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Securities Regulation of Alternative Litigation Finance

Wendy Gerwick Couture*

I. Introductions

Alternative Litigation Finance—or ALF—is a rapidly growing largely unregulated industry, which poses myriad potential benefits and problems. Although ALF has attracted significant scholarly attention, the potential role for securities regulation of ALF has not been widely discussed. This Essay seeks to begin that discussion by analyzing the potential securities regulation of the ALF contract—which is the agreement between the ALF client (the recipient of ALF funds) and the ALF company (the supplier of ALF funds).

This Essay proceeds in five additional parts. Part II provides an overview of ALF, including a summary of the potential pros and cons of ALF and the various regulatory responses proposed by scholars. Part III analyzes whether an ALF agreement satisfies the definition of “investment contract” so as to qualify as a “security,” concluding that an ALF agreement probably qualifies as a security in those jurisdictions that apply a vertical commonality test. Part IV analyzes whether ALF agreements implicate the central policy of the securities laws—full and fair disclosure—and concludes that ALF agreements are rife with information asymmetry, thus implicating this policy. Part V analyzes how securities regulation would affect ALF contracts, focusing on the prohibitions on the sale and advertising of unregistered, nonexempt securities and the antifraud provisions and concluding that these provisions would partially redress the informational imbalances identified in Part IV. Finally, Part VI briefly concludes, arguing that the flexibility of securities regulation makes it a particularly effective method of regulating an evolving industry such as ALF.

II. What Is Alternative Litigation Finance?

Alternative Litigation Finance—or ALF—is third-party financing of litigation, provided outside the traditional funding sources of contingency-fee attorneys and insurers. The ALF industry is growing rapidly. Even so, demand for ALF likely exceeds supply, setting the

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stage for the continued expansion of ALF. As it expands, this burgeoning industry continues to evolve, with myriad potential funding structures, so any description is merely a snapshot.

In the current market, however, two types of ALF are provided directly to litigants (generally plaintiffs): consumer ALF and commercial ALF. ALF plaintiffs obtain funds from ALF companies, as well as directly from high net-worth individuals, institutional investors, investment funds, and financial institutions. ALF companies usually focus on either consumer ALF or commercial ALF, with little overlap.

Consumer ALF and commercial ALF, while serving the same function, differ in their execution. In general, consumer ALF is composed of non-recourse loans to personal injury plaintiffs, to be repaid along with financing fees if the plaintiff recovers in the lawsuit. Consumer ALF loans are generally in the thousands or tens of thousands of dollars. Commercial ALF, on the other hand, is generally made up of non-recourse loans to companies, in return for a percentage of the ultimate recovery, if any, in a commercial lawsuit. Commercial ALF loans are typically at least six figures.

Under current law, both types of ALF are largely unregulated. One traditional barrier—the state-law prohibition on champerty—is falling away. Additionally, because ALF loans are non-recourse, most courts have exempted them from state usury laws.

Scholars have hotly debated the pros and cons of ALF in this rapidly growing, largely unregulated industry. The potential benefits of ALF are many. First, ALF serves unmet needs of ALF recipients. Consumer ALF recipients can use ALF to finance their immediate living expenses (like mortgage or health bills) during the pendency of the suit—expenses that even contingency fee attorneys are ethically barred from advancing on behalf of their clients. Larger commercial ALF recipients can use ALF to manage their cash flow when paying the expenses of litigation, and smaller commercial ALF recipients can use ALF to finance litigation that they might not otherwise be able to afford. Second, by adding competitors to contingency fee attorneys and by adding funders who can diversify their risk more efficiently than contingency fee attorneys, ALF could drive contingency fees lower, allowing plaintiffs to retain a greater percentage of recoveries. Third, ALF can remove risk preference from settlement negotiations by allowing risk-averse parties to offload the risk onto ALF funders, thus making settlements more accurately reflect the lawsuits' underlying merits and advancing the substantive law goals encapsulated therein. Finally, ALF can level the playing field with insured defendants so that plaintiffs can “remain in the legal battle long...
enough to have a realistic opportunity to achieve legal success,"23 thus deterring "behavior that causes or allegedly causes compensable harms."24

At the same time, ALF poses the risk of a number of negative consequences. First, ALF companies are logically drawn to high-probability suits where "underlying substantive law creates risk and cost imbalances that already give plaintiffs the advantage."25 The addition of ALF, which lessens the plaintiffs' remaining litigation risk and increases the resources available to the plaintiffs, risks "exacerbating existing cost and risk imbalances that favor plaintiffs."26 Second, the growing ALF industry may run out of high-probability suits to fund and turn to low-probability suits, comforted by the ability to diversify risk.27 As a consequence, ALF may "lead to an increase in speculative litigation and strike suits on the margin."28

Finally, consumer ALF, a subset of ALF, poses unique dangers. First, consumer ALF is potentially predatory, "target[ing] impoverished plaintiffs awaiting personal injury awards with the lure of quick cash."29 As a consequence, absent regulation, consumer ALF can involve "misleading advertising, inadequate disclosure of financing terms, and excessive financing charges."30 Indeed, commentators have documented interest rates as high as 15%, compounded monthly,31 which can result in investment returns for ALF companies as high as 250%.32 Second, consumer ALF can distort settlements. Early in the litigation, consumer ALF recipients may be incentivized by the prospect of compounding interest to settle the suit for less than the expected value,33 thus distorting the deterrent effect of liability and undercompensating the plaintiff. Late in the litigation, once the financing charges have exceeded the expected value of the suit, a consumer ALF recipient may reject even reasonable settlements because "the plaintiff has nothing to lose in going to trial in hopes of obtaining a recovery that leaves that person with money after repaying his or her ALF supplier."34

In light of the potentially negative consequences of ALF, commentators have called for a wide range of enhanced regulation of ALF—including outright prohibition,35 prohibition of ALF in personal injury claims,36 limits on consumer ALF fees,37 a uniform system of disclosure to consumers about the actual costs of ALF,38 state licensing of litigation funders,39 the adoption of a "one-way fee-shifting rule in favor of defendants" in cases where the plaintiff received ALF,40 the creation of an online marketplace of consumer ALF finance,41 and federal regulation by the Consumer Financial Protection Bureau or the Federal Trade Commission.42

Yet, the potential role for securities regulation of ALF has not been
widely discussed. This Essay seeks to expand this discussion by analyzing whether ALF contracts themselves—the agreements between ALF clients and ALF suppliers—are securities and, if so, the implications thereof.

