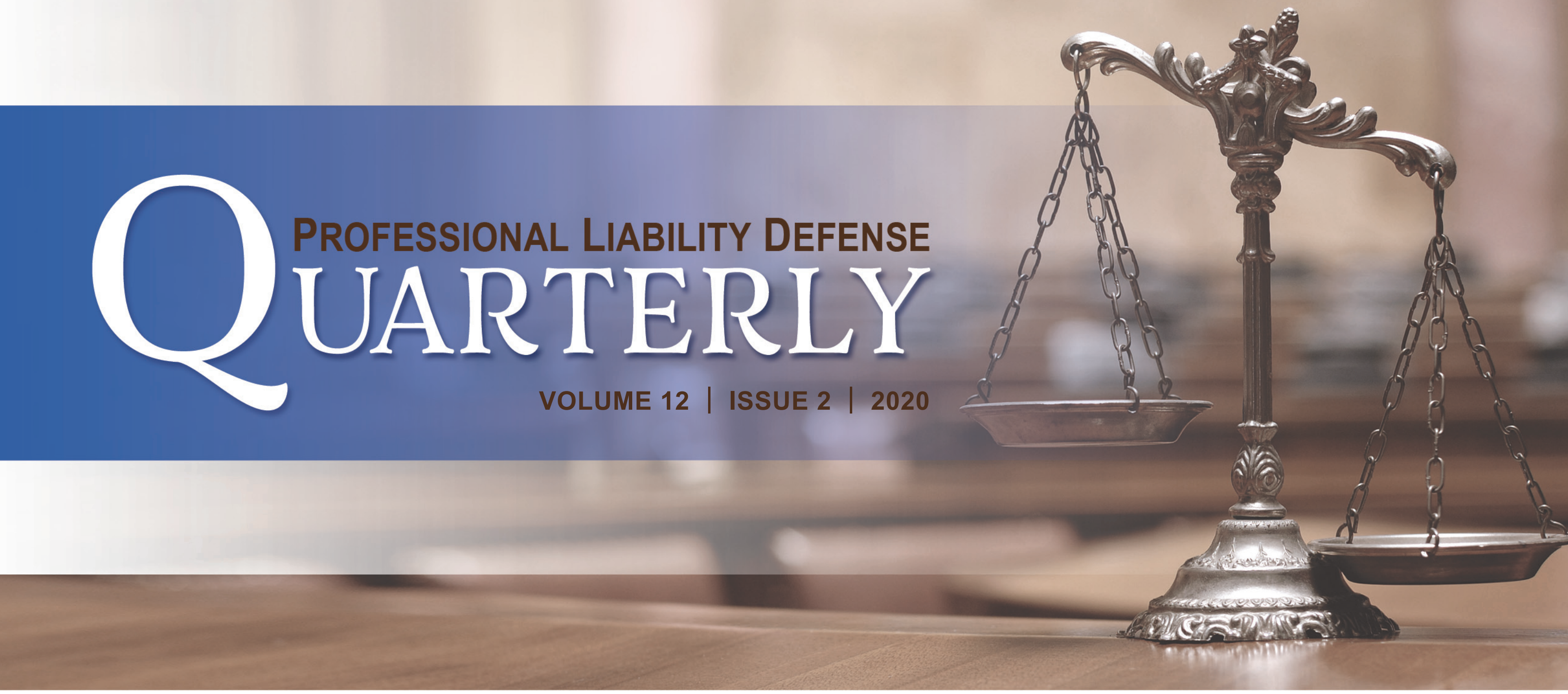

PROFESSIONAL LIABILITY DEFENSE
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# Choice of Law: State-Specific Pitfalls for the Unwary

**Michael D. Handler** | *Forsberg & Umlauf, P.S.*

Choice of law questions necessarily arise at the beginning of a claim for insurance coverage of liability claims. There are often significant differences between how multiple states with interests in the policy may resolve questions of whether there is a duty to defend, how to interpret the policy's provisions for defense or indemnity obligations, the parties' settlement-related duties, and whether or when insurers can recoup payments for costs not within the scope of the policy's coverage. These conflicting rules may add to or subtract from the insurer's defense or settlement-related obligations.

