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Loans, Prepaid Forward Contracts, and Portfolio Funding

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In this article, Wood and Board analyze litigation funding for contingent-fee lawyers, explaining some of the complexities in funding multiple lawsuits and the implications of using various funding structures.

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Lawsuits are expensive, and litigation funding provides capital to plaintiffs and law firms. But not everyone appreciates funders, like defendants who might fear that funding could foment litigation, making plaintiffs and their law firms bolder when fueled with a firehose of nonrecourse money. For a time, some argued the antiquated doctrines of champerty and barratry to combat litigation funding, but other attacks have come, too.

In November 2022 the Institute for Legal Reform (ILR), an affiliate of the U.S. Chamber of Commerce, released what it called cutting-edge research. Litigation funding, the ILR warned, could lead to "the infiltration of the American legal system" by persons "acting on behalf of a foreign adversary like China or Russia." The ILR calls for a crackdown on litigation funding to address the "intolerable weak point in America's national security architecture."[1]

Another argument invokes a familiar meme: According to the ILR, litigation funders are promoting "vexatious and frivolous" lawsuits.[2] Funders are economic animals and based on what we have seen, vexatious and frivolous lawsuits are probably the last thing they would want to invest in. Nuisance suits may keep some lawyers afloat, but their appeal to this "multibillion-dollar, global industry" that "hedge funds and other outside financiers" use to invest in litigation seems microscopic.[3]

Funders often want to invest in a stable of cases from a lawyer or law firm. Imagine if you were a real estate lender; rather than lending against one building, how about lending against a whole block? Multiple properties hedge your risk. The same principle applies when a lawyer seeks funding for six, 10, or 20 cases.

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[1] ILR, "What You Need to Know About Third Party Litigation Funding" (Feb. 7, 2023); and ILR, "A New Threat: The National Security Risk of Third Party Litigation Funding" (Nov. 2, 2022). Sen. John Kennedy, R-La., expressed similar concerns in a recent letter to Chief Justice John G. Roberts Jr. and Attorney General Merrick Garland. Referring to our foreign adversaries, Kennedy warned that "litigation financing in our courtrooms is another dangerous weapon among [*sic*] their arsenal." *See* release, "Kennedy Urges Roberts, Garland to Take Action to Protect National Security From Foreign Actors Meddling in U.S. Courts" (Jan. 9, 2023).

[2] ILR, "Selling More Lawsuits, Buying More Trouble: Third Party Litigation Funding a Decade Later," at 17 (Jan. 2020) (allowing litigation funding to "fester" in False Claims Act litigation "would also pose serious risks to the nation's civil justice system").

[3] ILR, "New Poll: Voters Want TPLF Disclosure" (Nov. 15, 2022).

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It is easier to explain and structure funding for a single case, whether it is the lawyer, plaintiff, or both doing the structuring. But what about a lawyer's funding of a series of cases? We focus here on transactions between litigation funders and contingent-fee lawyers, beginning by comparing traditional loan-based structures with contemporary transactions structured as prepaid forward contracts (PPFCs).

We then comment on some tax issues relating to the increasingly common practice of portfolio funding, by which attorneys obtain financing using the fees that they hope to earn from multiple cases.[4] Contract mechanics vary, of course, and we consider how the drafting of litigation funding documents can affect the tax treatment.

It's About the Benjamins

Contingent-fee lawyers must clear two big hurdles to fund their practices. First, they don't get paid unless they win — whether in court or at the negotiating table — and that doesn't always happen. Second, even when they win, they aren't paid until the end of the litigation process, which can last many years.[5]

The resulting cash-flow challenges make contingent-fee lawyers natural candidates for outside funding. Combine that with the fact that their cases (disregarding the merely vexatious and frivolous ones) sometimes generate large fees and it is not surprising that the litigation funding industry has developed to help meet their needs. It probably would have happened decades ago (as it did in Australia and the United Kingdom) but for the states' attachment to traditional doctrines regarding champerty, which disfavored maintaining a lawsuit in return for a financial interest in the outcome.