This Essay’s author has located only one case addressing the applicability of the securities laws to ALF agreements. In Anglo-Dutch Petroleum International, Inc. v. Haskell, the ALF suppliers sued the ALF client for breach of contract after the ALF client failed to comply with the ALF agreement, despite recovering in the funded litigation. In defense, the ALF client alleged that the ALF agreements were void because they were “investment contracts” and thus constituted unregistered securities under Texas law. While not conceding that the ALF agreements were securities, the ALF suppliers agreed for purposes of the summary judgment motion that the court could consider them to be securities. The trial court granted summary judgment to the ALF suppliers, and the court of appeals affirmed such grant, because under Texas law unregistered securities are voidable only by the purchasers (here, the ALF suppliers), not the seller (the ALF client). In light of the rapid expansion of the ALF industry and the absence of regulation, the issue of the applicability of the securities laws to ALF contracts will likely be litigated more frequently, and this Essay seeks to provide guidance to courts and litigants about this emerging issue.

This Essay’s discussion of this issue complements the work of Professor Richard Painter who has analyzed the applicability of the securities laws to the relationship between ALF suppliers and their investors. In addition, this Essay builds on the work of several scholars who have examined whether the securities laws apply to other iterations of ALF like litigation trust agreements and syndicated lawsuits. This Essay analyzes the issue anew as applied to the current iteration of the ALF industry: non-recourse loans extended directly to consumer and commercial litigants by ALF companies. Finally, this discussion responds to the work of Professor Maya Steinitz, who has written compellingly about the theory and practice of ALF contracting, and who has called for further study of these agreements, which form “the foundation and framework of the funding relationship.”

III. Are Alternative Litigation Finance Agreements Securities?

This section analyzes whether ALF contracts—the agreements between ALF clients and ALF suppliers—are securities. Before parsing the definition of “security,” it is worth noting that an ALF contract is, at its essence, an investment. Commentators have characterized ALF as an “investment asset class,” compared ALF agreements to bonds,
and analogized ALF companies to venture capitalists. Indeed, one commercial ALF company has noted that an ALF transaction, rather than being structured as an ALF agreement, could be accomplished by buying an equity interest in the company and becoming a minority shareholder or by creating a separate class of equity amounting to a percentage of the litigation outcome. Therefore, ALF contracts at least “sound in” securities regulation, regardless of whether they satisfy the technical definition of “security.” Of course, sounding in securities regulation is not sufficient to come within the scope of the federal securities laws.

Rather, in order to be subject to federal securities regulation, an instrument must satisfy the definition of “security.” “Unless the context otherwise requires,” the term “security” includes a laundry list of instruments, such as stock, notes, and the catch-all category of “investment contracts.” The inclusion of investment contracts within the scope of the securities laws “embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes by those who seek the use of the money of others on the promise of profits.” The securities laws do “not stop with the obvious and the commonplace”; rather, they apply equally to “uncommon and irregular instruments,” including within their scope “virtually any instrument that might be sold as a security.”

The Supreme Court, in SEC v. W.J. Howey Co., defined an “investment contract” as “a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” Assuming the investment of money (which ALF companies clearly make), there are three distinct elements that an ALF agreement must satisfy in order to qualify as an investment contract: (1) the expectation of profits; (2) solely from the efforts of the promoter or a third party; and (3) a common enterprise. ALF agreements likely satisfy the first two elements, and depending on the jurisdiction, may satisfy the third element.

(a) Expectation of Profits

ALF companies invest in litigation “in hopes of making money.” It is conceivably possible that an altruistic ALF provider could be incentivized to “improve access to justice for financially constrained or risk-averse plaintiffs,” but this is not the current reality. Indeed, one scholar has documented that ALF companies earn “a rate of return that far outstrips the average profit available in traditional investment markets such as bonds, CDs, and even the stock market.”

Both the percentage of recovery returns earned by commercial ALF companies, which depend on the total recovery in the underlying
lawsuit, and the financing fees earned by consumer ALF companies, which do not so depend, qualify as profits. Indeed, the Supreme Court clarified in SEC v. Edwards that both variable and fixed returns satisfy the Howey test: "We used ‘profits’ in the sense of income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment. There is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the test, so understood."

(b) Solely From the Efforts of the Promoter or a Third Party

The “solely from the efforts of the promoter or a third party” element focuses on the degree of control that ALF companies exercise over the litigation that they fund. The circuit courts have unanimously declined to treat the word “solely” literally, “instead holding the requirement satisfied as long as ‘the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.’” This interpretation prevents a wily issuer from evading the securities laws “by adding a requirement that the buyer contribute a modicum of effort.” When analyzing the degree of control exercised by the investor, “substance must govern over form.” Therefore, the purported allocation of control to the investor without the opportunity to exercise it does not destroy this element, and the purported passivity of an investor who actually exercises control does not satisfy this element.

The degree of control exercised by ALF companies depends on a complex interplay of competing incentives and policies. On the one hand, ALF companies have the incentive to exercise control over the litigation in order to protect their investments. Indeed, some commercial ALF companies tout their principals’ expertise in complex commercial litigation. Professor Steinitz has argued that, like venture capitalists who are “value-added investors,” ALF companies should have an active role in the management of the litigation, including “the raising of additional funds, helping in formulating legal tactics and litigation strategy, and assisting in structuring the ultimate settlement agreement in the same manner as VCFs help structure key deals executed by portfolio companies.”

On the other hand, if an ALF company exercises control over the litigation, the plaintiff’s attorney might be ethically required to withdraw from the representation. Model Rule of Professional Conduct 2.1 mandates that, “[i]n representing a client, a lawyer shall exercise independent professional judgment.” An ALF company’s exercise of control could interfere with the lawyer’s ability to comply with this mandate:
For example, to protect its own interest in maximizing the fee it may earn, a financing company may object to steps calculated to advance the client’s interests, such as pursuing a promising line of additional discovery at a cost the company would prefer to avoid, or accepting a settlement offer that does not meet the company’s expectations regarding the return on its investment. Indeed, it is “a significant open question” whether the contractual delegation of control to the ALF company—such as the control to accept or reject a settlement proposal—“is such a significant limitation on the lawyer’s representation of the client—because it interferes with the lawyer’s exercise of independent professional judgment—that the lawyer must withdraw from the representation of a client who has agreed to such a contract provision.” Likely to avoid implicating these ethical issues, many ALF suppliers expressly disclaim any control over the litigation in the ALF agreements. Indeed, some ALF companies even go so far as to describe themselves as “passive.” In addition, in the context of consumer ALF, the relatively small size of each individual lawsuit makes the exercise of control by the ALF company economically unfeasible, except perhaps in the context of settlement negotiations.

In sum, despite incentives to do so, most ALF companies currently do not exercise significant control over the litigation, likely out of fear of forcing the plaintiff’s attorney to withdraw from the representation. Therefore, in the current market, the efforts of the plaintiff’s attorney, as the agent of the plaintiff, are the “undeniably significant ones.”

