Do-It-Yourself Litigation Funding à la *Novoselsky*

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In this article, Wood and Board examine litigation funding transactions and the consequences of the Tax Court's widely noted *Novoselsky* decision.

This discussion is not legal advice.

The sky is falling! Judging from the calls and emails we have received, the Tax Court's recent decision in *Novoselsky*[1] has sent more than a ripple of concern through the world of litigation finance. Maybe a tidal wave of concern would be more accurate. Some litigation funders seem a little worried — because they too are getting calls. But a great many more lawyers are alarmed, particularly if they recognize themselves in this do-it-yourself funding fiasco.

David Novoselsky, a solo class-action lawyer, raised $1.4 million using loan agreements he drafted himself.[2] The Tax Court concluded that advances under these "litigation support agreements" did not qualify as indebtedness for tax purposes. You can see this one coming. If they were not loans, were they income? In fact, the court agreed with the IRS that Novoselsky should have reported the $1.4 million as income when he received it in 2009 and 2011.

Like any good lawyer, Novoselsky should surely complain to his tax attorney about putting this mess together in the first place. Except that here, there was no tax lawyer. Well, then he should complain to his business lawyer for documenting this business deal poorly (and for failing to bring in tax help). But he wasn't working with a business lawyer, either. Although these circumstances may suggest that *Novoselsky* is not worth reading, *au contraire*! In fact, the case is full of useful lessons.

Let's start with the premise that many callers seem to blurt out first: that this case means you can't have a loan, and that means upfront litigation funding money is always taxable. Even before *Novoselsky*, many a lawyer who should know better would ask how their litigation funding deal is taxed. Many want an answer without providing the documents! Whether the deal is papered as a loan, sale, or prepaid forward contract, the documents matter, and they can be surprisingly nuanced. The caption at the top of the agreement doesn't tell the whole tax story.

But to return to our caller, the "now upfront money is always going to be taxable" hyperbole is also puzzling. After all, litigation finance as we know it would vanish if lawyers and plaintiffs were always taxed on the gross amount of their

[1] *Novoselsky v. Commissioner*, T.C. Memo. 2020-68.

[2] The Tax Court noted that Novoselsky "had not advanced (and could not plausibly advance) any 'reliance on professional advice' defense." *Novoselsky*, T.C. Memo. 2020-68, at 32.

advances in the year of receipt. Take away deferral and net taxation, and it's time to break up the band.

Reports of My Death . . .

So has *Novoselsky* really sounded the death knell for litigation funding? That strikes us as highly unlikely. To begin with, *Novoselsky* dealt only with specific transactions structured as loans. Although loans were common a decade ago, the transactions we see these days are generally structured as prepaid forward contracts, or as straight investments or purchases. Advances meant to be treated as loans are rare. The Tax Court's arguments in *Novoselsky* do not touch prepaid forwards or purchase agreements.[3] So if litigation finance needs a Plan B, it is already up and running.

Even if it has become less common to document litigation finance transactions as loans,[4] are loans at least still possible? You bet. In our view, the tax problems in *Novoselsky* can be traced to a DIY drafting error. Taxpayers should be able to avoid a similar tax debacle by using standard loan documentation, and having a business lawyer vet it.

The Tax Court's decision also illustrates an unusual risk that can arise when lawyers borrow from their clients or other persons with an existing interest in the outcome of litigation. If repayment is due only when the lawyer would ordinarily collect a fee, there is room for the IRS to argue that the purported loan is really an advance payment of compensation. We doubt that this should be a concern in transactions with professional litigation funders, who will be strangers to the underlying controversy.

My Way

Frank Sinatra did it his way, and as "My Way" glorified, that had its ups and it downs. Novoselsky was an entrepreneurial litigator, and he too liked to do things his own way. Regrets, he's had a few.[5] After he identified several promising opportunities to bring lawsuits, he used his network of personal and professional relationships to find willing investors. In 2009 and 2011, he entered into litigation support agreements with eight doctors and lawyers around Chicago.

Novoselsky's investors were not a random sample of local professionals with money to burn. Although the Tax Court initially stated that the investors included "individuals seeking a high return on a speculative investment,"[6] the court's analysis treated them as falling into three groups, each with its own preexisting stake in the litigation: (1) doctors who were plaintiffs in some of the lawsuits that Novoselsky was cooking up; (2) doctors whose economic interests were aligned with those of the plaintiffs; and (3) lawyers with whom Novoselsky had fee-sharing agreements.[7]

Novoselsky self-documented all his transactions as loans. In some cases, he promised his investors a high rate of interest. In others, he agreed to pay them a multiple of their investments. All the contracts stated that the loans were being made on a nonrecourse basis.