Tax and Transaction Structure

To finance their cases on a nonrecourse basis, contingent-fee lawyers must offer funders unusually high returns on their advances, making litigation funding an expensive way to raise cash. Lawyers will want to take the lowest feasible advance to minimize their financing expenses.

Thus, it is best if the funder's advance does not subject the attorney to immediate tax. If an attorney needs to build up a $1 million litigation "war chest," he will not want a transaction that forces him to take a $2 million advance because he has to pay 50 percent of the funding straight to the tax authorities. Litigation funding transactions must be designed to be taxed on a deferred basis.

The most straightforward way to make sure the upfront money is not taxed immediately is to structure the transaction as a loan. If the funder's advance represents bona fide loan proceeds, it will not be taxable to the attorney when received — or ever, unless he fails to repay it. Twenty years ago, most funding transactions were loans.

Today, however, the funding transactions we see are only rarely cast as loans. That might in part be because of usury or other nontax issues. But there are also various tax reasons for funders and their flow-through investors to prefer transactions using PPFCs. A PPFC provides for a future sale of property, in this case a portion of the fees that the lawyer hopes to earn in the future. PPFCs generally work well for lawyers, too, and they have become the norm — at least among sophisticated litigation funders.

Nonrecourse, of Course

In a promising mass tort case, even a small law firm can spend $10 million on advertising and vetting expenses to assemble a few hundred plaintiffs with viable claims.[6] Even when drumming up clients is not an issue, the direct costs of litigation can be considerable. Even if litigation could be conducted without expenses, the timing problems inherent in contingent-fee practice mean that a firm may have to finance its overhead — notably its payroll and partner

[4] Portfolio funding is another ILR target. These transactions, the ILR warns, pose many hazards, including the risk that "a foreign adversary like China" could use them to "underwrite a portfolio of lawsuits against numerous U.S. companies across a wide swath of critical sectors." ILR, "A New Threat," *supra* note 1, at 14.

[5] For convenience, we freely use the term "litigation" to refer to legal disputes that are concluded without the filing of an actual lawsuit.

[6] The recent saturation advertising soliciting potential claimants in the Camp Lejeune contaminated-water litigation provides some idea of where the money goes.

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compensation — for months or years during which the firm collects no fees.

Given the sums involved and the risk that the litigation won't pay off, litigation funding is invariably conducted on a nonrecourse basis. When the transaction is structured as a loan, the funding will be nonrecourse in the technical legal sense. The attorney makes an unconditional promise to repay the loan principal, together with interest (although it may have a large contingent component).[7]

The funder, on the other hand, agrees that its only recourse in the event of default will be to make a claim against specified assets, in which the funder is granted a security interest. The assets in question (the funder's collateral) are the fees that the attorney-borrower recovers in the litigation. If those fees do not materialize or are insufficient to satisfy the attorney's obligations, the funder may not use creditors' remedies to collect what it is owed from the attorney's other assets.[8]

Under a PPFC, in contrast, the attorney does not promise to repay the funder's advance. The advance is simply the purchase price of the fees that, should he earn them, the attorney has agreed to sell to the funder. The attorney has promised to sell and pay over specified fees, not to repay a loan in the amount of the advance.

Technically, there is nothing nonrecourse about the attorney's obligation under a PPFC. If the attorney earns a fee and fails to pay, the funder can start a proceeding against the attorney personally for breach of contract. However, the arrangement is nonrecourse in a colloquial sense, because the funder has no rights against the attorney if no fee is earned.

That follows from the conditional definition of the attorney's obligation in the PPFC. If the litigation collapses and the lawyer gets nothing, the attorney's failure to pay anything to the funder is not a default under the contract terms. The disappointed funder cannot proceed against the attorney's other assets because the funder has no right to payment in the first place.