Finally, the plaintiff’s attorney’s efforts qualify as “essential managerial efforts.” Several courts have distinguished between managerial efforts and ministerial efforts, holding that if an investment’s profitability depends merely on the exercise of ministerial efforts “of the promoter or a third party,” the investment does not qualify as an investment contract, regardless of who exercises those ministerial efforts. For example, where the seller of silver bars retained possession of the bars, but “the profits of the investor depended upon the fluctuations of the silver market,” the sales of the silver bars were not investment contracts. Similarly, where the promoter of investments in viatical settlements retained record ownership of the settlements, but the investor’s rate of return depended almost exclusively on “how long the insured survives,” the investments were not investment contracts. In the context of ALF, one could argue that the ALF company’s profits, to be paid from any proceeds of the suit, depend on the application of the substantive law to the underlying merits of the suit and that the plaintiff’s attorney’s role should be characterized as ministerial. In reality, however, the plaintiff’s attorney’s judgment and skill undoubtedly affect the outcome of litigation, as evidenced by
the existence of attorney malpractice liability. Therefore, although the substantive law and underlying facts affect the ALF company's profits, so too do the efforts of the plaintiff's attorney.

(c) Common Enterprise

The federal circuit courts are split on the definition of "common enterprise." Professor James D. Gordon III summarizes the split as follows:

Some circuits use horizontal commonality, which is a pooling of investor contributions, and, according to some courts, a pro rata sharing of profits. Other circuits use vertical commonality, which has two versions. Broad vertical commonality requires that the investor's fortunes depend on the promoter's efforts. By contrast, narrow vertical commonality requires that the investor's profits be tied to the manager's profits—i.e., they must rise and fall together.  

Applying these definitions to ALF, ALF agreements do not satisfy horizontal commonality and likely satisfy both broad and narrow vertical commonality.

First, ALF agreements do not satisfy horizontal commonality because there is only one investor: the ALF company.  As such, neither the ALF company's contributions nor its fortunes are pooled with those of other investors.  As the ALF industry continues to evolve, however, it is possible that ALF suppliers will join together to fund litigation, thus satisfying the horizontal commonality test.

Second, ALF agreements likely satisfy the broad vertical commonality test because an ALF company's fortunes depend on the efforts of the plaintiff's attorney.  As discussed above, most ALF companies currently do not exercise significant control over the litigation, likely out of fear of forcing the plaintiff's attorney to withdraw from the representation. For this same reason, the broad vertical commonality test is probably met. Indeed, the overlap between the "solely from the efforts of the promoter or a third party" and the "common enterprise" elements is a significant criticism of the broad vertical commonality test.

Finally, ALF agreements likely satisfy the narrow vertical commonality test because the ALF company's and the plaintiff's fortunes rise or fall together.  As discussed above, ALF agreements are non-recourse. In short, if the plaintiff does not recover in the litigation, the ALF company also loses. If the plaintiff recovers in the litigation, the ALF company shares in the recovery, either by recovering financing fees in the context of consumer ALF or by recovering a percentage of the recovery in the context of commercial ALF. One narrow circumstance exists, however, where the plaintiff's and the ALF company's recoveries do not correlate: under some consumer ALF agreements, if the financing fees exceed the amount of the recovery in the litigation.
the ALF company will recover but the plaintiff will get nothing. This narrow potential exception to the relationship between the recoveries of the plaintiff and the ALF company probably does not prevent a finding of narrow vertical commonality.

(d) Unless the Context Otherwise Requires

In sum, ALF agreements likely satisfy the “expectation of profit” and “solely from the efforts of the promoter or a third party” elements of the Howey test. With respect to the “common enterprise” element, ALF agreements do not satisfy the horizontal commonality test and probably satisfy both the broad and the narrow vertical commonality tests. Therefore, whether ALF agreements satisfy the Howey test depends on the jurisdiction.

Separate and apart from the Howey test, however, an instrument qualifying as an investment contract is treated as a security “unless the context otherwise requires.” This contextual inquiry centers on whether the instrument needs the protection of the securities laws.

In other words, “the question of ‘what is a security’ is in many ways the same as asking; should we apply securities regulation here?” Indeed, in Marine Bank v. Weaver, even though the subject agreement arguably satisfied the Howey test, the Supreme Court declined to treat it as a security, citing its uniqueness (including the right to usage of a barn as one of its terms) and the fact that it was negotiated one-on-one by the parties. Therefore, this Essay turns now to the question of whether ALF implicates the policies underlying securities regulation.

IV. Does Alternative Litigation Finance Implicate the Policies Underlying Securities Regulation?

The essence of the securities laws is disclosure. The Supreme Court has often stated that the federal securities laws are designed to ensure full and fair disclosure to investors. For example, in Tcherepnin v. Knight, the Court explained: “The Securities Exchange Act quite clearly falls within the category of remedial legislation. One of its central purposes is to protect investors through the requirement of full disclosure by issuers of securities . . . .” As translated to the context of ALF, this policy focuses on whether there is an information imbalance such that ALF companies need the securities laws to ensure that they receive full and fair disclosure about their investments. Sometimes, however, the Supreme Court has stated the purpose of the securities laws more broadly, arguably widening the policy to include an interest in ensuring full and fair disclosure to all parties to a transaction, not only to investors. As applied to ALF, this broader policy potentially brings the information interests of ALF clients within its scope. As discussed below, both ALF companies and ALF
clients face information imbalances, arguably implicating the policy underlying the securities laws.

ALF companies are at an informational disadvantage to ALF clients who know more about the underlying facts (at least from the perspective). As explained by Dr. Steven Garber, this information imbalance contributes to the problem of adverse selection:

A fundamental challenge for all ALF suppliers is that ALF demanders will tend to be more willing to accept ALF, other things equal, the less optimistic they are about the financial prospects of the legal claims. Such opportunistic exploitation of information that ALF demanders have are ALF suppliers don’t have exemplifies the well-known general problem called adverse selection, the precise nature of which differs across segments.

Therefore, ALF companies have the incentive to conduct extensive due diligence in order to decrease their informational disadvantage. Ethical and practical limitations prevent them from doing so, however.

First, from a practical perspective, an ALF company will engage in as much due diligence as merited by the size and risk of the investment. Therefore, consumer ALF companies, who fund low-dollar suits and pool risk across a portfolio of loans, are unlikely to spend very much money on due diligence. Commercial ALF companies who fund high-dollar suits and achieve less portfolio diversity, engage in more extensive due diligence, but even their willingness to engage in due diligence is not infinite, again limited by practical realities.

