November 14, 2010

Investors Put Money on Lawsuits to Get Payouts

By BINYAMIN APPELBAUM

Large banks, hedge funds and private investors hungry for new and lucrative opportunities are bankrolling other people's lawsuits, pumping hundreds of millions of dollars into medical malpractice claims, divorce battles and class actions against corporations — all in the hope of sharing in the potential winnings.

The loans are propelling large and prominent cases. Lenders including Counsel Financial, a Buffalo company financed by Citigroup, provided $35 million for the lawsuits brought by ground zero workers that were settled tentatively in June for $712.5 million. The lenders earned about $11 million.

Most investments are in the smaller cases that fill court dockets. Ardec Funding, a New York lender backed by a hedge fund, lent $45,000 in June to a Manhattan lawyer hired by the parents of a baby brain-damaged at birth. The lawyer hired two doctors, a physical therapist and an economist to testify at a July trial. The jury ordered the delivering doctor and hospital to pay the baby $510,000. Ardec is collecting interest at an annual rate of 24 percent, or $900 a month, until the award is paid.

Total investments in lawsuits at any given time now exceed $1 billion, several industry participants estimated. Although no figures are available on the number of lawsuits supported by lenders, public records from one state, New York, show that over the last decade, more than 250 law firms borrowed on pending cases, often repeatedly.

The rise of lending to plaintiffs and their lawyers is a result of the high cost of litigation. Pursuing a civil action in federal court costs an average of $15,000, the Federal Judicial Center reported last year. Cases involving scientific evidence, like medical malpractice claims, often cost more than $100,000. Some people cannot afford to pursue claims; others are overwhelmed by corporate defendants with deeper pockets.

A review by The New York Times and the Center for Public Integrity shows that the inflow of money is giving more people a day in court and arming them with well-paid experts and elaborate evidence. It is helping to ensure that cases are decided by merit rather than resources, echoing and expanding a shift a century ago when lawyers started fronting money for clients' lawsuits.

But the review shows that borrowed money also is fueling abuses, including cases initiated and controlled by investors. A Florida judge in December ordered an investment banker who orchestrated a shareholder lawsuit against Fresh Del Monte Produce to repay the company's legal expenses, ruling that the case should not have reached trial.

Such financing also drains money from plaintiffs. Interest rates on lawsuit loans generally exceed 15 percent a year, and most states allow lawyers that borrow to bill clients for the interest payments. The cost can exceed the benefits of winning. A woman injured in a 1995 car accident outside Philadelphia borrowed money for a suit, as did her lawyer. By the time she won $169,125 in 2003, the lenders were owed $221,000.

Lawyers are not required to tell clients that they have borrowed money, so the client may be unaware that there is financial pressure to resolve cases quickly. Lenders also seek detailed information about cases, which can jeopardize client confidentiality. A federal judge in Delaware ruled in June that a company suing Facebook for patent infringement had to show Facebook documents that its lawyer had shared with a lender.

Citing these issues, critics of lending for lawsuits say the practice should be banned.

"It sends shivers down the spines of general counsels all across the globe," said Lisa A. Rickard of the Institute for Legal Reform, an arm of the United States Chamber of Commerce.

But proponents, who argue that people often need help to fight corporations, have won a series of victories in state courts and legislatures in recent years, overturning old laws that prohibited investments in lawsuits.

"If you want to use the civil justice system, you have to have money," said Alan Zimmerman, who founded one of the first litigation finance companies in 1994, in San Francisco, now called the LawFinance Group. "If there's less money, you'd have less litigation. But then you'd also have less justice."

A Case in Point

A legal battle between residents of a faded Texas factory town and the BNSF Railway, the nation's second-largest railroad company, highlights what some see as the benefits and others see as the excesses of lawsuits driven by borrowed money.

Somerville, Tex., 80 miles northwest of Houston, has hosted the noxious work of treating wood to make railroad ties for more than a century. The railroad runs through the town, dividing a small grid of residential streets from the lumber yard and treatment plant where stacks of wood are soaked in preservatives.