Although the PPFC in itself creates an obligation to remit fees only if they are earned, there is no reason that this contingent obligation cannot itself be secured. Indeed, it is a rare litigation funder that does not also have the lawyer sign a security agreement that will provide the funder with a lien on any fees that are recovered.[9] However, the main purpose of the security interest is to establish the funder's priority claim to the fee as against third parties if the lawyer defaults or goes into bankruptcy.[10]

Attorney's Tax Treatment

The attorney's tax treatment in a loan-based funding transaction is straightforward. The lawyer does not include the funder's advance in gross income, and he is not permitted to deduct his payments of loan principal. However, the lawyer should generally be able to deduct the portion of each payment that is determined to be actual or deemed interest on the advance.

If the funding transaction is structured as a PPFC and classified as a sale for tax purposes, you might expect the lawyer to have a taxable event upon receipt of the funder's advance. Sales are taxable, after all. However, a critical feature of the PPFCs used in litigation funding is that they are drafted as "variable" PPFCs.

In a variable PPFC, the amount of fees that the attorney must deliver depends on facts that won't be known until the relevant litigation is resolved.

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[7] If the attorney's obligation to pay the funder is contingent by its own terms (*i.e.*, if the agreement states that the attorney has no *duty* to pay unless he earns a fee), the IRS has a good argument that the purported loan does not qualify as indebtedness for tax purposes. In a much-publicized case, the Tax Court required a contingent-fee attorney to include several advances in income in the years received because (among other factors) the funding agreements stated that repayment of the purported loans was due only if the attorney recovered fees. *See Novoselsky v. Commissioner*, T.C. Memo. 2020-68; Robert W. Wood and Donald P. Board, "Do-It-Yourself Litigation Funding à la *Novoselsky*," *Tax Notes Federal*, Aug. 31, 2020, p. 1665.

[8] Given that description, it might be better to describe the loan as being made on a "*limited* recourse" basis. However, if the funder's recourse consists of nothing but a security interest, the funder has waived its normal right to proceed against the lawyer personally (obtain a judgment *in personam*) and retains only specified rights *in rem* (a security interest that can be enforced against persons generally). From that perspective, the loan is indeed nonrecourse, because the funder has no recourse against the attorney if its rights *in rem* prove insufficient to recover all that it is owed.

[9] Sometimes, the grant of security is included as a provision in the PPFC itself, but it is still just a supplement to the underlying contract for the future sale of a portion of the attorney fees.

[10] It also helps that it is easier and faster for a secured creditor to foreclose on collateral than it is for an unsecured creditor to get a judgment and send the sheriff to seize the debtor's property. However, those timing advantages typically disappear if bankruptcy intervenes. Another function of a security interest is to provide backup rights in case the PPFC is recharacterized as a loan.

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In a sale of attorney fees, the lawyer's gain or loss depends on the difference between the funder's advance and the amount of fees that the lawyer pays to the funder.[11] If the latter is unknown when the attorney receives the advance, there is no way to calculate the actual amount of the lawyer's gain.

Under section 61(a)(3), taxpayers are taxed on their gains derived from dealings in property, not the purchase price they receive. Hence, the lawyer has a prima facie case that no tax is due on his receipt of the purchase price. As long as the purported sale of fees is respected as a sale of property, the lawyer should generally be able to defer tax until it is possible to calculate whether he realized a gain and in what amount.[12] In the meantime, the amount paid to the lawyer is treated as if it were a tax-free deposit.

From a sale perspective, it is notable that the property being sold — that is, the actual fee recovered (or, more accurately, the attorney's liquidated and fixed claim to be paid a fee) — does not exist when the parties enter into the PPFC and the attorney receives the advance.[13] Under the sensible axiom that one cannot sell or transfer property that does not exist, the attorney's entry into a properly drafted PPFC doesn't result in the immediate sale of anything.[14]

PPFCs and Rev. Rul. 2003-7

One can argue that postponing the effective date of the sale because the parties are using a PPFC may be artificial. Given the right facts, the IRS could contend that (1) it is pretty clear *which* items of property will ultimately be sold; and (2) the uncertainty regarding *how much* property will be transferred is not great enough to justify deferring tax on some or all of the transaction.