Second, even to the extent that an ALF company desires to engage in extensive due diligence, the ALF company is limited from doing so by the specter of waiver of the ALF client’s attorney-client privilege work product protection, which—even if consented to by the ALF client—would have a “value-diminishing effect.” Although ALF companies have argued that they share a “common interest” with the ALF client so as to prevent such a waiver, the applicability of the doctrine to the ALF context remains unresolved. As such, even ALF companies that desire to engage in extensive due diligence operate in an informational disadvantage. Therefore, ALF companies, often without the ability to verify truth or falsity, must rely on the ALF client’s representations about the merits of the case.

In light of ALF companies’ reliance on unverifiable representations by ALF clients, a number of commentators have recognized the potential for ALF clients to mislead ALF companies. Professor Stein has noted that “[i]t is obviously in the self-interest of the entrepreneur or plaintiff to overstate the quality and likely outcome of the company or of the litigation.” Similarly, Dr. Garber has described this risk as an example of moral hazard:

ALF demanders may exploit their informational advantage relative to
ALF suppliers by taking such actions as misrepresenting the strengths of their legal claims in efforts to benefit financially. Such opportunistic actions, which may not be detectable by ALF suppliers, are examples of the well-known general problem called moral hazard.\textsuperscript{108}

In fact, some commentators have even called for regulation requiring "claimants to provide financiers full disclosure."\textsuperscript{109}

As an example of alleged misrepresentations to an ALF company, the CEO and co-founder of Burford Capital LLC, a commercial ALF company, recently filed a declaration claiming that Burford was fraudulently induced into investing in the Ecuadorian Lago Agrio Litigation against Chevron Corporation.\textsuperscript{110} Even though Burford conducted "months of due diligence and negotiation" and the "Funding Agreement included specific representations, including that none of the plaintiffs or any of their lawyers knew anything 'reasonably likely to be material to the Funder's assessment of the Claim that has not been disclosed to the Funder,'" Burford now claims that it was deceived about important components of the litigation, including the alleged "ghostwriting" of a key plaintiffs' expert's report.\textsuperscript{111} Of note, the plaintiffs and their attorneys dispute Burford's claims and attribute various motives to its current allegations, including fear of "being blackballed by its target market following unanticipated public disclosure of Burford's support of mass-tort plaintiffs."\textsuperscript{112} Regardless of the merits of Burford's allegations, they demonstrate the potential for fraud in this industry.

An ALF company can protect itself to a certain degree by negotiating for the inclusion of penalty provisions in the ALF agreement\textsuperscript{114} and for staged financing based on the achievement of milestones.\textsuperscript{115} Once the ALF company's funds are disbursed, however, an ALF company's right to sue for breach of the ALF agreement or right to withhold future stages of funding may be of cold comfort. In short, therefore, the securities laws' policy interest in ensuring full and fair disclosure to investors is implicated in the context of ALF.

To the extent that the securities laws are concerned with full and fair disclosure to all parties to a transaction, rather than merely to investors, this policy is also implicated from the perspective of the consumer ALF client. As discussed above, consumer ALF has the potential to be predatory. Information asymmetries between the parties about the content of the ALF agreement exacerbate that potential. Consumer ALF clients are often vulnerable,\textsuperscript{116} possessing unequal bargaining power,\textsuperscript{117} and they "do not receive any precise information regarding interest rates, fees, and repayment schedules until their cases are approved for financing."\textsuperscript{118} As such, they may enter into ALF agreements without understanding their terms. For example, in response to this problem, the New York Attorney General announced an
agreement with an ALF company to implement a series of reforms to ensure that consumers fully understood the terms of the financial arrangements. According to the press release announcing the agreement, “Spitzer’s office was concerned that consumers did not fully understand the terms of the financing arrangement because the contracts were not clearly written and did not disclose all its terms. Additionally, contracts were written only in English even when the consumer was not fluent in English and the transaction was conducted in a language other than English.” Other critics of consumer ALF have cited “an exorbitant rate of return on repayment of ALF advances, quick and easy online applications, nondisclosure of annual percentage rates by ALF companies, and accompanying mandatory arbitration clauses as indications that ALF companies take advantage of vulnerable consumers.”

In sum, ALF implicates the securities laws’ concern with disclosure. Therefore, unlike in Weaver, this is not a context where there is a need for the protections of the securities laws. To the extent that ALF agreements qualify as investment contracts, they should be subject to securities regulation. The next section outlines some of the implications of securities regulation of ALF agreements.

V. How Would Securities Regulation Affect Alternative Litigation Finance?

This Essay analyzes two major implications of treating ALF contracts as securities and considers whether securities regulation would solve the informational disparities outlined above. In particular, this Essay applies two aspects of securities regulation to ALF: (1) restrictions on the sale and advertising of unregistered securities, absent exemption; and (2) antifraud protections. In sum, this Essay concludes that these protections partially address the informational imbalances inherent in ALF agreements.

(a) Restrictions on Sale and Advertising of Unregistered Securities, Absent Exemption

ALF potentially implicates two provisions of § 5 of the Securities Act. Section 5(a)(1) prohibits the sale of unregistered securities, unless the securities are exempt from registration, and § 5(c) prohibits the transmission of an “offer to sell or offer to buy” unregistered securities, unless the securities are exempt from registration. The application of these prohibitions to ALF agreements encompasses three issues: (1) whether the sale of an ALF agreement is exempt from registration; (2) assuming no, whether § 5 is violated in the current marketplace; and (3) assuming yes, whether any party or regulator has the ability to enforce § 5.

First, as the ALF industry currently operates, ALF agreements are
probably exempt from registration under § 4(a)(2) of the Securities Act and Rule 506 promulgated thereunder. Section 4(a)(2) exempts from registration “transactions by an issuer not involving a public offering.” As interpreted by case law, this exemption requires that (1) the offerees “have access to the types of information that would be contained in a full-fledged 1933 Act registration statement,” and (2) the offerees “be sufficiently sophisticated to demand and understand the information that is available to them.” An ALF agreement likely satisfies this agreement because the ALF company has the ability to engage in at least some due diligence and because the ALF company, as an institutional investor, is probably sufficiently sophisticated. Rule 506, a safe harbor under § 4(a)(2), contains a laundry list of requirements, the most stringent of which (the requirements to disclose specific information and to verify the investor’s knowledge and experience) are inapplicable to accredited investors. In the current market, ALF companies likely qualify as accredited investors under Rule 501(a)(8) because their owners are likewise accredited, either as natural persons or as other entities owned by accredited owners. As the ALF industry evolves to include non-accredited investors without access to detailed information about ALF clients, however, these exemptions from registration may no longer be available.

Second, assuming for purposes of analysis that ALF agreements are not exempt from registration, the current ALF industry doubly violates § 5. First, ALF agreements are not typically registered with the Securities and Exchange Commission before sale, thus violating § 5(a)(1). Second, ALF companies routinely advertise their willingness to enter into ALF agreements, effectively “offering to buy” unregistered ALF agreements, in arguable violation of § 5(c).