Dennis L. Krueger crossed the tracks to begin work at the factory the week after he graduated from the local high school, in 1974. Three decades later, he was found to have a malignant skin cancer that his doctor said was most likely caused by prolonged exposure to creosote, the tar oil in which the ties are soaked.

Mr. Krueger, who is 54 but looks much older, reduced by manual labor and medical treatment, is suing the railroad for damages, claiming that BNSF failed to provide basic safety equipment or to warn workers that the federal government had linked creosote with skin cancer. He recalled cleaning the inside of the treatment tanks wearing no safety gear except steel-toed boots and mule-skin gloves.

“I got so high off that stuff I’d be laughing one minute and crying the next minute,” said Mr. Krueger, sitting at the local Dairy Queen beneath old photographs of factory workers. “I’ve got a 2-year-old grandson. My goal was to live to 101. What I’d like is a fair shake from the railroad for missing out.”

Mr. Krueger’s lawsuit is financed by investors he has never met. His lawyer from Houston, Jared R. Woodfill, has borrowed more than $3.5 million from a New York hedge fund run by Stillwater Capital Partners, in a deal arranged by the litigation finance specialist Oxbridge Financial Group, also based in New York.

Mr. Woodfill first drove to Somerville in 2000 to meet with a former factory worker who has since died of skin cancer. He said that his work on that worker’s case, which BNSF agreed to settle in 2003, convinced him that toxic emissions from the factory had poisoned the town’s air, water and land.

Mr. Woodfill, who is 42 and the chairman of the Republican Party in Harris County, is empathetic and well-spoken. He found a ready audience in Somerville, which has declined with the railroad industry. The population peaked in the 1930s. About 1,700 people still live in the timeworn residential section, but automation has further reduced employment at the factory, and a quarter of the households now live in poverty. Residents with a wide range of health problems embraced the idea that the factory was responsible.

Mr. Woodfill signed up workers with skin cancer, like Mr. Krueger, and those with gastrointestinal cancers that he says can be caused by the chemicals used at the factory. He also signed up Somerville residents who never worked at the factory but had developed cancers. And he signed up property owners with no health problems, arguing that the value of their property had suffered.

About 400 people sued the railroad — almost a quarter of the town's residents.

Oxbridge spent several months reviewing the cases before agreeing to arrange the financing, sending lawyers to Texas to look at documents and to question Mr. Woodfill and his partners. Stillwater Capital is charging about 16 percent annual interest.

"But for a hedge fund, I couldn't afford to take on a railroad," Mr. Woodfill said.

BNSF's general counsel, Charles Shewmake, said the company had carefully reviewed claims brought by its former workers and decided they had no merit. He said the claims by Somerville residents who did not work at the factory were "physically impossible and without any scientific basis."

Company executives were outraged when they learned that a hedge fund was backing the lawsuits, Mr. Shewmake said. He said that BNSF had been forced to spend millions of dollars mounting its courtroom defense and defending its reputation.

"They're stirring up cases that don't need to be in the courthouses," he said.

An Opportunity for Lenders

Lawsuit lending is a child of the subprime revolution, the mainstream embrace of high-risk lending at high interest rates that began in the early 1990s.

Mr. Zimmerman, the founder of the LawFinance Group, practiced law for more than two decades before moving into finance in California in 1992. A lawyer friend called to ask if he would lend to a client who had won a sexual harassment lawsuit. The woman's former employer had appealed, and she needed money for living expenses or she would be forced to take a smaller settlement.

Mr. Zimmerman invested $30,000 in the case; the former employer almost immediately dropped the appeal and paid out the verdict. Mr. Zimmerman made $20,000.

"I said: 'That's an interesting way to make money. Is there a way to turn that into a business?' " he recalled. The company he created has since invested more than $350 million in litigation.

Others in the lending business saw the same opportunity at about the same time, including a mortgage salesman in Buffalo; a subprime auto lender from Nashville; and a Las Vegas man who had been convicted of threatening borrowers who failed to repay his previous business, Wild West Funding.

By the late 1990s, several of those companies were also making loans to lawyers. Plaintiffs needed small sums for living expenses; their lawyers needed much larger sums to mount cases, and they had few other options. Banks make loans against assets, and law firms generally have little property to pledge as collateral.