Novoselsky did not report the advances as income on his 2009 and 2011 tax returns. After all, they were loans! On audit, however, the IRS argued that the obligations did not qualify as indebtedness for tax purposes, and that Novoselsky omitted $1.4 million of gross income. When Novoselsky refused to extend the statute of limitations, the IRS assessed tax deficiencies and penalties totaling more than $600,000.

Agreeing to extend the statute is, of course, customary and usually something taxpayers should do. If you refuse, the IRS almost always issues a 90-day letter based on unfavorable

[3] We are assuming, of course, that bona fide prepaid forward contracts and purchases will not be recast as loans that do not qualify as indebtedness. Such a recast is theoretically possible, but we leave that topic for another occasion.

[4] *See* Robert W. Wood and Donald P. Board, "Taxing Litigation Finance: Plaintiff, Lawyer, and Funder Tax Goals," *Tax Note s Federal*, June 8, 2020, p. 1735.

[5] It appears that Novoselsky has not always colored inside the ethical lines. In 2019 a panel of the Illinois Attorney Registration and Disciplinary Commission issued a 79-page report recommending that he forfeit his license to practice law. Debra Cassens Weiss, "Lawyer Engaged in 'Sustained Campaign of Unfounded Litigation,' Disbarment Recommendation Says," *ABA Journal* (June 14, 2019). In April 2020, however, a review panel recommended that this be reduced to a three-year suspension. The matter is still under review by the Illinois Supreme Court.

[6] *Novoselsky*, T.C. Memo. 2020-68, at 4.

[7] *See id.* at 24.

assumptions, so you have to go to Tax Court. Every tax professional knows this, so Novoselsky should surely complain to his tax lawyer. Oh, wait, there wasn't one.

Of course, the IRS issued a 90-day letter. Novoselsky filed a timely petition with the Tax Court, but proceedings were stayed when he declared bankruptcy in 2014, apparently for strategic reasons. Several years of acrimonious litigation ensued. Novoselsky, who was also acting as his own bankruptcy lawyer, emerged from the process without a discharge. When the case in the Tax Court started moving again, Novoselsky naturally proceeded pro se.

Nonrecourse What?

The litigation support agreements stated that the advances were being made on a nonrecourse basis. That is standard practice for litigation funders, even the few who are willing to write transactions as loans. However, Novoselsky's implementation of the nonrecourse feature diverged significantly from the commercial norm.

In a conventional nonrecourse loan, in litigation finance or otherwise, the borrower grants the lender a security interest in specific property. The lender agrees that this collateral will be its exclusive source of repayment in the event of default. The substantive terms of the loan itself are unaffected. It is only the lender's potential remedies that are changed.

The application of this bedrock principle to litigation funding loans is straightforward. The borrower grants the funder a security interest in the future proceeds (if any) of the lawsuit. The funder agrees that it cannot look beyond those proceeds for payment in the event of default. If the litigation does not pay off, the funder will have no way to extract payment from the borrower. Unless the borrower pays voluntarily,[8] the obligation will remain unsatisfied.

Like Sinatra, Novoselsky didn't follow the playbook. Instead of going through the tedious business of granting security interests, getting them perfected, and limiting his investors' remedies, he cut to the chase. Because the point of the exercise was to ensure that he would not have to pay unless the litigation was a success, why not just make that a term of the obligation itself?

So Novoselsky didn't bother with security agreements, financing statements, or any of that rigmarole. Instead, he framed his obligation under the litigation support agreements as a duty to pay the investor "at the successful conclusion of this litigation." If the litigation was a bust, he wouldn't owe a cent.

This probably sounded like DIY common sense. But the Tax Court jumped all over it, citing some of the numerous cases holding that an obligation is not indebtedness for tax purposes if it is contingent on the occurrence of a future event.[9] That specifically includes obligations that are contingent on the outcome of litigation.[10]

The obligations under the litigation support agreements were contingent on the successful conclusion of the lawsuits, so they were not loans. The burden then shifted to Novoselsky to provide some other justification for excluding the advances from gross income. He might have turned to his tax lawyer for ideas, but there was no tax lawyer. Predictably, the Tax Court dismissed Novoselsky's arguments that the advances were gifts, or that they were deposits held "in trust" for the investors.[11]

Fear Factors

At that point, the Tax Court could have called it a day. However, the court went on to observe that it "would reach the same conclusion under a multi-factor approach, which [the IRS] suggests might be an alternative mode of analysis." This was followed by a largely ceremonial review of the seven-factor *Welch* test,[12] which the Ninth Circuit developed to help determine whether funds received by a taxpayer from a business

[8] Fat chance.