The IRS considered those issues in Rev. Rul. 2003-7, 2003-1 C.B. 363, which remains its most important statement regarding the tax treatment of PPFCs. In the ruling the taxpayer entered into a PPFC, committing him to a future sale of between 80 and 100 shares of a publicly traded stock, depending on the future price of the shares. The prospective buyer, an investment bank, paid the purchase price of the shares upfront. The taxpayer's goal was to get cash in hand based on the value of his appreciated shares without triggering realization of gain (a stock monetization transaction).

To secure future performance of his obligation, the taxpayer pledged 100 shares of the stock in question. The taxpayer delivered the shares to an independent trustee, although he retained the right to receive dividends and to vote the shares in the absence of a default. The question was whether the taxpayer should be taxed as if he had sold the pledged shares when he entered into the PPFC and received the investment bank's advance.

The IRS held that the PPFC should be respected as merely providing for a future sale if: (1) the number of shares that the taxpayer was required to deliver under the contract was subject to "significant variation"; (2) the taxpayer was legally free to settle his obligation by delivering the same amount of value in the form of cash or shares other than those that he had pledged; and (3) the taxpayer was not subject to "economic compulsion" to settle the PPFC by delivering the pledged sharers to the investment bank.[15]

How does a contingent-fee lawyer's PPFC stand up under Rev. Rul. 2003-7? The lawyer is agreeing to sell a variable portion of the fees that may (or may not) be recovered in the future. The lawyer should generally have no problem

[11] If the attorney has been capitalizing his litigation expenses, those amounts should also be taken into account.

[12] For a spirited argument that the attorney should nonetheless be taxed on receipt of the funder's advance, see Mark H. Leeds and Stephanie Wood, "Litigation Finance Update: US Tax Court Refutes Loan Treatment for Upfront Litigation Support Payments in *Novoselsky v. Commissioner*," Mayer Brown (June 2, 2020).

[13] For expository purposes, we will continue to describe PPFCs as sales of a portion of the fee itself. However, the fee should probably be characterized as cash proceeds of the attorney's liquidated and fixed claim that was purchased by the funder.

[14] The commercially minded may note the analogy to the operation of an after-acquired-property clause in a security agreement or mortgage.

[15] Because the PPFC involved publicly traded stock, Rev. Rul. 2003-7 considered not only common-law tax principles but also the constructive sale rules of section 1259. The IRS held that the PPFC did not provide for the sale of a "substantially fixed amount of property," which removed it from the definition of "forward contract" in section 1259(d)(1). Thus, the taxpayer's entry into the contract did not trigger a constructive sale under section 1259(c)(1)(C).

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establishing that the amount of property to be sold was subject to significant variation.[16]

It is also advisable to include a provision making it clear that the attorney may settle using cash drawn from sources other than legal fees from the litigation being financed. That should make it harder for the IRS to contend that the transaction was a current sale of the attorney's unliquidated and contingent fee claim because he was required to pay the funder from the fee proceeds generated by that claim. Of course, it is helpful if the attorney has other sources of funds to pay the funder (that is, the attorney will not be under any economic compulsion to draw on the fee recovered), but there is not much that can be done if he does not.

Reporting Gain or Loss From a PPFC

Suppose that a lawyer enters into a PPFC in 2023 to obtain $2 million in funding for a consumer fraud suit against an automobile manufacturer. If the lawyer recovers a fee, the contract requires him to pay the funder a multiple of the $2 million advance that depends on the amount of the fee and the year in which it is recovered. In 2027 the lawyer earns an $11 million fee and pays $6 million to the funder.