The parties to the insurance policy have mutual risks in an underlying lawsuit, which they in turn rely on defense counsel to assess and develop recommendations about. The contracting parties' initial, justified expectations may ultimately prove incorrect regarding what state's laws will be applied to the policy and their related responsibilities, and location(s) of claim handling may contin-

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## Inside This Issue



# Letter from the President

**Lisa Tulk** | *Kessler Collins, P.C.*

The Professional Liability Defense Federation exists to support and benefit its members, each of us sharing a common purpose in upholding the highest standards in managing claims which substantially impact the livelihoods of our clients and insureds. The work we each do day-to-day protects professionals and mitigates damage to their businesses and careers. With this year's world-wide uncertainty stemming from the novel coronavirus, the Board of Directors of the PLDF has turned that same focus inward, trying to find ways we can protect our members and mitigate damage to the PLDF in these uncertain times.

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insured's right to California Department of Insurance review. Cal. Code Regs. Title 10 § 2695.7(b)(3). However, in practice, insurers often state such notices in reservation of rights letters, after scrutinizing available facts for clear California connections. California also statutorily bars coverage under liability insurance policies for punitive damage awards. Cal. Ins. Code § 533. Without such enactments, several other states (e.g. Illinois and New York) have held that it frustrates the punitive award's deterrence of wrongful conduct if the penalized defendant simply passes such penalties along to an insurer. For defense counsel to weighs the risks of proceeding to judgment, it is proper to consider whether punitive damages, if awarded, will be paid by their client and not by its insurer.

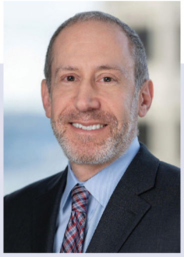
Duties to address an insured's settlement options are described in some states as part of the insurer's defense obligations, and elsewhere as indemnity obligations. This distinction alone may lead to unpredictable application of states' laws to the so-called "duty to settle". One common issue is whether sufficient limits remain available for settlement, after their reduction due to enforceable defense-within-limits provisions. Electronic settlement discussions, including "virtual" mediations conducted by video conference or in states other than the underlying suit's forum state or the parties' home office state(s), may yield further risks: the "duty to reasonably explore settlement" in the state where discussions are "deemed" to take place can newly be considered.

At this point, defense counsel may need a scorecard to keep up with all of the possibly applicable states' laws.

### Conclusion—Choose Your Own Law Adventure, But Choose Wisely

Choice of law consultations probably should happen more often than they do. If early (and ongoing) check-ins with supportive coverage counsel isn't possible, published resources include state-specific lists of procedural timelines for the insurer's decision-making and other controlling law. As to some above-specified issues, like punitive damages insurance coverage, 50-state surveys have become reliable online resources. Deskbook reference manuals are published on nationwide liability defense practices and insurance coverage, with their subscribers receiving periodic updates. Finally, localized coverage counsel with expertise in each state may have proprietary "resource guides" to make available, if requested. ■

**NOTE:** *Any opinions expressed are the author's own, rather than being issued on behalf of Forsberg & Umlauf, P.S., or their clients.*



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# Litigation Funding: Will This Glittering Investment Bring on a Malpractice Gold Rush?

**Andrew P. Carroll** | *Goldberg Segalla, LLP*

An old concept, third-party litigation funding, has been modernized in a way that has serious implications for professional liability. Historically, lawsuit funding involved loans to personal injury plaintiffs. An accident victim files a lawsuit and, while the lawsuit is pending, borrows money that is repaid out of any settlement proceeds. Although the lending terms are typically harsh, the market for such traditional litigation financiers remains robust.

Modern litigation funding similarly started by finding potential plaintiffs, only this time focusing on the commercial litigation space. Funders began targeting litigants who are low on funds but hold a plausible claim for recovery. For example, a small company that owns a patent allegedly being infringed upon by a large corporation may be unable to afford the legal fees necessary to protect its intellectual property. In such cases, modern litigation financiers provide the necessary capital to fight the proverbial goliath in exchange for a cut of the judgment or settlement.