[9] *See, e.g.*, *Frierdich v. Commissioner*, 925 F.2d 180 (7th Cir. 1991); *United States v. Henderson*, 375 F.2d 36 (5th Cir. 1967); and *Taylor v. Commissioner*, 27 T.C. 361 (1956), *aff'd*, 258 F.2d 89 (2d Cir. 1958).

[10] *See Bercaw v. Commissioner*, 165 F.2d 521, 525 (4th Cir. 1948) (an advance to a guardian to pursue litigation was not indebtedness because the guardian's duty to repay the advance arose only in the event that the litigation was successful); and *Estate of Paine v. Commissioner*, T.C. Memo. 1963-275 (purported loans were not indebtedness when repayment was due only if lawsuit generated proceeds).

[11] That Novoselsky did not deposit the advances in his client trust account certainly did not help.

[12] *See Welch v. Commissioner*, 204 F.3d 1228 (9th Cir. 2000); and *Todd v. Commissioner*, T.C. Memo. 2011-123, *aff'd*, 486 F. App'x 423 (5th Cir. 2012).

associate were a loan or taxable income. The Tax Court's use of the *Welch* factors signals that it viewed the investors as having a material economic stake in the litigation they were funding.

The Tax Court summarily dealt with six of the seven factors in a paragraph:

> The litigation support agreements that petitioner executed with his counter-parties generally refer to the advances as "loans." But petitioner did not execute a formal promissory note; no fixed schedule for repayments was established; petitioner provided no collateral or security; and no payments of principal were ever made. Some of the agreements provided for interest, others specified a fixed-dollar success premium. But no interest or other amount was ever paid. The counter-parties evidently viewed petitioner's personal ability to repay as irrelevant: They made the loans nonrecourse, with the advances being repayable only out of future litigation proceeds.

The picture here is mixed, as it typically is for nonrecourse loans. The Tax Court then turned its attention to the seventh *Welch* factor, which it said was the most important: Had the parties conducted themselves as if the transactions were bona fide loans?

That inquiry usually focuses on the parties' conduct after the purported loan is made. For example, if an alleged creditor responds to serious and prolonged payment defaults with a yawn, that is a good sign that the transaction is not really a loan. Honest-to-goodness creditors do not take payment defaults lying down. That doesn't necessarily mean breaking legs, but the creditor should be pursuing commercial debt-collection techniques.

The analysis in *Novoselsky*, on the other hand, focused on the loan terms — that is, the nonrecourse provision. Each of the investors had agreed that Novoselsky would have no obligation to pay unless the litigation was a success. That was not a conventional loan term, so the Tax Court seems to have concluded that Novoselsky and the investors had failed, *ab initio*, to conduct themselves as if the advances were bona fide loans.

Advance Compensation

Following its pro forma review of the *Welch* factors, the Tax Court turned to the case law. It immediately invoked *Friedrich*,[13] which it declared "the most relevant precedent." As such, *Friedrich* can help us understand what the Tax Court thought was going on in *Novoselsky*.

In *Friedrich*, a widow hired the taxpayer, an attorney, to represent her as the executor of her late husband's estate. The widow was well acquainted with the attorney, who had been her husband's partner in various real estate ventures. The attorney had also dealt with the widow in some business matters.

They came to an unusual arrangement. The widow not only hired the attorney to provide legal services, but also lent him $100,000. The attorney gave the widow a note bearing interest at 8 percent,[14] but there was no fixed schedule for repayment. Instead, the principal and accrued interest were payable when the attorney was due his fee, which was "subject to [the] closing of the estate." The widow was also authorized to deduct the loan balance from the attorney's fee.

The Tax Court recharacterized the widow's purported loan as an advance payment of the attorney's fee. The attorney's obligations under the note were not due until he was paid for the closing of the estate. He even testified that his fee would have provided him with the means to satisfy the note. The Tax Court found that, at the time of the advance, "both parties intended that repayment would be in the form of legal services with a final accounting and set-off at the time petitioner closed the estate and billed [the widow] for the legal services rendered."[15]

Novoselsky extended this analysis to include not only the advances received from the formal

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[13] *Friedrich v. Commissioner*, T.C. Memo. 1989-393, *aff'd*, 925 F.2d 180.

[14] That may be high by current standards, but the prime rate in the year of the loan (1980) exceeded 15 percent.

