a greater share of the recovery should the claim succeed. In the individual case, the net recovery of a successful claimant will be diminished. While this is unfortunate, it seems to us that it is a cost that the impecunious claimant can reasonably be expected to bear. Overall justice will be better served than leaving defendants in a position where they have no right to recover any costs from a professional funder whose intervention has permitted the continuation of a claim which has ultimately proved to be without merit."*[37]

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[31] *Cairns v McGregor* 1931 SC 84 applied by the Inner House in *Eastford Ltd* v *Gillespie and Airdrie North Ltd* 2010 CSIH 12.

[32] See for example, *O'Connor v Bullimore Underwriting Agency Ltd* 2005 SCLR 1111.

[33] The House of Lords held in *Aiden Shipping Co. Ltd. v Interbulk Ltd* [1986] AC 965 that section 51 of the Senior Courts Act 1981 confers a sufficiently wide discretion on the court on the question of costs to allow it to award costs against non-parties.

[34] Nicholls LJ in *Re Land and Property Trust Co. plc* [1991] 1 WLR 601.

[35] *Dymocks Franchise Systems (NSW) Pty Ltd v Todd (Costs)* [2004] UKPC 39, at paragraph 25 per Lord Brown

[36] [2005] EWCA Civ 655

[37] *ibid*, paragraphs 39-41

56. By contrast, Jackson LJ considered it wrong in principle that a third party funder, which stands to recover a share of any monies recovered in the event of success, should be able to escape part of the liability for costs in the event of defeat. This was unjust not only to the opposing party (who may be left with unrecovered costs) but also to the client (who may be exposed to costs liabilities which the client cannot meet). He recommended that the extent of a third party funder's liability for costs should be for the court's discretion, and should not be limited by the extent of its investment in the case.[38]

57. I am persuaded by the reasoning in *Arkin*. A funder, motivated by a desire to make a profit, who effectively purchases a stake in the outcome of a litigation should not be protected against an award of expenses. However, the funder should not be liable for the whole award as that would have the potential to make third party funding so unattractive that it would not be offered. Third party funding is a means of securing access to justice for litigants who would otherwise not be able to afford an attempt to have the court vindicate their rights. It seems to me to be proportionate that the funder should be liable only to the extent of its investment in the case. Thus, at any hearing on expenses after the case has been decided in favour of the other party, the court will require information from the funder as to the extent of the funding provided. I am also of the opinion that any award of expenses against the funded litigant should be on a joint and several basis, albeit with the funder's liability capped at the extent of its investment in the case. It is insufficient that the award is against the funded litigant only, since the successful party would have no recourse to the funder should the funded litigant take no steps to require the funder to satisfy its liability. **I therefore recommend that a professional funder who finances part of a pursuer's expenses of litigation should be potentially liable for the judicial expenses of the opposing party to the extent of the funding provided. Any award of expenses against the funded litigant should be on a joint and several basis, with the funder's liability capped at the extent of the funding provided by it.**

58. A number of respondents identified the funder taking control of the litigation as the primary risk of third party funding. It has been suggested that this may be a particular risk in jurisdictions which, like Scotland, do not have a prohibition on maintenance and champerty.[39] This could not only interfere with the solicitor-client relationship but conflict with the interests of funded parties. So, for example, funders could exercise control over the amount and timing of settlement. They could also withdraw funding at short notice. I have been told that this may happen where funders have not been tied into funding the litigation to proof under the terms of the funding agreement.

59. As Hodges and colleagues observe, the central issue in all types of third party funding, whether provided by lawyers under damages based agreements, by the state under legal aid or by private investors under third party funding agreements, is the potential for conflicts of interest. Any solution, however, must have regard to competing interests. As they explain: *"the essential conflict that needs to be balanced in any situation in which an independent party provides funding to another who is a party to litigation is between the interests of*

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[38] Jackson LJ, *Review of Civil Litigation Costs: Final Report* (2009), Chapter 11, paragraphs 4.5-4.7

[39] Hodges et al, *op cit* (2012), page 106

*enabling justice to be accessed as a result of the availability of funding, of recognising the commercial interests of the investing funder, of protecting the interests of the litigant from unfair pressure, and of protecting the integrity of the legal process."*[40] In their view, contemporary public policy in England and Wales should accept third party funding subject to the following principles:

1. The client retaining control over their litigation;

2. The integrity of the lawyer-client relationship remaining intact;

3. The integrity of the court process and cases being pursued on legal merits remaining core factors in any litigation; and

4. The client understanding the terms of any agreement that they enter into with a third party such that they are making an informed decision on whether to accept third party funding.[41]

60. These are basic principles that I fully accept, and which I commend to the Scottish Civil Justice Council when it comes to consider the new voluntary Code of Practice.

**Disclosing the funding mechanism**

61. In Scotland, with the exception of parties in receipt of civil legal aid,[42] there is no obligation to disclose to the court, or to an opponent, how the litigation is to be funded. While third party funding may afford parties a degree of privacy, it has been observed that some parties may prefer to make this information public for tactical reasons.[43] The question is whether disclosure of the means of funding a litigation should be a requirement.

62. I am of the view that disclosure of the means of funding should be required in every litigation. With respect to third party funding, I note that defenders are in favour of a requirement to disclose, and for good reason. Disclosure has implications for how defenders proceed, for their willingness to settle, and for their willingness to settle early. Funders, who mainly fund claimants, likewise referred to the advantages of disclosure. In particular, they could look forward to earlier settlement, which had implications for the return on their investment.[44] It would appear, then, that disclosure expedites dispute resolution to the benefit of both parties and promotes efficiency in the legal system. If this is correct, I fail to see why disclosure of a litigation funding arrangement should not be desirable for all funded parties, whether they are pursuers or defenders. If, as I recommend, third party funders are liable for a proportion of the other side's expenses should the funded client be unsuccessful, then disclosure is also necessary.

63. **I therefore recommend that in all civil litigation in the Scottish courts, parties should be under an obligation to disclose to the court and intimate to all parties the means by which the litigation is being funded at the stage when proceedings are raised or**

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[40] Hodges et al, *op cit* (2012), page 139
[41] Hodges et al, *op cit* (2012), pages 139-140
[42] Act of Sederunt (Civil Legal Aid Rules) 1987 SI 1987/492
[43] Gary Barker, 'Litigation Funding – Latest Developments,' *MBL Seminars* (April 2012)
[44] Hodges et al, *op cit* (2012), page 105

**notification given that a case is to be defended. Thus if an action is being funded by a trade union or a damages based agreement, for example, it should be disclosed in the same manner as a legally aided party is obliged to disclose that assistance has been obtained from the Legal Aid Fund. Disclosure should include both the type of funding and the identity and address of the funder. It should not include details of the financial agreement made between the funder and the funder's client before the case has been decided as this may provide opponents with too deep an insight into the funder's view as to the strength of the funded case.**