Finally, assuming that the current operation of the ALF industry violates § 5, the ALF client does not have the right to rescission, and the ALF company may be barred from seeking rescission by the in pari delicto defense; as such, enforcement of § 5 will likely depend on SEC involvement. Section 12(a)(1) of the Securities Act provides the “purchaser” of a security offered or sold in violation of § 5 a right to rescission. By statute, therefore, the rescission right resides in the purchaser alone—here, the ALF company. Consistent with the Anglo-Dutch Petroleum court’s interpretation of a comparable provision under Texas securities law, § 12(a)(1) does not provide the issuer—here, the ALF client—the right to rescission. The right to rescission under § 12(a)(1) is further limited, however, to purchasers who are not in pari delicto. As the Supreme Court has interpreted the in pari delicto defense in this context, a purchaser is barred from rescinding the purchase of an unregistered security where (1) the purchaser is “at least equally responsible for the actions that render the sale of

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the unregistered securities illegal”; and (2) the purchaser’s “role in the offering or sale of nonexempted, unregistered securities is more as promoter than as an investor.” At least as the ALF industry currently operates, the ALF companies are at least equally responsible for the terms of the ALF agreement, including the decision whether to register it, and are often involved in the “planning stages of the offering.” Therefore, ALF companies may be barred by the in pari delicto defense from rescinding their purchase of ALF agreements, especially if it appears that ALF companies selectively use this right to rescind only unprofitable agreements. Finally, the SEC is authorized to seek to enjoin the sale and advertising of unregistered securities and to bring an action for civil penalties against those who violate § 5. In the current ALF environment, therefore, SEC involvement is the most likely implication of the restrictions on the sale and advertising of unregistered securities. Indeed, through its enforcement authority, the SEC could potentially play a role in remedying the informational disparities discussed above in Part IV.

(b) Antifraud Protections

The federal securities laws contain broad antifraud provisions, including § 10(b) of the Securities Exchange Act, which is enforceable by the SEC and by private parties in private rights of action. Section 10(b) might help prevent, and redress, the risk of fraud arising from the informational disparities between ALF clients and ALF companies.

First, ALF companies would have a private right of action for securities fraud under § 10(b) against ALF clients and their attorneys. This private right, which is broader than common law fraud in some respects40 and which is subject to federal court jurisdiction,141 might counteract the risk of moral hazard posed by the ability of ALF clients to profit from misrepresentations to ALF companies.

Second, consumer ALF clients, as issuers of the ALF agreements, would have a private right of action under § 10(b) against ALF companies that mislead consumers about the contents of ALF agreements. Section 10(b) prohibits fraud “in connection with the purchase or sale of any security,” and purchasers and sellers have standing to assert claims under § 10(b).44 Although § 10(b) claims asserted by sellers are usually asserted by investors who sold in the secondary market, rather than by issuers, the text of the statute does not limit the action to non-issuing sellers. Indeed, courts have recognized that issuers (and their shareholders derivatively on their behalf) have standing to assert § 10(b) claims.44

Finally, the SEC has the power to seek to enjoin practices that violate § 10(b)44 and to bring an action for civil penalties against violators of § 10(b).46 As in the context of the sale and advertising of
unregistered securities, the potential for SEC involvement may be the most meaningful effect of the securities regulation of ALF.

VI. Conclusion

The ALF industry is complex, featuring commercial and consumer ALF, and its future evolution is uncertain. As such, flexible regulation is imperative. Securities regulation, whose gap-filling role this author has previously noted, might be the appropriate tool to regulate the ALF industry, at least until such time as the industry stabilizes.

Indeed, this essay concludes that ALF agreements—which are entered into by ALF clients and ALF companies—arguably satisfy the definition of “investment contract,” thus qualifying as “securities” for purposes of the federal securities laws. In addition, ALF agreements, which the parties enter into with unequal information and which pose the resultant risk of fraud, implicate the securities laws’ central policy of full and fair disclosure. Finally, the application of the securities laws to ALF agreements, including the restrictions on the sale and advertising of unregistered, nonexempt securities and the antifraud provisions, would arguably redress the problem of informational asymmetry that ALF agreements pose.

NOTES:


2Steinitz, The Litigation Finance Contract, 54 Wm. & Mary L. Rev. 455, 461 (2012) (“[W]hat started as a trickle of investments by hedge funds—not specializing in litigation but rather investing opportunistically—has recently turned into a flood.”).

3Garber, supra note 1, at 27 (characterizing the current environment as one “in which the demand for ALF investments may greatly exceed supply of capital for such investments”).

4Shepherd, Ideal Versus Reality in Third-Party Litigation Financing, 8 J.L. Econ. & Pol’y 593, 593-94 (2012) (describing the “cash-advance industry” and “the syndicated lawsuit” as forms of ALF that have been in existence since the 1980s and commercial ALF as “a new breed of third-party litigation financing [that] has evolved in the United States”).

5Steinitz, supra note 2, at 461 (listing an array of potential funding structures).

6Garber, supra note 1, at ix (noting that little is known “about how ALF activity and ALF markets will evolve in the near and longer terms”).

7Id. at 8 (identifying the routes from suppliers of capital to demanders of ALF).
Shepherd, supra note 4, at 594 (identifying six commercial ALF companies to invest in U.S. lawsuits); Garber, supra note 1, at 11 & 15 (identifying 30 consumer ALF companies and six commercial ALF companies, without any overlap).

Garber, supra note 1, at 9 (describing consumer ALF).


Garber, supra note 1, at 13.

Pardau, supra note 10, at 67 (“[I]n the context of higher-stakes consumer claims that typically involve sophisticated corporate litigants, funding ranges from six to seven figures or more.”).


The Association of the Bar of the City of New York Committee on Professional Ethics, Formal Opinion 2011-2: Third Party Litigation Financing (2011) (“Champerty is a form of maintenance in which a nonparty furthers another’s interest in a lawsuit in exchange for a portion of the recovery. The law of champerty varies by jurisdiction.”).
percent of a settlement or award for the ‘easier claims,’ thus making it harder for them to subsidize riskier litigation with the work based on those ‘easier claims.’

21 Painter, Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?, 71 Chi.-Kent L. Rev. 625, 681 (1995) (“If more efficient risk diversifiers could enter the market for legal-cost insurance, some lawyers probably would be forced to lower their risk premiums or switch to billing by the hour instead.”).

22 Molot, supra note 13, at 66 (arguing that litigation finance can remove risk preference from settlements) (“The Article recasts litigation finance as a potential engine for good—a force that may promote accuracy in adjudication where conventional reform efforts have failed.”).