When the attorney reports his income for 2027, he should report two items. The first is $11 million in compensation, corresponding to his fee. The second is the gain or loss he realized when he settled the PPFC. That is the difference between the $2 million he received from the funder in 2023 and the $6 million paid to the funder in 2027.[17]

The attorney should therefore report a $4 million loss on the PPFC. Because the attorney's right to payment for his services was not a capital asset, the loss should be ordinary. Taken together, the $11 million fee and the $4 million ordinary loss should result in the attorney having to pay income tax on $7 million of ordinary income.

What if the suit against the auto manufacturer generates only a $500,000 fee, all of which must be paid to the funder? Now the attorney has $500,000 in compensation and a $1.5 million ordinary gain on the PPFC ($2 million received minus $500,000 paid). That adds up to $2 million of ordinary income. Not coincidentally, that is the same amount that the attorney received from the funder without paying tax back in 2023, and the piper must now be paid.

Portfolio Funding

Like other litigators, contingent-fee lawyers often pursue more than one case at a time. If a firm has six pending cases, it might enter into six different deals with six different funders. That might sound a bit extreme, but it is not uncommon for contingent-fee lawyers to have concurrent arrangements with more than one funder. This is especially true of lawyers who make it a point to shop around as market conditions change.

However, there are factors that can encourage a law firm to finance multiple cases with a single funder. Besides administrative convenience and possible economies of scale, litigation funders may be able to reduce their investment risks by diversifying their nonrecourse investments in a specific firm. That may translate into more favorable terms for attorneys who bundle multiple cases into a portfolio for funding purposes.

Keeping It Together: Loans

If the funder is going to lend against a portfolio of cases, the transaction could be structured as a single nonrecourse loan (potentially with multiple advances) secured by all the fees that the attorney may earn from the portfolio. If the funder prefers to use case-by-case loan agreements, the loans can all still be secured collectively using a single security agreement (with a future-advance clause to cover loans made at different times) that will cover all fees generated by the portfolio. Or the funder could use multiple security agreements with cross-collateralization provisions.

There is nothing especially exotic about such a loan structure. The loan is paid off in installments as the attorney recovers specific fees. A tax

[16] The "significant variation" requirement does not strictly apply to litigation funding transactions because they are not subject to section 1259. However, the amount of variation in the amount of property to be delivered seems relevant to an analysis under common-law tax principles. As discussed below, that there is significant uncertainty regarding how much the attorney will be required to pay the funder typically means that it is not feasible to calculate the attorney's gain or loss under the PPFC until the underlying litigation has been resolved.

[17] To keep things simple, assume that the attorney has no capitalized expenses and that none of the sale proceeds is treated as interest.

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accountant can work out how much of each payment represents principal and how much is accrued but unpaid interest. Interest payments should generally be deductible by the attorney and includable by the funder in the year paid and received.

Breaking It Down: PPFCs

Multiple cases and advances can easily be consolidated by using a portfolio loan structure, but transactions using PPFCs are less accommodating. A PPFC is a contract for the future sale of attorney fees. Thus, we must consider the implications when a PPFC provides for the sale of fees generated by the multiple cases that make up the portfolio.

Ever since *Williams v. McGowan*,[18] the general principle governing the sale of a set of assets has been that the seller's gain or loss must be determined on an asset-by-asset basis, even if the assets are sold simultaneously to a single buyer under a single contract and are undeniably part of a single trade or business. It is therefore necessary to allocate the purchase price paid for the full set of assets among its component items. Absent an allocation by the parties, that is done by allocating the overall price to each asset in proportion to its fair market value.

The same principle applies when the assets are sold at different times. A portfolio funding transaction using a PPFC cannot remain unreported and untaxed until the final case is settled, when we can determine the attorney's *overall* gain or loss on the contract. Unlike attorneys who take secured loans, attorneys who use PPFCs should report their gains and losses piecemeal as specific cases are resolved and they settle up with their funders.

Allocating Advances to Cases

Calculating case-by-case gains and losses requires an allocation of purchase price. However, it is rare to see a PPFC that allocates the funder's advance among the cases in the portfolio. When the point has come up — typically a week or two before tax returns are due — we have seen attorneys have some success going to the funder and asking for an allocation based on how the funder valued the component cases during the underwriting process.

