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Funding Key To Hulk Hogan's Gawker Suit, Kanye West, And Many Other Cases

The notion that an iconic Silicon Valley billionaire has secretly funded Hulk Hogan's suits against Gawker might rub Gawker fans the wrong way. 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. Reports say Hulk Hogan's secret funder is Peter Thiel, a PayPal cofounder and early Facebook investor. We do not know any details of the deal, and how it is documented, if at all.

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 ago.

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. So does Kanye West, who wanted $1 billion from Mark Zuckerberg, but we'll come back to him.

One answer is lawsuit funding. Of course, getting money from investors can be documented in several ways. The primary choice is between loan and sale, but from there it gets more complicated. In a loan, the lawyer or client (or both) receive loan proceeds. 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 resolves 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.

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. It 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.

And that brings us to Kanye West, who not long ago wanted Mark Zuckerberg to pony up $1 billion. The story broke that Kanye West had $53 million in debt, so he wanted Mark Zuckerberg to invest $1 billion in Mr. West's musical ambitions. In addressing just how Kanye could get that $1 billion from Zuckerberg tax-free, the prepaid forward seemed cleanest and best.

Whether the seller is Kanye or a litigant, the 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 arrangement can be easiest to document, and some lawyers and clients prefer it. Yet most litigation funders do not like straight loans because of usury or regulatory rules. The risk premium they charge can look like 100% interest or more.

Moreover, these loans are generally non-recourse, secured only by the proceeds from the claim. This 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. They have the advantage of no immediate tax on the upfront payments, just like loans.

However, good documentation is critical. Under any structure, lawyers and clients face tax traps. You don't want to receive taxable legal fees or settlement money, but find that you can't deduct the payments made to the funder.

To reach me or for future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.