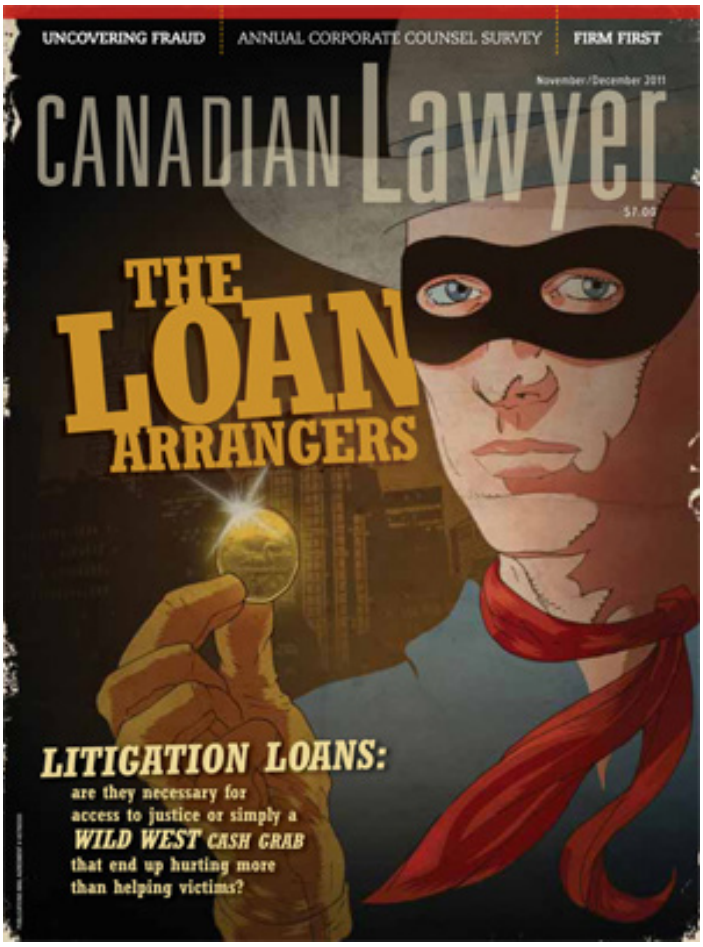
CANADIAN Lawyer

November 14, 2011 | Written By Ava Chisling

The Loan Arrangers



Third-party litigation loans have a rather nasty reputation. The funding of legal cases by complete strangers causes many intelligent people, some of them lawyers, to declare these kinds of loans abusive, predatory, and a black mark on the justice system. And yet there are others, some of them also lawyers, MBAs, and financial advisers, who believe when administered to the right people, by the right people, these "lawsuit loans" help those in need when no one else will. Stephen Pauwels is one such person. Yes, Pauwels is in the loan business. Yes, he profits from plaintiff-victims. But his point of view will surprise you. Pauwels believes his own industry is dangerous, similar to both the Wild West and the American subprime catastrophe.

"Any time you've got desperate people with money dangled in front of them, they're going to take as much of it as they can get, regardless of what the cost is," says Pauwels, co-founder and co-owner of BridgePoint Financial Services Inc., one of Canada's largest providers of litigation loans. "The loan companies say, 'Here's more money. Take it. Take it.' They don't care what the cost is; they have dollar signs in their eyes right now."

Most lawsuit loan companies in Canada entice people by offering a "don't win, don't pay" policy, giving vulnerable people the sense they have nothing to lose by taking one of the loans. After all, if they lose their case, they don't pay a dime. The reality is that this business model is seriously flawed. With extremely high interest rates, and equally high fees, plaintiffs have plenty to lose and they usually don't know exactly how much until the bill arrives in their mailbox at the end of their case.