It is unnecessary for the funder to provide the attorney with specific dollar amounts, which could be sensitive information. All the attorney needs is an allocation cast in percentage terms. The attorney can then use the percentages to allocate the funder's advance to specific cases.

We have also seen lawyers comb through the history of their negotiations with the funder and then try to make reasonable inferences about how the parties were implicitly valuing the cases in the portfolio. As you would expect, some of these efforts are more convincing than others. Perhaps as you would *not* expect, we have seen no sign that the attorneys were pushing for allocations that would accelerate their losses and defer their gains.

Lawyers involved in portfolio deals can probably do themselves and their tax return preparers a favor by getting an allocation of the funder's advance into the PPFC (or a side letter) before they sign. Since the parties have opposing tax interests (the attorney's loss is the funder's gain), the IRS will likely defer to any allocation they come up with unless it is patently unreasonable.

What if we look beyond the funder's initial advance? If an attorney has a portfolio of five or 10 cases, it is a good bet that the funder will make multiple advances over an extended period. All this additional purchase price needs to be allocated, too.

In that case, the parties might want to include a provision in the PPFC that allocates the funder's future advances. The simplest approach would be for the parties to agree that the allocation of the funder's initial advance will apply to all advances. Of course, future advances should not be allocated to cases that have been resolved and paid off. That could be dealt with by recalculating the allocation percentages when a case drops out of the portfolio.

Those kinds of mechanical allocations have their advantages, but they can collide with reality. In many PPFCs, the funder commits to making additional advances if specified cases reach designated milestones. For example, the funder might become obligated to advance an additional

[18] *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945).

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$1 million if the *Smith* case survives a motion for summary judgment.

Suppose that the lawyer exercises the right to take a $1 million advance. Should we conclude that the funder is paying it as additional purchase price for the funder's slice of fees generated by the *Smith* case? If so, allocating the advance over a portfolio of 10 cases based on the original percentages would seem perverse. Would the parties be willing to live with that kind of arbitrary allocation?

We might ask similar questions about some negotiated future advances. Suppose the attorney politely asks the funder for another $500,000, and the funder makes that advance. What if the attorney simultaneously agrees to increase the funder's potential return from the *Jones* case, from the first $750,000 in fees recovered to the first $1.5 million? Would that make it unreasonable to allocate any of the $500,000 to cases other than *Jones*?

It is hard to know what the IRS would make of all this. Fortunately, it does not appear that allocations can be used to manipulate the character of the parties' gains and losses. Everything is ordinary income for the lawyer, and the funder will presumably report either all capital or all ordinary income from its investment in the cases. The IRS should find that reassuring.

As suggested, allocations affect timing. But that is an issue in which the parties' interests will generally be directly opposed. So portfolio funding could be an area in which the IRS might not see a reason to object if the parties adopt an initial percentage allocation and stick with it through thick and thin.

Conclusion

Litigation funding has become an integral part of many firms' contingent-fee practices, and the trend seems to be increasing. Yet the amount of authority or even informal IRS guidance addressing how attorneys should be taxed on these transactions, especially those structured as PPFCs, remains sparse. The same can be said about the tax treatment of litigation funders and their investors when transactions are settled.

Of course, one never knows what tomorrow will bring. In the wake of the *Childs* case — now almost 30 years old — an industry that helps contingent-fee attorneys defer tax on their fees has flourished.[19] However, fee-structuring firms and their counterparties were knocked for a loop in December 2022, when they first learned about an IRS legal memorandum in which IRS lawyers challenged fee-deferral structures.[20]

Nothing indicates that the IRS is about to start challenging litigation funding transactions, but as we have suggested, areas of uncertainty remain. ■

[19] *Childs v. Commissioner*, 103 T.C. 634 (1994), *aff'd without opinion*, 89 F.3d 856 (11th Cir. 1996).

[20] AM 2022-007.

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