24 Garber, supra note 1, at 29 (explaining that “if ALF enables many individuals or organizations to strengthen their claims or to bring claims that they otherwise would not bring, this could increase the costs to potential defendants of activities that lead to claims and, as a result, decrease behavior that causes or allegedly causes compensable harms”).

25 Shepherd, supra note 4, at 610.

26 Id.

27 Lysaught and Hazelgrove, Economic Implications of Third-Party Litigation Financing on the U.S. Civil Justice System, 8 J.L. Econ. & Pol’y 645, 663 (2012) (“As cases are funded as part of a diversified portfolio or shared among several investors, the risks of individual cases can be spread out across more secure investments or many investors. This diversification and syndication of risk could facilitate even further investor speculation in the litigation asset class.”).

28 Id. at 647.

29 McLaughlin, Litigation Funding: Charting A Legal and Ethical Course, 31 Verm. L. Rev. 615, 647 (2007).

30 ABA, Commission on Ethics 20/20, Informational Report to the House of Delegates, at 7.

31 Estevao, supra note 13, at 475-76 (“Interest rates can vary according to the size of the cash advance and the facts of the particular lawsuit, and range from 2.5 percent to 15 percent, compounded monthly.”); Molot, supra note 13, at 93 (identifying “the very high interest rates charged by cash advance firms—typically 3% to 5% monthly interest, and often much higher”).

32 Estevao, supra note 13, at 475-76.

33 Garber, supra note 1, at 33; ABA, Commission on Ethics 20/20, Informational Report to the House of Delegates, at 7.

34 Garber, supra note 1, at 33; see also ABA, Commission on Ethics 20/20, Informational Report to the House of Delegates, at 27 (“The nonrecourse nature of ALF means that there is no downside for the plaintiff in going to trial, because settling for less than the amount owed to the ALF supplier yields the plaintiff nothing, while losing at trial means owing nothing to the ALF supplier, so the plaintiff still receives nothing.”).

35 U.S. Chamber Institute for Legal Reform, Selling Lawsuits; Buying Trouble 12 (Oct. 2009).

36 McLaughlin, supra note 29, at 656.

38 Taubman, supra note 37, at 2.
39 Martin, supra note 23, at 115.
40 Lysaught and Hazelgrove, supra note 27, at 647.
41 Estevao, supra note 13, at 474.
42 Taubman, supra note 37, at 4.

44 Id. at 101.
47 Richard Painter, Litigation Financing and the Securities Laws (Feb. 25, 2013), available at http://litigationfinancecontract.com/litigation-financing-and-the-securities-laws ("Now, a critical question is how litigation finance companies can raise enough money to fund the vast amount of litigation that needs financing.").
48 Carlucci, Note: Litigation Funding Devices for Franchises: Are They Securities?, 25 Hofstra L. Rev. 393, 372-75 (1996) (analyzing whether litigation trust agreements and syndicated lawsuits are "investment contracts" for purposes of the securities laws and concluding that they probably are); Abraham, Note: Investor-Financed Lawsuits: A Proposal to Remove Two Barriers to an Alternative Form of Litigation Funding, 43 Syracuse L. Rev. 1297, 1319 (1992) (analyzing whether syndicated lawsuits fall within the definition of "investment contracts," concluding that they do not and arguing for an exception in the federal securities laws for "investment vehicles created to finance litigation").
49 Steinitz, supra note 2, at 463 ("Further study of litigation funding agreements is badly needed.").
50 Lysaught and Hazelgrove, supra note 27, at 647; see also Submission of Burford Group LLC on the Working Group’s Issue Paper Concerning Alternative Litigation Financing 2 (ALI Nov. 1, 2012) ("What is newer and more novel is the highly visible emergence of dedicated investment funds like Burford—visible because they raise public capital and offer investors the opportunity to obtain investment exposure to commercial litigation as an asset class, just as investors can buy specialized investment exposure to other facets of corporate finance.").
51 Payau, supra note 10, at 81 (noting the argument that "different investors have a full range of "risk tolerance" levels and that focusing exclusively on the "probability" of success of any given lawsuit overlooks the fact that ALF providers can negotiate for a larger share of the proceeds from less meritorious lawsuits in much the same way investors obtain higher yields from issuers of junk bonds, as opposed to AAA-rated bonds").
52 Estevao, supra note 13, at 481 ("Comparing litigation finance to venture capital investment, an LFC executive observed, ‘if it’s as if your buddy came up to you and said, I’m starting a business, I need $25,000—and, by the way, you may never get..."
your money back.’”); Steinitz, supra note 2, at 461 (“Like VCFs, which create and manage portfolios of high risk in potentially high-risk companies, litigation finance firms develop portfolios of high-risk, high-return litigation. To state the obvious, both litigation finance and VC are forms of finance.”).


60Garber, supra note 1, at 23.

61Shepherd, supra note 4, at 595 (“Instead, third-party investors aspire only to maximize the returns from their investments in litigation.”).

62McLaughlin, supra note 29, at 621.

63Garber, supra note 1, at 13.

64Id. at 9.


69ABA, Commission on Ethics 20/20, Informational Report to the House of Delegates, at 22 (“In order to protect their investments and to maximize the expected value of claims, suppliers may seek to exercise some measure of control over the litigation, including the identity of lawyers [pursuing] the claims, litigation strategy to be employed, and whether to accept a settlement offer or refuse it and continue to trial . . . ALF suppliers may also seek the right to advise on, or even veto, decisions made by lawyers during the course of litigation.”).

70U.S. Chamber Institute for Legal Reform, Selling Lawsuits; Buying Trouble 7 (Oct. 2009) (citing examples).

71Steinitz, supra note 2, at 499.

72Id. at 508.

73Model Rule of Professional Conduct (ABA) 2.1; see also ABA, Commission on Ethics 20/20, Informational Report to the House of Delegates, at 4 (2011) (“A lawyer
must always exercise independent professional judgment on behalf of a client, not be influenced by financial or other considerations. Moreover, a lawyer must permit a third party to interfere with the exercise of independent professional judgment.


75 ABA, Commission on Ethics 20/20, Informational Report to the House Delegates, at 27; see also id. at 23 (“A lawyer and client may agree among themselves to limit the scope of the lawyer’s duties, but these limitations must be reasonable under the circumstances (and the client must give informed consent to the limitation). A contract between a would-be client and an ALF supplier may create onerous duties on the part of the client that a lawyer would be unable to repudiate, even in a limited-scope representation.”).

76 ABA, Commission on Ethics 20/20, Informational Report to the House Delegates, at 23 (“Some ALF suppliers disclaim any control over the decision making of lawyers, stating that they are in an entirely passive role.”); Adler, supra note 16, at 347 (citing example ALF contracts) (“An ALF company often stipulates contractually that it has no right to make any decisions regarding the underlying legal claim and its settlement, or resolution.”); The Association of the Bar of the City of New York Committee on Professional Ethics, Formal Opinion 2011-2: Third Party Litigation Financing (2011) (noting that “litigation financing companies typically represent that they will not attempt to interfere with a lawyer’s conduct of the litigation.”)