The exorbitant fees charged by many loan companies have not gone unnoticed by the courts. While assessing costs in Giuliani v. Region of Halton, a case that included a litigation loan, an Ontario Superior Court judge expressed outrage at the whopping $92,734.26 of interest charged by a third-party lender on a $150,000 lawsuit loan (after roughly 12 months). Writes Justice John Murray: "the interest rate on the loan obtained by the plaintiff for disbursements is unconscionable. It is turning the world on its head to assert, as does [the plaintiff's lawyer] Ms. Chittley-Young, that this is an access-to-justice issue and that ordering interest payments on the Lexfund is reasonable. This loan agreement does not facilitate access to justice. This loan agreement does nothing to advance the cause of justice. It is difficult to believe that any lawyer would refer a vulnerable client to such a lender."

Pauwels completely agrees with Murray's comments. "That case is a classic example of why we feel like we're getting a black eye from the practice of others in this space. This shows you exactly how not to use these loans and how they can be a disservice." Pauwels believes that litigation finance is a tool that can be very effective when used responsibly and conservatively, and like any form of leverage of debt, it can be disastrous if it's used irresponsibly.

A former investment banker, Pauwels compares his own industry to the Wild West. He would welcome regulation. "This is an unregulated industry and the terms offered are all over the map. There are lenders who, unfortunately, when you add up all different interest rates, admin charges, cheque-cashing fees, early-payment fees, penalties (and any other euphemisms for costs), charge close to the criminal-level 60-per-cent interest annually. There are lenders who advertise 19 per cent, but when things are added up, it's 55 per cent."

The number of disreputable and predatory lawsuit loan companies angers Pauwels, who strongly believes he is providing an important service to needy clients. In fact, Lexfund, the company mentioned in the Giuliani case, no longer advertises the funding of individual plaintiffs, although it does continue to fund commercial litigation. Pauwels' company was one of the first to enter the Canadian market in 2005. At the time, he was in corporate finance, working with businesses to fund their operations. His wife was a case manager who organized medical and rehab experts to help accident victims. "She was always infuriated by the amount of time she had to fight with her clients over benefit entitlements, whether financial or medical rehab. Everything was an application with an opportunity for the insurer to deny." So Pauwels started personally providing lawsuit loans. "Clients thought their lawyers were heroes for getting them funds to sustain themselves, and the lawyers thought it was great because they didn't have to spend half their time dealing with their clients' financial crisis."

How it works

BridgePoint has a team of three full-time assessment specialists on staff. Former law clerks with decades of experience in both defendant and plaintiff law firms, they evaluate liability and come up with an estimate of value and a projected time frame for a resolution of the claim. Pauwels says BridgePoint is the only company in Canada that uses this assessment system and other lenders rely on the lawyers involved to determine the value of their own cases, and like homeowners who overestimate the price of their own houses, lawyers often overestimate the amount their case will be worth at settlement or at trial. This causes many plaintiffs to gamble, taking large loans against what they hope will be a very large settlement. And when the settlement is half that amount, or less, they are then stuck with a large bill. "We have lawyers who tell us it's a million-dollar case and from our point of view it's maybe a $50,000 to $75,000 case. We have the ability to value the security independently and make lending decisions on that basis," says Pauwels.

His company, as a rule of thumb, does not lend more than 10 per cent of what it conservatively values the cases at. It charges a maximum of 24-per-cent interest, compounded semi-annually, and the average loan for an individual is about $7,500. The loan is dispersed on a monthly basis, which is less expensive for the client, says Pauwels.

Byron Dudley, CEO of Rhino Legal Finance, in business since 2003, explains his company's high-interest rates this way. "On a $3,500 loan, the client may pay 35-per-cent interest in the first year. We cannot offer the same rate as a bank. We have no cash flow. We have some files that are in the system for seven years. We have overhead, we are non-recourse, so if the client loses, we lose, and our cost of operation is way beyond a bank's. So what should the interest rate be?" Dudley says his fees only become problematic if the case goes on for a long time. "After three or four or six or seven years, interest becomes an issue, especially if the case also settles for less than expected."