The biggest difference between this form of litigation funding and its predecessor is the concentration of investment in only a few sophisticated matters. Rather than extend 1,000 loans of $5,000 per plaintiff, modern financiers are lending millions for a single case in the hope of a multi-million dollar judgment and commensurate return on investment. This new form of third-party funding has quickly gained traction in the

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corporate world, with two financiers taking their companies public. As publicly traded entities, these companies show exorbitant profits that are drawing significant attention from the investing world. Burford Capital ("Burford"), for example, touts its increase in assets under management from $541 million in 2016 to a jaw dropping $2.3 billion in the first half of 2019. Burford proudly advertises various investment performance metrics north of 30%, and claims that in-house counsel is becoming more and more comfortable with third-party litigation financing. At the Litigation Finance Dealmakers Forum in Manhattan in 2019, one panel described this "explosive growth" in the field as an indication that the increase in high end litigation funding will not be slowing down anytime soon. Financiers believe that as lawsuits are increasingly viewed as an asset, they will prove to be among the highest yielding investments in the market. But is this growing perception leading too many to overlook what happens when billions of dollars is suddenly injected into the civil litigation system by non-litigant stakeholders?

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### The Burford Capital Short Attack and Investment Expectations

Only two litigation-funding companies have gone public thus far, but the risks associated with public capital markets have already been revealed. A clear example is Burford's confrontation last summer with a common but unwanted beast in the world of publicly traded companies—short attackers. A short attacker analyzes the disclosures of public companies, and if it finds what it believes to be a significant weakness, will place a bet that the company is overvalued. However, a short attacker only profits if the company's stock value is driven down significantly. To ensure this price drop occurs, a short attacker may attempt to trigger a sell-off of the company by publishing its analysis explaining why the company is overvalued. The more the public agrees with the short attacker's position, the more the stock price falls, and the more money it makes on its bet. The first of such short attacks on litigation financiers occurred to Burford, and the arguments alone reveal an unfamiliarity with operating on a contingency fee basis and, with it, the likelihood that more and riskier claims are sure to come.

Short attacker Muddy Waters Research ("Muddy Waters") completed its deep dive of Burford and concluded that its "operating expenses, financing costs, debt, and funding commitments . . . put it at a high risk of a liquidity crunch." Muddy Waters further described Burford as "a fund that invests in an illiquid and esoteric asset class, which few investors can understand well." Specifically, Muddy Waters points to the supposedly creative accounting benchmarks used by Burford, known as Return on Investment Capital ("ROIC") and Internal Rate of Return ("IRR"), to paint a misleadingly rosy picture for investors. The critiques supporting this claim, however, seem to mostly describe predictable risks involved in contingency-based litigation.

For example, Muddy Waters analyzed the case of *Napo Pharmaceuticals Inc. v. Salix Pharmaceuticals Inc.* that Burford categorized as concluded in 2013 and booked as a 100% ROIC in favor of Napo. In reality, Burford's client *lost* this case in 2014, and then converted its investment into a $30 million debt. Since Napo was essentially worthless, it merged with a different company using financing from one of Burford's largest investors. As a condition of the merger, Napo had to immediately pay $8 million to Burford, and trade the remainder of the debt for the merged entity's stock. Burford put a value on this stock that actually increased the ROIC on the case, only for it to eventually yield about $600,000 in liquidation. Muddy Waters noted that it was only in 2019 that Burford finally conceded the stock was worth far less than it was booked as in public disclosures. So while Burford may have seen this as a creative response to an uncollectible judgment, Muddy Waters called it fraud.

Muddy Waters also pointed out various judgments or settlements that were highly speculative in their valuation and ultimately proved uncollectible. In one case, the value obtained was dependent on the continuing operations of a patent holder who died unexpectedly. Another investment in a divorce judgment was also questioned, as the oligarch husband undertook significant asset-hiding and actually sued the wife for impounding one of his yachts. Finally, Burford took a large judgment against a company that soon after filed for bankruptcy, leaving Burford behind a very long line of secured and unsecured creditors who are themselves unlikely to ever collect on their claims. In sum, Muddy Waters brings up these various examples of "paper wins" to support its argument that Burford inflates returns to raise funding, despite knowing that many judgments were unlikely to be monetized.

