Breaking the chains

Thomas Jones argues that sophisticated clients should not be bound by DBA regulation

In October 2019, Professor Rachael Mulheron and Nicholas Bacon QC published the draft Damages-Based Agreements Regulations 2019. The draft regulations represent an ambitious and welcome attempt to fix some of the well-rehearsed challenges with the Damages-Based Agreements Regulations 2013 that have impeded the adoption of damages-based agreements (DBAs) as a viable fee model for funding litigation. Introduced in 2010 as a product of the Jackson reforms, DBAs were viewed as an efficient form of funding, increasing the number of options available to litigants – which would, in turn, increase access to justice and allow commercial parties to agree fee arrangements that best fit their needs. But the adoption of DBAs in the market has been sluggish, at least in part due to the restrictions and ambiguity inherent in the 2013 regulations.

The problems with the 2013 regulations are well known, and do not need rehearsing here in any great detail. However, the 'all-or-nothing' approach, the concerns over the outcome of the termination of a DBA, and the treatment of counsel's fees are some of the more common complaints about the efficacy and enforceability of DBAs as currently regulated. The draft regulations are a great improvement on the current regulations, and are to be applauded in their attempt to solve these problems. The task is not easy though, and the solutions proposed raise a host of questions themselves. In particular, the balancing lines drawn between allowing for a more robust and flexible DBA regime while protecting litigants, and the court system, from abusive practices and unfair bargains create a complex and restrictive system that is unnecessary for the protection of more sophisticated claimants.

A ONE-SIZE-FITS-ALL APPROACH

There is nothing novel in pointing out the difficulties in this sort of regulatory balancing act, but the issue is exacerbated by the fact that the draft regulations are over-reaching in their scope.

The draft regulations propose a one-size-fits-all regulatory scheme with significant restrictions on commercial arrangements, that is applicable to all litigants, regardless of their size or sophistication.

While the protection afforded to smaller or less sophisticated litigants is salutary, in the case of those fee arrangements that are often necessary to finance large, complex disputes, one size does not fit all. By attempting to regulate (read, restrict) all DBAs in the same manner regardless of the experience, bargaining position and commercial needs of the client, what results is an overly restrictive regime that places artificial contractual restrictions on parties that do not require additional regulatory protection. Instead, such parties should enjoy the same freedom of contract that they otherwise have in the market to arrange their commercial affairs.

At their heart, the draft regulations are a type of financial regulation. They are an attempt to police the economic affairs of the parties involved, to improve or prevent failures in the market for lawyer/client contracting.

It is common for financial regulatory schemes to have one approach for consumers and less sophisticated market participants, and another more permissive regime for other participants. A similar approach should be adopted by the draft regulations, and doing so will have a significant, positive impact on the take-up of DBAs.

Of course, this is not just any market, it is the legal market, and arguably this market has a distinct place in society that requires a regulatory scheme far removed from that appropriate to the financial sector. That is a sound argument as a general proposition and, as a result, the legal profession is already a uniquely regulated segment of the market, with a myriad of rules regarding the behaviour of lawyers and strict regulations regarding lawyer malpractice affecting clients, their funds and their matters.

The draft regulations on DBAs could be viewed as an adjunct to the existing regulations governing lawyers, but they are only really concerned with one thing - the economic agreement between the parties for the lawyer to pursue a case on behalf of the client. Therefore, the comparison to financial regulation is apposite, and the need for a more nuanced approach is merited.

UNNECESSARY BARRIERS

One of the difficulties with the draft regulations, in particular Regulation 4 which principally deals with the fee arrangement, is that the limitations and restrictions imposed by the regulations regarding, for example, financial caps, limited availability for hybrid DBAs, and the treatment of expenses, appear to be largely designed for the protection of individuals and smaller entities. However, such regulatory components impose unnecessary barriers to constructing appropriate commercial arrangements with sophisticated counterparties who do not require regulatory protection when negotiating fee arrangements with their lawyers.

> DBAs present cash-constrained companies with a way of accessing justice suited to their financial needs

For example, the draft regulations reduce the existing cap on the amount of the recovery that the lawyer can retain from 50% to 40%, in return for a different approach to the recovery of expenses and adverse costs paid by the other side in the dispute. However, it should be uncontroversial if a corporate client and its law firm want to structure a DBA where the lawyer takes a 50% DBA payment in return for taking all of the financial risk of running the case, including expenses and non-recovery of costs from the other side.

Another example would be a case that is expected to be hard fought, but eventually settles before the conclusion of a trial. This could be problematic if the lawyer and its client now have to devise a way to apportion a part of the settlement proceeds to 'recoverable costs' in order to compensate the lawyer for being capped at 40% of the recovery.

A widely anticipated change in the draft regulations is to allow for hybrid DBAs. Hybrid DBAs can generally be described as a form of fee arrangement where the lawyer is paid a discounted fee during the life of the case, but is also entitled to a share of the recovery if the case is won.

However, the hybrid DBA regime as contemplated by the draft regulations allows for only one, quite limited, type of hybrid solution.

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As envisaged by the draft regulations, hybrid DBAs shift much of the risk to the lawyer by preventing a lawyer from being paid any more than 30% of its fees, which can be retained whether the case is won or lost, and could lead to an even lower fee if the case is won, but with a low recovery amount. Many lawyers would prefer a less restrictive part payment/part share of recovery hybrid arrangement, that could solve understandable cashflow concerns in a more flexible and certain way.

The real issue, though, is that these are commercial negotiations, and a variety of structures might be envisaged depending on the needs of the client and the lawyer as well as the size, type and complexity of the case. In many cases, greater flexibility would be beneficial to both client and lawyer, and reducing the options available to sophisticated litigants is an unnecessary commercial restriction.

AN EXEMPTED CLASS

There are several ways, as well as regulatory precedents for, a class of protected or exempted person to be defined. The FCA has a definition of 'consumer' that could be used as a starting point to define the protected class, and it could be enhanced by the inclusion of smaller companies with, for example, total assets of less than a prescribed amount.

However defined, the goal would remain to offer the protection envisaged by the draft regulations to that segment of the legal market where there is greater potential for misuse of, or unfair terms in, a DBA.

The exempted part of the market should be able to rely on its own commercial acumen, principles of contract law (with its greater range of available remedies other than draconian avoidance of the contract), and the substantial regulatory scheme that already applies to the conduct of lawyers, for adequate protection without complicated restrictions that forces them into a sub-optimal financing structure. By removing many of the operative restrictions on DBAs for this class of litigant, the court system would also be less burdened with challenges on the validity of DBAs.

Corporate clients want their lawyers to provide innovative pricing structures, and to share risk with them on litigation (and even transactional) matters. Engaging lawyers on a DBA basis can certainly be an attractive pricing structure for the client, but it also requires that law firms take on substantial risk as well. These risks are best balanced when a commercial structure can be negotiated that fits both party's needs.

DBAs present cash-constrained or growth-phase companies with a way of accessing justice that is best suited to their financial needs, and gives them a more attractive recovery prospect than existing funding options. If the government's policy is truly to make DBAs a workable component of the legal system and to keep the English legal market competitive, allowing lawyers and their larger clients to structure legal engagements that best meet their legal and commercial needs is a commendable approach to achieving those ends.

Thomas Jones is managing director, Legis Finance