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He claims Rhino has no hidden fees. People pay from 1.65-per-cent to 2.95-per-cent interest per month, plus a five- to 10-per-cent loan application fee. Dudley does not believe his industry has a bad reputation, and like Pauwels, says he is providing a service no one else will.

Not on the regulators' radar

Canada's various law societies have little to say about third-party loans. Both the Law Society of British Columbia and the Law Society of Upper Canada say these loans are not specifically mentioned in the rules and regulations governing lawyers and the practice of law. Barbara Buchanan, a practice adviser at the LSBC, says, "lawsuit loans made by third parties that are independent and unrelated to the lawyer are not specifically mentioned in our rules and guidelines. However, Chapter 7 of the Professional Conduct Handbook refers to ethical obligations related to lawyers lending

money to clients or even acting for a client if anyone, including a relative, partner, employer, employee, business associate, or friend of the lawyer, has a direct or indirect interest that would reasonably be expected to affect the lawyer's professional judgment."

Malcolm Heins, CEO of the LSUC, says it "regulates Ontario's lawyers and paralegals in the public interest and does not regulate loan companies." Heins adds that reported cases do not show that litigation lending is an area that has attracted complaints. "The [society's] access-to-justice committee is monitoring this in order to keep apprised of any development in the context of the Canadian litigation system, but is not currently studying the topic of third-party litigation funding."

Pros and cons

So if the law societies do not expressly forbid or regulate litigation loans, and if there are seemingly legitimate businesses offering small loans at reasonable rates, what is the problem? Ron Kalish can answer that question, and it has nothing to do with high interest rates.

Kalish has been a partner at Steinberg Goodman & Kalish in Chicago since 1997. Specializing in medical malpractice, he never recommends lawsuit loans to his clients. "I don't care about high interest rates," says Kalish. "I am fine with them because there are interest rates for every risk product out there. If a company wants to take a chance, OK, that's a risk it's willing to take. The problem is that these loans hamstring the plaintiff's lawyer. They change how a reasonable plaintiff should think and act."

Kalish does not see a place for the loans in the justice system. In his experience as a contingency-fee lawyer, clients borrow money early on in the process, and then later, when the case goes through discovery, perhaps becoming more difficult, the whole value of the case can change. This leaves the plaintiff with a loan and leaves the lawyer in a serious bind. "If my client has borrowed $50,000, he cannot then settle and end the case for $20,000. The settlement value drops. In these cases, I recommend that the client settle, but they cannot; they know that if they do, they will have to pay back the loan."

He sees the loans as a lose-lose proposition. "The client has not put a penny into his case. I, on the other hand, have put two years of my time and $10,000 in expenses into the case. And then this little loan gets in the way. If I see that the case is a dog after a year or so, I will walk away. Then I am out $10,000, the client owes $50,000, and his whole case may be worth $40,000. Everyone loses."

Connecticut-based lawyer George M. Kelakos doesn't see it that way. Kelakos heads his own company, Kelakos Advisors LLC, and works for the American law firm, FSB FisherBroyles. He has represented opportunistic buyers of patent assets and believes the loans are mostly a good idea. "I have been in the distressed [patent] business for 29 years as a lawyer and an adviser. I don't judge the loans. There are times when you don't have money and your options are limited. You put up with the high cost because it is the only kind of loan you can get. I have bit my tongue when I've heard some of the fees and the interest rates, but then I turn to the client and ask what he wants to do. And when he asks me what his options are, the answer is usually not many."

Kelakos doesn't see any other way for small companies and individuals to protect their rights. "If you're an inventor and you have something that you put a lot of sweat equity in, and a lot of money, and you want to protect your rights, then loans make sense. I look at it from a property rights point of view. If you find out a very big company is stepping on your space, what do you do? You can hire a lawyer and send them a letter, and then what? The next thing you know they in turn take action against you and want to examine your patent search."

