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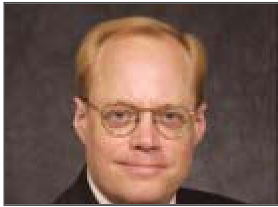

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Lawsuit Funding Lures Investors, Plaintiffs & Lawyers

Investing in lawsuits sounds strange. Selling off pieces of a suit does too. But inside the U.S. and abroad, it is becoming more and more common. As a result, rules are developing in the courts and with taxing authorities for how to deal with the issues.

As with contingent fee lawyers, defendants may not like the idea of litigation funding. After all, it puts more money behind lawsuits. But in many ways, litigation funding serves a real need. Contingent fee lawyers often need cash. So do their clients.

One answer is lawsuit funding. But the mechanics need to be considered. 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 good news is that money isn't taxable because you have to pay it back. Getting a loan has the advantage of deferring all taxes on the receipt of that loan money. But when the case resolves in a subsequent tax year, there can be a mismatch when it comes to taxes.

In fact, you may have to include the entire amount in income and claim what could be a very large offsetting interest deduction. The deduction may be limited, which means 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.

In contrast to structuring the funding as a loan, one of the most common structures is a prepaid forward contract. That’s a fancy name, but it is basically a sale, not a loan. It might be the plaintiff selling a piece of his or her claim, or the lawyer selling a piece of the contingent fee.

It arguably offers the best tax result for the plaintiff or the lawyer. Because it’s a sale, you might assume you have to report the sale proceeds as income. However, this is a sale contract with an unclear final return. When you sign the documents and receive the money, you have entered a contract to ***sell*** a portion of your case (if you are the client) or a portion of your contingent fee (if you are the lawyer) when the lawsuit is resolved.

That’s why it’s called “forward.” You are contracting to sell now, but the sale does not close until the case is resolved. 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.

Since a loan arrangement can be easiest to document, some lawyers and clients prefer it. Yet most litigation funders don't 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 nonrecourse, 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.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.