The new lenders jumped into the void. LawFinance's slogan is "We do what banks won't."

The industry's great innovation, and still its defining trait, is the willingness to lend based on the potential value of unresolved cases.

The roughly one dozen major lenders tend to cultivate an image of conservative prudence. Counsel Financial, which bills itself as the largest, with more than $200 million in outstanding loans to law firms, shares a suburban office building outside Buffalo with an insurance firm.

But the work sits somewhere between banking and gambling. Lenders employ experienced lawyers to judge the strength of cases. They consult databases showing the results of similar lawsuits, just as appraisers value homes based on recent sales. A corporate defendant may have a history of battling personal injury claims; or juries in a specific county may have a history of siding with local employers. Then they place their bets. Counsel will invest up to $10 million in a law firm.

The returns can be lucrative. Counsel Financial charges 18 percent annual interest. "If firms have access to lower-cost financing, our first comment back to them is that you really shouldn't be talking to us," said Paul R. Cody, president of Counsel Financial. "We're not going to be competitive" with the interest rates charged by banks.

Law firms are generally obligated to repay loans even if they lose. In reality, however, firms that make less than expected often struggle to make the required payments, and a number of firms that borrowed from Counsel Financial have filed for bankruptcy protection.

Increasingly, banks are making lawsuit loans, too. During the lending boom of the last decade, companies including Citigroup, Commerce Bank of New Jersey and Credit Suisse provided financing for lawsuit lenders. More recently, some banks have started cutting out the middlemen. Deutsche Bank recently refinanced one of Counsel's largest clients, the New

York firm Napoli Bern Ripka. TD Bank, which absorbed Commerce, lends to lawyers and plaintiffs.

The founders of LawCash, a Brooklyn lender, won a charter from New York in 2006 to establish Esquire Bank, the first American bank to specialize in the business of financing lawyers and lawsuits.

Defendants on the Defensive

A recent Nevada case illustrates one reason many companies are troubled by the rise of financing: They fear that investors will move from supporting to producing lawsuits.

Steven and Roz Flans left Los Angeles in 2004 for Sun City Anthem, a sprawling retirement community of 7,000 one-story homes, from ranches to mansions, at the edge of the Las Vegas basin. When the gas fireplace stopped working during their third winter in the desert, the couple contacted their home builder, Del Webb.

“We called and said, ‘We have a minor problem,’ ” Mr. Flans recalled. “And they said: ‘We can’t talk to you. You’re suing us!’ ”

It emerged that the Flanses had accepted a free home inspection the previous year from a company, MC Mojave Construction, that had papered their neighborhood with brochures. They said they did not realize that the forms they signed authorized MC Mojave to sue Del Webb on their behalf for the money to correct any problems.

By 2008, MC Mojave had initiated more than 500 lawsuits against Del Webb. The company acted as an investor, providing inspection reports to the Las Vegas law firm that handled the cases in exchange for a share of any winnings.

Del Webb sued MC Mojave, arguing that Nevada law prohibited fomenting and investing in lawsuits. Jacque Petroulakis, a company spokeswoman, said that Del Webb would have fixed legitimate problems under its warranty policy, and that the lawsuits served solely to make money for MC Mojave and the law firm.

“They were throwing people into litigation that many of them never anticipated or wanted,” Ms. Petroulakis said.

MC Mojave did not return calls for comment, but in court filings, it called the Nevada law “medieval” and said it should not be enforced. The company said it was providing a service at the request of the homeowners.

This year, a federal judge barred MC Mojave from initiating further lawsuits, ruling that Nevada law indeed prohibits such investments.

But a growing number of states have eliminated similar laws.

The Massachusetts Supreme Judicial Court started the trend in 1997, citing a "fundamental change in society's view of litigation — from a social ill, which, like other disputes and quarrels, should be minimized, to a socially useful way to resolve disputes."

South Carolina, Texas and Ohio are among the states that have followed.

Stephen C. Yeazell, a law professor at the University of California, Los Angeles, and a leading historian of the civil justice system, said the trend was likely to continue. He said there was little legal justification for allowing lawyers to pay for cases but barring third parties from doing so. "This is another step in leveling the playing field between plaintiffs and defendants," Mr. Yeazell said.