Patent litigation can take years and cost millions of dollars. This is obviously very daunting for the small-time plaintiff. So, says Kelakos, "if someone out there can provide the money, the inventor can afford a firm that may work on contingency, but not 100 per cent." There are a lot of expenses that accompany even a contingency lawyer's fee.

The fundamental problem

Jordan Furlong, a partner at Edge International Consulting, believes giving plaintiffs more options is not the solution. "We are saying we need to bring in more people and offer more options to finance litigation because the price is beyond the reach of most Canadians. And although this is true, I don't believe the answer is to create more options of funding it. The best answer is to reduce the price of litigation. That's the fundamental problem."

Furlong says the failures of the justice system to ensure that litigation and going to trial are available regardless of how much money people have is manifest. "Lawyers often say 'I couldn't afford to hire myself' about the high cost of litigation, and that's actually not very funny," he says. "At the same time, there are obvious drawbacks and red flags regarding the loans. In the Giuliani case, what's interesting is that the judge doesn't pass judgment on third-party litigation per se. By any stretch of the imagination, the facts of that case justify the judge's description as unconscionable," but he was angry at the interest rates, not the loan company, says Furlong.

The one thing that just about everyone can agree on is that it's

the vulnerability of the client-victim that is most worrisome about these loans. It is why ambulance chasing is not allowed. And why champerty and maintenance laws exist. Furlong's problem with lawsuit loans is that they bring a stranger into a trial, into a civil dispute. He says some of the oldest ethical and legal standards in law go back to the essential question of who gets to bring a case to court. "We have a very long-standing tradition that says it is only the parties in question, and that's it," says Furlong. "And when we allowed contingency fees to be recognized, we carved out an exception to the champerty laws, the whole question of a stranger entering the case. If a plaintiff's lawyer takes on the case for 30 per cent of the eventual award, is that lawyer a stranger to the case? Yes, but we said we'd make an exception only for lawyers, who we try and should hold to a very high standard."

"The majority of our borrowers would still want our loans if we doubled our rates. There are lenders out there who see big value in future settlements and they see a borrowing population that is very desperate and will borrow at any cost. It sounds counterintuitive but we don't encourage plaintiffs to borrow money personally on their future settlements. We advise them to exhaust every other avenue before coming to us: friends, family, selling assets, other traditional lenders if possible, because most of them don't realize how long it could take before the settlement and most think they get much more money than they actually receive."

A last resort

Lender Stephen Pauwels has to deal with the issue of vulnerability and maintaining high standards on a constant basis. "The majority of our borrowers would still want our loans if we doubled our rates. There are lenders out there who see big value in future settlements and they see a borrowing population that is very desperate and will borrow at any cost. It sounds counterintuitive but we don't encourage plaintiffs to borrow money personally on their future settlements. We advise them to exhaust every other avenue before coming to us: friends, family, selling assets, other traditional lenders if possible, because most of them don't realize how long it could take before the settlement and most think they get much more money than they actually receive."

Pauwels, Kelakos, and others believe litigation loans serve a purpose when distributed and used responsibly and only as a last resort. "Lawsuit loans are not really a developed market in the sense that you can't just pick up the phone and call Bank of America," says Kelakos. "The risk requires people who have access to resources to evaluate the different claims and can assess the value." According to Pauwels, no bank will touch these loans because they involve ongoing litigation. He asks what lender would expose themselves to the uncertainties of the litigation process? You don't know how much a plaintiff is going to get, if he will get it, or when he will get it, and he has no ability to service the loan in the meantime. "This made it a no-brainer for us," says Pauwels. "We understand the value of this business, and lending against that value, where no one else really can."

Furlong sums up the lawsuit loan business this way: "This is an area we have not seen before and it's one I think we have to manage very carefully. If a plaintiff has a case that no lawyer will take on a contingency basis, and no one else is interested in supporting the case — not friends or family — it is possible it is not a very good case."