77 Submission of Burford Group LLC on the Working Group’s Issue Paper Concerning Alternative Litigation Financing 3 (ALI Nov. 1, 2012) (“Burford does not require the party in interest or direct the litigation. Burford does not hire or fire the lawyer, direct strategy or make settlement decisions. Instead, Burford is a purely passive provider of non-recourse financing to a corporate party.”).

78 Taubman, supra note 37, at 9.


80 Id.

81 Noa v. Key Futures, Inc., 638 F.2d 77, 79, Fed. Sec. L. Rep. (CCH) ¶ 97568 (Fed. R. Serv. 2d 1560 (9th Cir. 1980).


85 See Revak v. SEC Realty Corp., 18 F.3d 81, 87, Fed. Sec. L. Rep. (CCH) ¶ 98098, R.I.C.O. Bus. Disp. Guide (CCH) ¶ 8496 (2d Cir. 1994) (defining horizontal commonality as “the tying of each individual investor’s fortunes to the fortunes of the other investors by the pooling of assets”).

86 See id. at 88 (2d Cir. 1994) (“[T]he fortunes of the investors need be linked only to the efforts of the promoter . . . “); Long v. Shultz Cattle Co., Inc., 881 F.2d 129, 143, Fed. Sec. L. Rep. (CCH) ¶ 95330 (5th Cir. 1989) (holding that broad vertical con-
monality was demonstrated by the investors’ “reliance on the promoter’s expertise even where the promoter receives only a flat fee or commission rather than a share in the profits of the venture”).

Gordon III, supra note 83, at 76 (“Broad vertical commonality is present whenever the first, third, and fourth prongs of the Howey test are met . . . . Thus, the broad vertical commonality test eliminates the common enterprise prong of the Howey test.”); Revak v. SEC Realty Corp., 18 F.3d 81, 88, Fed. Sec. L. Rep. (CCH) ¶ 98098, R.I.C.O. Bus. Disp. Guide (CCH) ¶ 8496 (2d Cir. 1994) (“If a common enterprise can be established by the mere showing that the fortunes of investors are tied to the efforts of the promoter, two separate questions posed by Howey—whether a common enterprise exists and whether the investors’ profits are to be derived solely from the efforts of others—are effectively merged into a single inquiry . . . .”).


Estevao, supra note 13, at 476 (“In some cases, the agreement may specify that the LFC is entitled to 100 percent of the proceeds in the event that the actual recovery is less than the scheduled payoff amount.”).

Marine Bank v. Weaver, 455 U.S. 551, 558–59, 102 S. Ct. 1220, 71 L. Ed. 2d 409, Fed. Sec. L. Rep. (CCH) ¶ 98471 (1982) (“The definition of ‘security’ in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires.”).

Gordon III, supra note 83, at 72; see Securities and Exchange Commission v. C. M. Joiner Leasing Corp., 320 U.S. 344, 350, 64 S. Ct. 120, 88 L. Ed. 88 (1943) (characterizing instruments as securities where “trading in these documents had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end”).

Gordon III, supra note 83, at 72 (quoting Stephen J. Choi & A.C. Pritchard, Securities Regulation: Cases and Analysis 89 (2d ed. 2008) (emphasis omitted)).


Id. at 555 (“The [1934] Act was adopted to restore investors’ confidence in the financial markets . . . .”); Gordon III, supra note 83, at 63 (“The securities acts are in large measure designed to provide enhanced disclosure to investors, either directly or through the specific and general deterrent effects of civil, criminal, and administrative remedies.”).


Reves v. Ernst & Young, 494 U.S. 56, 61, 110 S. Ct. 945, 108 L. Ed. 2d 47, Blue Sky L. Rep. (CCH) ¶ 73218, Fed. Sec. L. Rep. (CCH) ¶ 94939 (1990) (“Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.”); S.E.C. v. W.J. Howey Co., 328 U.S. 293, 299, 66 S. Ct. 1100, 90 L. Ed. 1244, 163 A.L.R. 1043 (1946) (“It permits the statutory purpose of compelling full and fair disclosure relative to the issuance of ‘the many types of instruments that in our commercial world fall within the ordinary
concept of a security.’") (citing the legislative history of the Securities Act of 1933 and 1934 was to eliminate serious abuses in a largely unregulated market. The focus of the Acts is on the capital market of the enterprise securities are traded, and the need for regulation to prevent fraud and to protect the interests of investors.”); see also § 10(b) of the Exchange Act; 15 U.S.C.A. (authorizing the SEC to prescribe such as rules and regulations “as necessary and appropriate in the public interest or for the protection of investors”) (emphasis added).

97Steinitz, supra note 2, at 488 (“Litigation financiers’ face similar issues because the plaintiffs have private knowledge of the facts, including potential key facts, harmful ‘smoking gun’ documents, potentially harmful witnesses, and the like.”).

98Garber, supra note 1, at 24.

99Id. at 25 (“First, the amount that an ALF supplier in this consumer sector segment would be willing to spend on due diligence for any amount fairly small. Second, for suppliers of consumer legal funding that are well-capitalized to have many (e.g., 50 or more) non-recourse loans outstanding on a currently portfolio risk—that is, variation in the returns on the portfolio—can be small because of risk pooling across deals.”); Taubman, supra note 37, at 2 (emphasis added).

100Garber, supra note 1, at 26 (citing examples) (“The levels of due diligence costs per deal that make financial sense are likely to be much higher in this segment than in the other two.”); id. (“Some of the ALF companies in this segment may be sufficiently capitalized currently to have enough cases for their portfolio risk to be negligible through the operation of a law of large numbers.”); Taubman, supra note 37, at 5 (“Because of the large amount of money invested by commercial companies, the amount of due diligence on each case is usually very significant, often running into the hundreds of thousands of dollars if not more.”).

101The Association of the Bar of the City of New York Committee on Professional Ethics, Formal Opinion 2011-2: Third Party Litigation Financing (2011) (“Recourse financing arrangements may result in waiver of the attorney-client privilege or other protection from disclosure. This risk arises from provisions requiring the plaintiff or his or her lawyer to disclose documents and information to finance the financing company in order to make an informed decision. In commercial context, ask for considerable detail in order to make an informed investment for a commercial ALF company or in the case file.”); Taubman, supra note 37, at 8-9 (“ALF companies, especially in the commercial context, ask for considerable detail in order to make an informed investment for a commercial ALF company or in the case file.”).