Gathering Plaintiffs

Anthony Flammia, a former New York City police officer who spent three months working in the wreckage of the World Trade Center, did not learn that his lawyers had borrowed money to pursue his claim of compensation for health problems until he received a bill for $828.93 in interest charges.

Mr. Flammia left ground zero at the end of 2001 for a job with a suburban police department. A few years later, a passer-by found him asleep in his patrol car. His health had been deteriorating, and the episode prompted him to visit a free clinic established to treat ground zero workers for the consequences of inhaling dust. He was found to have sleep apnea and scarring in his lungs. In 2007, he passed out after inhaling smoke at a house fire and was forced to retire.

Lawyers led by Napoli Bern Ripka sued the City of New York and a host of agencies and companies on behalf of more than 9,000 ground zero workers. When Mr. Flammia signed up as a client, the paperwork included a general notice that the lawyers might borrow money to pursue the case, and that they might bill clients for the interest.

Mr. Flammia said he did not see the general warning, and there was no further notice as the lawyers borrowed more than $35 million.

In June, the city and other defendants agreed to settle the case for up to $712.5 million. The workers have until Tuesday to approve the settlement. Workers received letters detailing how much they would receive, and how much the lawyers would keep to cover the costs of pursuing the case.

Among the costs billed to clients was $6.1 million of the $11 million in total interest payments, which the law firms said reflected the share of the borrowed money covering the workers' expenses.

Lawsuit lenders, including Counsel Financial, encourage lawyers to bill clients. They advertise in trade magazines that lawyers can borrow money free if the client is paying the interest. Bar associations in most states, including New York, condone the practice.

Paul J. Napoli, one of the lead lawyers representing the ground zero workers, said that the firm needed money to pursue the case, that the loans were taken at the lowest available interest rates and that clients were properly notified.

"We followed the rules. Do people want to have it sky-written over their house every day?" Mr. Napoli asked. "They didn't read it. Or maybe they didn't care at the time. At what point do people have a self-responsibility to read something and be bound by it?"

But Mr. Flammia and other workers said they had not agreed that the law firm could pay for its work by borrowing money at their expense.

"If I'm ever involved in a lawsuit again, I'm going to be very careful and read every document line by line," Mr. Flammia said. "I'm also going to find a lawyer who is acting on my behalf and not to line their own pockets."

The judge overseeing the case, Alvin K. Hellerstein of the Federal District Court of Manhattan, ordered the lawyers to swallow the cost.

Judge Hellerstein acknowledged that the charges were legal, but said that the lawyers already were earning enough from the case. He said that it was not clear that clients had understood or approved the decision to borrow, and that it was clear that clients had no control over how the money was spent.

The workers, Judge Hellerstein said, "want to have the fruits of this settlement not diminished by an effort of lawyers to finance much of the way that they work this case."

A War of Attrition

The residents of Somerville, Tex., have yet to win a trial.

The case of Linda Faust, who never worked at the railroad plant, was the first to reach court, in 2008. She had stomach cancer.

The jury deliberated three days before deciding that BNSF was not responsible.

The following year, a jury ruled against Dennis Davis, a former worker at the factory with pancreatic cancer.

Mr. Woodfill's nine-lawyer firm, Woodfill & Pressler, has spent more on the Somerville cases than any of its previous litigation. Win or lose, it must repay Stillwater, the hedge fund that is bankrolling the cases. Mr. Woodfill said he remained confident that the cases could be won. He is appealing the two losses and preparing for a third trial next year.

He drove through Somerville recently on his way to meet with clients, rolling down the windows so the smell of the factory came into the car. "They're hoping to spend us into the ground and make us go away, but we're not giving up," he said.

Mr. Shewmake of BNSF said the company was braced to continue fighting the cases until Stillwater ran out of patience.

"Right now," he said, "I'd say it's starting to look like a bad investment decision."

This project was initiated by the Center for Public Integrity, a nonprofit investigative news organization in Washington. It is based on reporting by Ben Hallman of the center and Binyamin Appelbaum of The Times, and was written by Mr. Appelbaum.