[15] *Friedrich*, T.C. Memo. 1989-393, *aff'd*, 925 F.2d 180.

plaintiffs, but also those received from the doctors and lawyers who were not parties but had interests in the outcome of the litigation. Notably, there was no reference to any investors who were simply "seeking a high return on a speculative investment":

> The facts of this case closely resemble those in *Frierdich*. Petitioner's counter-parties were clients, medical professionals with interests aligned to the interests of his clients, or lawyers with whom he had existing fee-sharing agreements. As in *Frierdich*, repayment of the supposed loans was explicitly linked to successful conclusion of the legal matters that petitioner had been retained to handle. Indeed, the facts here are stronger for respondent than in *Frierdich*. In this case, repayment of the advances was not just *linked* to successful conclusion of the litigation; repayment was not *required at all* unless the litigation was successful.

This last point refers to the fact that the estate in *Frierdich* was pretty much certain to be closed at some point, so the contingency related only to the timing of the attorney's fee. In *Novoselsky*, the contingency determined whether any obligation arose in the first place.

The Tax Court then held that the investors' advances were actually compensation for Novoselsky's legal services:

> We accordingly conclude that the advances petitioner received under the litigation support agreements were not loans for Federal income tax purposes. Rather, they were advance payments for the legal services that the counter-parties expected him to perform. As such, the advances were includible in petitioner's income when received as gross income under section 61(a).[16]

Novoselsky's resemblance to *Frierdich* is something less than exact.[17] Still, it is significant that the Tax Court's rationale was based on analogizing Novoselsky's "investors" to a widow who paid her lawyer in advance for his services.

In a professional litigation funding transaction, the funder will generally have no preexisting interest in the subject matter of the controversy. That should make it difficult for the IRS to argue that the funder's advance is a disguised payment for the attorney's legal services. As long as the loan documentation does not condition the borrower's obligation on the outcome of the litigation, *Novoselsky* should not prevent the advance from qualifying as indebtedness.

Conclusions

Novoselsky reminds us (if a reminder is needed) that plaintiffs and attorneys who want their loans to qualify as indebtedness should generally not prepare the documents themselves. In particular, they should not include language suggesting that their obligation to repay the loan in any way depends on the success of the litigation being funded. To avoid putting their personal assets at risk, they should simply limit their funders' recourse to a security interest in the litigation proceeds.

Of course, loans are not common in commercial litigation funding, further diminishing the reach of *Novoselsky*. In the few loans that we see these days, professional funding documentation already includes a non-contingent payment obligation. So that aspect of *Novoselsky* should not upset any apple carts. But there are some more nuanced lessons here, too.

Novoselsky cautions attorneys to avoid borrowing from clients or anyone else with a stake in the outcome of the litigation. Otherwise, there is a risk that the purported lender's advance will be recharacterized as an advance payment of compensation. If, on the other hand, the lender is a professional funder with no prior interest in the

[16]*Novoselsky*, T.C. Memo. 2020-68, at 24.

[17]The widow was paying for the attorney's legal services and nothing more. The investors in *Novoselsky*, however, were also getting a shot at recovering their capital and a premium. Nevertheless, the Tax Court characterized the full amount of their advances as "advance payment for legal services."

lawsuit, the probability of a recast seems considerably more remote.

Finally, *Novoselsky* may offer us a kind of general and nonspecific warning about attorneys receiving litigation funding, even legitimate litigation funding. The concern is that lawyers in stand-alone funding transactions — even properly documented ones — may face a somewhat greater risk of having their upfront money taxed than plaintiffs who are similarly situated.

That is, suppose that a plaintiff sells a part of his case under a prepaid forward contract that complies with the rules. It may be awfully difficult for the IRS to find a way to tax the upfront money until the contract closes at the conclusion of the case. But let's take the same facts, but say that only the contingent-fee lawyer is the seller under the contract, and the plaintiff is not even participating in the deal.

Suppose that the lawyer is entitled to 40 percent if the case produces money, and he sells his right to half of that fee. Even if the lawyer's funding deal is documented as a legitimate prepaid forward, it may be more tempting for the IRS to seek ways to attack the arrangement. After all, we know that the lawyer, unlike the plaintiff, is always earning compensation income, so a successful challenge will hit the lawyer with a lot of ordinary income. And, of course, the IRS has a long history of going after lawyers to set an example.

Perhaps this is one reason many lawyer funding deals are structured with the plaintiffs also participating on some level. It is another reason that the tax timing issues for lawyers may be a little more sensitive than for plaintiffs. And the tax timing issues for lawyers doing portfolio litigation finance transactions seem trickier still.

But those are issues for another day. As for Novoselsky, he could certainly say:

The record shows I took the blows
And did it my way. ∎