The dangers of funding assumptions

Mark Fletcher looks at a recent Supreme Court decision highlighting the risks of creative funding

Mark Fletcher

Mark Fletcher is a solicitor at Russell-Cooke LLP
russell-cooke.co.uk

In *R (on the application of PACCAR Inc and others) (Appellants) v Competition Appeal Tribunal and others (Respondents)* [2023] UKSC 28, the Supreme Court issued a majority decision which has significant implications for litigation funding and highlights some of the challenges for firms making investment decisions to act under alternative funding arrangements.

THE DANGERS OF ASSUMPTIONS

The specific issue in *PACCAR* was whether litigation funding agreements (LFAs), pursuant to which the funder is entitled to recover a percentage of any damages recovered, fell within the regulatory scheme for damages-based agreements (DBAs). This regulatory scheme provides that DBAs will be unenforceable unless they comply with certain conditions.

A number of participants in the third-party funding market had assumed that LFAs were not DBAs if they assigned funders a passive role in relation to the conduct of the litigation. Such LFAs were not regarded as being contrary to public policy and so would be enforceable as ordinary binding commitments. This meant that LFAs often did not comply with the conditions for DBAs.

In what many regarded as a surprising outcome, the Supreme Court held that LFAs were DBAs if the third-party funder is remunerated by receiving a share of any compensation recovered, even if the third-party funders play no active part in the conduct of the litigation. The Supreme Court was told that the likely consequence in practice would be that most third-party litigation funding agreements would be unenforceable as the law currently stands. However, the Supreme Court concluded that the assumptions made by participants in the third-party funding market did not justify changing or distorting the meaning of the relevant statutory provisions.

CLAIMS MANAGEMENT SERVICES

The requirement for DBAs is set out under s58AA of the Courts and Legal Services Act 1990 as amended in 2013 (s58AA). This definition has two elements: (1) the provision of advocacy services, litigation services, or claims management services (services test); and (2) payment being determined by reference to the financial benefit obtained from the matter in relation to which the services are provided (the benefit test).

The definition of "claims management services" is "advice or other services in relation to the making of a claim". The "other services" are specifically stated to include: "financial services or assistance", "legal representation", "referring or introducing one person to another" and "making inquiries". However, giving or preparing to give evidence (whether or not expert evidence) is not by itself a claims management service.

This definition was taken from provisions enabling the Secretary of State to choose which types of claims management services should be subject to regulation. In *PACCAR*, it was agreed that the LFAs met the benefit test, and so the case turned on the services test and whether the LFAs fell within the meaning of "claims management services", in particular by being "financial services or assistance".

STATUTORY CONSTRUCTION

Alone, none of the four listed services have the connotation of or involve a power of management of a claim. Instead, these services will help someone bring a claim. In the context of "financial services or assistance", this could include an ordinary bank giving loans for the purposes of assisting customers bring claims.

The Supreme Court, therefore, had to decide whether the four listed services are "claims management services" when they are provided by themselves, or only when they are provided as part and parcel of managing a claim.

In her dissenting judgment, Lady Rose held that the fact that claims management services might include providing financial assistance did not mean that all financial assistance was a claims management service whenever it related to a claim. Instead, Lady Rose concluded that the definition of "claims management services" included the ancillary services commonly provided by claims managers so that those ancillary services could also be regulated but did not elevate those ancillary services into claims management services in and of themselves when they were undertaken outside the context of a claims management business.

In contrast, most of the Supreme Court held that the definition of "claims management services" was broadly framed to allow for regulation to be properly targeted in a new

and fast-developing area at a time when the financing and business models being used were not fully understood. The Supreme Court did not consider there to be any ambiguity in the definition, which was meant to be wide by covering financial services provided "in relation to the making of a claim", rather than for the management of it.

Unlike other cases where a statutory definition had been coloured by the term being defined (such as cases involving "wages", "town", or "village green"), there was no generally accepted meaning of "claims management services". The terms used in the definition could not be read as involving the management of claims or having claims management as a unifying core of meaning. Doing so would then treat the words used to define the term (including "financial services and assistance") as essentially illustrative. This would make those terms redundant as a definition, since a service provided in the context of claims management would necessarily be a claims management service.

NARROWING THE DEFINITION

In the regulatory context, the wide scope of "claims management services" is mitigated by the need for the Secretary of State to exercise the power to regulate certain types of activity. Therefore, the regulation of claims management services would be more precisely targeted as and when particular needs are identified.

In the case of DBAs, the additional requirement is that the benefit test is met. In those circumstances, having a wide definition of "claims management services" can be justified. An agreement will only be a DBA where the parties regard the services provided as sufficiently integral to the claim that this justifies the provider sharing in the risk and reward of the claim.

Notwithstanding the general relaxation of the rules on maintenance and champerty, there are risks with agreements that involve third parties participating in and obtaining a share of the benefit of litigation. This creates public policy tensions between increasing access to justice and protecting the due administration of justice.

In *PACCAR*, one of the examples considered was an ordinary bank lending money to a customer to fund litigation. Providing loans (and other ancillary services) would facilitate the pursuit of litigation, but is also conceivably an area where regulations relating to "claims management services" might be necessary to protect consumers. Such loans would only be DBAs where the lender's payment is tied to the outcome of the claim, which creates a risk of third parties extracting more than a

reasonable share of recoveries. This means that stipulating specific requirements for those types of agreement can be justified.

***PACCAR* shows the challenges and risks in building innovative business models for litigation**

THE *PACCAR* PROBLEM

The underlying problem in *PACCAR* was not the wide definition of "claims management services" itself, but rather the context in which it is reused. The draconian consequence under s58AA is that DBAs that do not satisfy the stipulated requirements are automatically unenforceable. This applies irrespective of whether the funder has already spent millions of pounds over a number of years.

The simple point made by the Supreme Court was that LFAs classified as DBAs are still enforceable provided that they satisfy the stipulated requirements. The challenge for funders is that there are difficulties in making LFAs comply with the regulations for DBAs because these regulations were not drafted in a way that applies to their businesses. In addition, DBAs are not permitted in certain types of litigation (in particular opt-out collective proceedings).

PACCAR, therefore, further illustrates the problems caused by the drafting of the regulations for DBAs. *PACCAR* shows the challenges and risks in building innovative business models for litigation. Unless a client has both sufficient resources and an appetite to fully fund a claim, the provision of some form of credit in relation to the services provided will be needed. Unless the challenges and risks in obtaining security can be overcome, the firm will be left as an unsecured creditor dependent upon the client having sufficient assets or a successful outcome in order to be paid in full.

Firms which share in the risk of litigation will seek additional payments which will ultimately need to be met out of client recoveries. However, the development of funding options in the legal market will continue to be constrained unless and until the uncertainties and risks of enforceability challenges and sanctions can be mitigated. SJ