102Parad, supra note 10, at 73 (“To determine whether to fund a case, an ALF provider likely will want the litigation documents from the attorney in order to adequately assess the case. These documents may be confidential, attorney-client privilege, or attorney work product . . . . If the information in these documents is of confidentiality and attorney-client privilege.”).

103Steinitz, supra note 2, at 506.
There is a significant unresolved question of whether disclosure of privileged communications to an ALF supplier waives the privilege—that is, whether the ALF supplier and the client have interests sufficiently in common to fall within the rule of non-waiver.” The Association of the Bar of the City of New York Committee on Professional Ethics, Formal Opinion 2011-2: Third Party Litigation Financing (2011) (“We note, however, that the argument has been made that the common interest privilege does not apply to such communications because the financing company’s interest in the outcome of a litigation is commercial, rather than legal.”).

Steinitz, supra note 2, at 487 (“[C]urrent ethical rules greatly increase information asymmetries . . . .”).

E.g., McLaughlin, supra note 29, at 623 (examining a consumer ALF application and noting that it requests information about “past and future wages lost and past and future medical expenses”).

Steinitz, supra note 2, at 505.

Garber, supra note 1, at 24.

Rand Institute for Civil Justice, Conference Proceedings, Third-Party Litigation Funding and Claim Transfer: Trends and Implications for the Civil Justice System 21 (2010) (“[O]ne area of regulation that needs immediate attention concerns claimants. Such regulation should require claimants to provide financiers full disclosure. The market has suffered from claimants trying to pull the wool over people’s eyes by failing to disclose to financiers all relevant information. This has made it more difficult for proper risk allocation and has slowed down the funding process.”).

Declaration of Christopher Bogart, Chevron Corp. v. Steven Donziger, No. 11-Civ.-691 (S.D.N.Y. April 17, 2013) (docket number 1039, exhibit 2).

Declaration of Christopher Bogart, Chevron Corp. v. Steven Donziger, No. 11-Civ.-691, at 2–3 (S.D.N.Y. April 17, 2013) (docket number 1039, exhibit 2).

Declaration of Christopher Bogart, Chevron Corp. v. Steven Donziger, No. 11-Civ.-691, at 9 (S.D.N.Y. April 17, 2013) (docket number 1039, exhibit 2).

Javier Piaguaje Payaguaje et al.’s Motion to Strike the Declaration of Christopher Bogart from the Docket, Chevron Corp. v. Steven Donziger, No. 11-Civ.-691, at 19 (S.D.N.Y. June 20, 2013) (docket number 1256).

Garber, supra note 1, at 44 n.4 (“In principle, adverse-selection and moral-hazard concerns may also be mitigated by pricing or contractual arrangements. For example, ALF suppliers may successfully negotiate for contract terms penalizing ALF recipients for withholding adverse information that subsequently comes to light.”).

Steinitz, supra note 2, at 506 (“Staged financing, by pegging additional funding to the achievement of milestones—and by imposing penalties should the entrepreneur or plaintiff fail to meet those milestones, which have been specified ex ante—renders the entrepreneur’s or plaintiff’s projections more credible.”).

Pardau, supra note 10, at 73 (discussing the differences in bargaining power when the ALF client “a vulnerable individual” as opposed to when the ALF client is “a sophisticated business”).

McLaughlin, supra note 29, at 642 (characterizing “unequal bargaining power” as a “hallmark” of consumer ALF).

Estevao, supra note 13, at 474.

120 Id.

121 Adler, supra note 16, at 332-33.

122 Beyond the scope of this Essay, but worthy of note, is the potentially transforming characterization of an ALF company as an investment company subject to the Investment Company Act, if ALF agreements are classified as securities, the ALF company is primarily engaged in investing in ALF agreements, and the ALF company has failed to satisfy an exemption. See Section 3 of the Investment Company Act; 15 U.S.C. § 80a-3.


124 Section 5(c) of the Securities Act; 15 U.S.C.A. § 77e(c).


126 Hazen, Law of Securities Regulation § 4.24 (6th ed.); see also Securities Act Exchange Commission v. Ralston Purina Co., 346 U.S. 119, 125, 73 S. Ct. 981, 98 L. Ed. 1494 (1953) ("An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

127 Rule 506; 17 C.F.R. § 230.506.

128 Rule 506(b)(1); 17 C.F.R. § 230.506(b)(1); Rule 502(b); 17 C.F.R. § 230.502(b).

129 Rule 506(b)(2)(ii); 17 C.F.R. § 230.506(b)(2)(ii).

130 Rule 501(a)(8); 17 C.F.R. § 230.501(a)(8).

131 Rule 501(a)(5)–(6); 17 C.F.R. § 230.501(a)(5)–(6).

132 Rule 501(a)(8); 17 C.F.R. § 230.501(a)(8).

133 Garber, supra note 1, at 12 (reporting that many consumer ALF companies advertise through sponsored links on Google and that at least one advertises on television).


135 Anglo-Dutch Petroleum Intern., Inc. v. Haskell, 193 S.W.3d 87, 91, Blue Sky Rep. (CCH) ¶ 74563 (Tex. App. Houston 1st Dist. 2006) ("To the contrary, federal and state authority indicate that the agreements are not automatically void, but instead are voidable by the purchaser.").


137 Id. at 638 & 639.

138 Section 20(b) of the Securities Act; 15 U.S.C.A. § 77t(b).

139 Section 20(d) of the Securities Act; 15 U.S.C.A. § 77t(d).

140 Gordon III, supra note 83, at 63-64.


143 Bromberg and Lowenfels on Securities Fraud & Commodities Fraud § 4:12.
(2d ed.) ("A company's issuance of its own shares (treasury or authorized but unissued) is widely recognized as a sale for 10b-5 purposes, permitting derivative or similar suits on behalf of the company."); see also Note: Securities Exchange Act: Defrauded Issuer Has Private Right of Action Under Section 10(b), 1961 Duke L.J. 330 (1961).


146 ABA, Commission on Ethics 20/20, Informational Report to the House of Delegates, at 3 ("Regulation that might be appropriate for products in a sector of the market such as relatively unsophisticated one-off individual personal-injury plaintiffs, may be inappropriate in a different segment of the market, as exemplified by investments by hedge funds or high-net-worth individuals in commercial litigation."); Garber, supra note 1, at xi ("Be skeptical of one-size-fits-all policy prescriptions, because context matters, and it seems implausible, for example, that policies affecting all kinds of ALF will be broadly effective in promoting social objectives.").

147 Garber, supra note 1, at 39 (arguing that "there are major unknowns pertaining to the current effects of ALF," that "the current and recent effects of ALF would provide unreliable bases for predicting the future effects of ALF," and that "we won't know what new business modes for ALF suppliers might emerge").