PERSPECTIVE

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A Tax Hypo, Funded By Silicon Valley

By Robert W. Wood

The recent story that billionaire PayPal cofounder Peter Thiel has been secretly funding Hulk Hogan as he sues Gawker got a lot of people excited. Not too many people seem to be rushing to defend Gawker, or hoping that Gawker weathers this legal and financial storm and can keep publishing. But the titillating news is prompting new discussions about litigation funding.

Regardless of who is paying for what, of course, Hogan has been doing pretty well. First, Hogan won $115 million against Gawker. Then, the jury awarded punitive damages for a total of $140.1 million. Gawker probably has had big legal bills, too.

Even though we know the funder is Thiel, the details are scant. We do not know any terms of the deal nor how it is documented, if at all. It might be a handshake deal, a personal loan, or a purchase.

Gawker defenders might squawk that litigation funders foment litigation, and in this case, might even hinder the First Amendment. But litigation funders are used to hearing a clamor of reasons why financial aid to litigants and their lawyers should be tightly controlled. In contrast to naysayers, many lawsuit plaintiffs, whistleblowers, and their lawyers are *very* happy financing exists.

Litigation funders help to level the playing field, just as contingent fee arrangements for lawyers did a generation or two ago. Of course, contingent fee cases are no longer just personal injury case. And the costs of cases are no longer small. Consultants, experts, economists, and many other expenses can reach sky-high totals.

All of that makes outside financing more attractive. Of course, investing in lawsuits sounds strange. Selling off pieces of a suit does too. But it is increasingly common. And legal and tax rules are developing for how to deal with the issues.

As with contingent fee lawyers, defendants are unlikely to like litigation funding, for it puts more money behind lawsuits. But contingent fee lawyers often need cash, and so do their clients. One answer is lawsuit funding.

Getting money from investors can be documented in several ways. The primary choice is between loan and sale, but from there it can become considerably more complicated. In a loan, the lawyer or client (or both) receive loan proceeds.

Loans can be simple, but one must deal with issues such as an appropriate interest rate, whether the loan is recourse or not, etc. From a tax viewpoint, the plaintiff or lawyer receiving the loan proceeds does not have income. The money isn't taxable because there is an obligation to pay it back.

Getting a loan defers all taxes on the receipt of that loan money. But when the case is resolved in a subsequent year, there can be a tax mismatch. You may have to include the entire amount in income and claim a large offsetting interest deduction.

The deduction may be limited, which means that you can be paying tax on money you never see. You may also be required to report the interest to your "lender" on a Form 1099. And litigation funders may also have regulatory concerns about loans, lending licensure issues, usury laws, etc.

Aside from loans, one of the most common structures is a prepaid forward contract. Despite the fancy name, it is basically a sale. The plaintiff might sell a piece of his claim, or the lawyer might sell a piece of the contingent fee.

The prepaid forward contract arguably offers the best tax result for the plaintiff and the lawyer. You might *assume* that you have to report the up-front money as income. However, this is a sale contract with an unclear final return.

When you sign the documents and receive the money, it is not a loan. You have entered a contract to *sell* a portion of your case (if you are the client), or to sell a portion of your contingent fee (if you are the lawyer) when the lawsuit is resolved. That is why it is a "forward" contract.

You are contracting to sell *now*, but the sale does not close until the case is resolved. Prepaid forward contracts can be employed in other contexts too, not just to arrange litigation financing. Not long ago, the story broke that Kanye West wanted Mark Zuckerberg to pony up $1 billion to invest $1 billion in West's musical ambitions.

It does not appear that it happened, and it may never have been a serious proposal, especially on Zuckerberg's end. But more than a few people were probably thinking that a prepaid forward contract might have been used to get Kanye that $1 billion tax-free. Well, perhaps 'tax deferred' would be a better description, since there eventually has to be a taxable event.

Whether the seller is Kanye West or a plaintiff in a lawsuit, a sale via a prepaid forward contract can be pretty slick. The tax result is that you generally should not have to report income until the conclusion of the case. That sounds similar to a loan, but it's actually better in many cases.

A loan can be easiest to document, and some lawyers and clients prefer it. Yet most litigation funders do not like straight loans because of regulatory concerns. Moreover, these loans are generally non-recourse, secured only by the proceeds from the claim.

That type of feature can make the "loan" look more like equity. For all of these reasons, loans seem increasingly rare. Prepaid forward contracts are preferred by many lawsuit funding sources. However, good documentation is critical. Perhaps a billionaire might do a handshake deal, but any commercial funding deal should be documented. Regardless of which position you are in or whom you represent, try to think through the financial — and the tax — ramifications in advance.

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