Muddy Waters also questioned the overall performance of the fund after evaluating individual case figures pulled from large portfolios. As is increasingly true in litigation finance, Burford takes a cross-collateralization approach to investing. Rather than link one investment to one case, capital is raised for an entire portfolio, and the returns are gauged based on the overall performance. According to Muddy Waters, this covered up the reality that just four cases accounted for 66% of Burford's ROIC over the past 7.5 years. Muddy Waters claims that this overconcentration of risk tied to just a few cases is a recipe for disaster, particularly if an entire group of investments ends up failing.

Those familiar with the operation of a plaintiffs' side firm will find these allegations to be hardly surprising. While the involvement of an investor in the *Napo* case may seem unusual, creative judgment collection is not out of the ordinary. Particularly with large cases, creativity in ensuring collection is sometimes necessary. Converting an uncollectible judgment into a partially collectible one can be a strategic part of bringing the lawsuit. In fact, some firms have even taken a large if uncollectible verdict at trial at least partially for marketing purposes, rather than accept a negligible settlement amount. Furthermore, it is common for many plaintiffs' side firms to have a few big hits, a few total losses, and a whole lot of cases in the middle that mostly break even. This is often the cost of doing business in the world of contingency fees, and while these and other discoveries may surprise some investors, practicing attorneys are likely to shrug their shoulders. Given the recent withdrawal of a shareholders' suit against Burford based on the Muddy Waters allegations, it appears investors are already beginning to understand this is the nature of the beast.

## Idle Capital Is the Devil's Playground

The Muddy Waters findings may currently have Burford's stock trading lower than before its report, but the fund and its brethren still have billions of dollars in capital and do not plan on turning investors away any time soon. In the first half of 2019 alone, Burford received $751 million in new investment commitments, up from a mere $81 million in the first half of 2015, and deployed $448 million in litigation financing. Such dramatic increases in capital infusion in unique investment vehicles is not unprecedented, however, and one prior comparator suggests the result will be more and riskier litigation across the board before any reduction in litigation funding.

Much like Burford, in 1994, Long-Term Capital Management ("LTCM") was formed to take advantage of an untapped investment market. In the case of LTCM, the focus of investing was fixed-income arbitrage, which in the simplest terms, sought to turn profits on discrepancies in the valuation of government bond securities. LTCM's use of complex mathematical models yielded tremendous success, with annualized returns of 21% in its first year followed by returns of 43% and 41% the next two years. These outsized profits led to garish praise from the market and an exponential increase in investment. Starting with a few hundred million dollars in late 1993, by 1998 LTCM had $4.7 billion in equity and had borrowed over $124.5 billion to stake out its positions in the market.

This precipitous rise preceded a dramatic downfall, but the process in getting there sheds light on what will likely occur in litigation finance. Investors flocked to LTCM so quickly that it had more capital than it knew what to do with. Needing to employ its capital while faced with narrowing anomalies in the fixed-income arbitrage market, LTCM started looking outside of its specific area of expertise. This lack of familiarity, combined with models that did not account for black swan events, led LTCM to be caught completely off guard by economic crises in both Russia and Asia in 1998. Losses started mounting, and by the end of the year, LTCM had lost a staggering $4.6 billion that required a bailout and, eventually, the complete liquidation of its positions.

The availability of such unjustified levels of capital is precisely where Burford found itself, and in an economy that encouraged riskier trading every day. Critics of the current Federal Reserve's low interest rates before the onset of COVID-19 often pointed to the level of speculation that naturally results from low rates. When interest rates are at moderate or high levels, institutional investors are happy to blend portfolios with safe havens like U.S. Treasury bonds. By contrast, interest rates at the current level have the opposite effect, encouraging investors to look for returns in companies that otherwise might be deemed a bit too risky. This became evident in the quick stock price fall of several companies after their Initial Public Offerings ("IPO"), and the cancellation of the WeWork IPO altogether. In the case of WeWork, its most recent private capital raise valued the company at $47 billion and its IPO was planned at a similar valuation. However, critics noted that WeWork lost

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$900 million in the first six months of 2019 and is saddled with leases that last up to fifteen years, even though it rents out space on much shorter terms. In a recession economy, the company could therefore find itself on the hook for obligations based on the currently high real estate prices, without the ability to turn around and lease space at a profitable rate. The market ultimately determined the valuation was at least twice as high as it should have been, dashing investors' grandiose expectations.

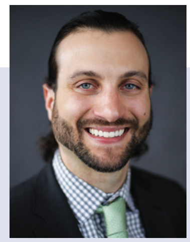
### The Wave of Trickle Down Litigation is Coming

So where does that leave Burford, which went from $378 million in 2016 to $2.3 billion in 2019? While the overall market took a dramatic turn for the worse due to COVID-19, Burford still holds billions in assets and litigation funders have gone on record to say that plenty more investments have come in since. Furthermore, much like LTCM in the 1990s, the extensive publicity of Burford's investment returns has also increased competition in the field. With their own investment commitments growing exponentially, and competition from various angles, Burford will surely see a shortage of multi-million dollar commercial cases and look for new and creative ways to deploy its capital.

In late 2019, Burford appeared to already be venturing outside of its traditional model when it expressed a desire to explore the insolvency and bankruptcy field while touting increasing investments in asset recovery, post-settlement actions, and adverse cost indemnities. The COVID-19 economic downturn provides litigation funders with fertile ground to pursue this area, as legal industry analysts have pointed out that during the 2008 recession, there was a massive spike in both bankruptcies and professional malpractice claims. In other words, we have a perfect storm brewing wherein a natural spike of professional malpractice claims from the downturn will now be combined with increased resources to fund such lawsuits through third party financiers. Burford may also look to continue stepping up its cross-collateralized strategy by aggregating a greater amount of smaller claims into one large portfolio. In combination, it becomes very likely that mid-size or even small professional firms will find themselves in the cross hair of litigation finance in the coming years.

However, even if Burford itself does not drive the gold rush toward middle and small market professional malpractice claims, it is almost certain that others will. Burford is just the most public company in what has become a $9.5 billion U.S. litigation finance market. While it began as loans to accident victims, companies like Burford have shown that money can be made by funding many types of lawsuits. It should be no surprise if smaller private investment funds continue to crop up and increase funding of professional malpractice lawsuits. As this occurs, the landscape of professional malpractice litigation will change for *all* claims, and attorneys and insurers alike must be prepared for the impending shift in underwriting and defense strategy.

All is not lost, however, and in Part Two I discuss how litigation finance will increase both the volume and value of claims, as well as the methods available for evening the playing field for malpractice carriers and defense attorneys alike. ■



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**Andrew P. Carroll** of *Goldberg Segalla, LLP* in Philadelphia focuses on handling matters relating to professional liability, real property, and commercial litigation. His professional liability practice includes representing attorneys, accountants, brokers, and directors and officers in civil litigation and investigative matters. His experience spans through trial and appeal, including multiple forms of alternative dispute resolution. His practice includes professional liability matters relating to commercial and residential real estate transactions, as well as contests to title in Pennsylvania and New Jersey. Additionally, Andrew handles complex commercial litigation matters stemming from various claims of statutory violations, contractual disputes, and alleged breaches of fiduciary duty. Andrew may be reached at acarroll@goldbergsegalla.com.

# Use of Federal Law in Defense of State Legal Malpractice Claims

**Alice Sherren** | *Minnesota Lawyers Mutual Insurance Company*
**Donald Patrick Eckler** | *Pretzel & Stouffer, Chartered*

A couple of years ago we wrote on the use of *Rooker-Feldman* and *res judicata* in federal cases against lawyers that arose out of underlying state litigation. See *"Unusual Names, Powerful Doctrines: Use of Rooker-Feldman and Res Judicata in Defending Federal Lawsuits Brought Against Attorneys Arising from Litigation in State Court,"* PLDF Quarterly, Vol. 10, No. 4, Alice Sherren, James J. Sipchen, and Donald Patrick Eckler. Two recent cases, *Zander v. Carlson*, 2019 Il App (1st) 181868 and *Ritchie Capital Management, LLC v. McGladrey & Pullen, LLP*, 2020 IL App (1st) 180806, show how federal law can be used to defeat legal malpractice claims filed in state court.