Legal Insight

K&L GATES

www.klgates.com

27 September 2011

Commercial Disputes

Reducing Litigation Risk for Pension Funds - Recouping Losses from Recent Economic Failures by Utilising Alternative Funding Mechanisms

How the prudent trustee can (and ought to) maintain a robust approach to litigation when confronted with the need to sue defendants with deep pockets.

The pensions industry is known for its conservatism when it comes to litigation. Whilst high profile collapses such as Enron and Parmalat have forced bigger schemes to be more proactive about the recovery of pension assets, typically prudent trustees will seek to avoid litigation. This is unsurprising, given the potential costs obligation to an opponent in the event of the loss or withdrawal of the claim and the cash flow burden of running litigation. But a trustee has a fiduciary duty to act in the best interests of the beneficiaries, and investing in a claim against a negligent third party could generate as much "benefit" as any other form of investment in the right circumstances. In fact, litigation is increasingly regarded by some private equity funds as an ideal investment opportunity, particularly in light of insurance products which are purchased after the dispute arises to alleviate cost risk. This article considers developments in the funding of litigation and the availability of costs insurance. These changes serve to release the prudent pension trustee from the constraints of the traditional litigation model.

The Obligations of Trustees: To Litigate or Not to Litigate?

The obligations of UK pension trustees are clearly defined and include an obligation to set out a statement of investment principles, together with their policy in relation to the exercise of rights attaching to investments. What if the investments have performed poorly as compared to expectations or the market generally? What “rights” attach aside from the usual voting rights? Would this include the right to seek the restoration of badly managed assets? If there is a possible claim against investment advisers for example, to what extent must this be investigated? Whether or not it is considered prudent to commence litigation it is undoubtedly the case that such a decision ought to be an informed one. This issue is one which must be addressed by existing trustees without regard to the passing of time or personal responsibility. Any trustee has a responsibility to investigate any claim which becomes known during his or her period of office regardless of when the claim arose. Any delay in the investigation or prosecution of a claim could give rise to an allegation of contributory negligence.

Pensions litigation is unusual in that trustees have to conduct themselves in a way which affects many members, who are not themselves involved in the litigation. Protections therefore need to be put in place not merely for the trustees themselves, but also for the scheme generally so that the individual interests of members are protected. However where once a trustee would have to carefully consider the effects of litigation on a scheme, particularly a scheme which is underfunded, the availability of alternative funding mechanisms permits greater flexibility in decision making, and can protect the scheme from the vicissitudes of litigation.

Reducing Litigation Risk for Pension Funds

New Cost Models –Management Tools for Pension Trustees

Pursuing litigation using alternative funding mechanisms has become commonplace in the personal injury market, but such mechanisms are still used in a surprisingly limited way for commercial disputes. Theoretically, in today's legal market, a party could litigate without any cost risk at all, both in terms of paying their own costs or that of a winning opponent. Fully offsetting the cost-risk could have knock-on consequences in terms of expectations on recovery, but there are a wide range of intermediate possibilities which provide appropriate risk management tools for commercial litigation. These include:

- 'After the Event' insurance policies
- Conditional Fee Agreements
- Third Party Funding

At K&L Gates we have a team of lawyers who regularly advise on insurance coverage matters and who can advise on the terms of 'After the Event' insurance arrangements. We have experience in advising on the effective combination of various alternative funding mechanisms to facilitate litigation for a range of clients.

After the Event Insurance ("ATE")

ATE insurance policies initially grew out of the need to protect personal injury claimants from the cost risk of losing their claims. This was necessary because of the general principle in the UK that the losing party pays the costs of an opponent. At its most basic, an ATE policy will pay an opponent's costs in the event that the insured is ordered to pay them, but ATE has developed to become a more complex product and is one of the most significant factors stimulating the growth of alternative litigation funding. Private equity funds who are active in the funding litigation market often utilise ATE to offset their own cost risk, and it facilitates conditional fee agreements as between clients and their legal advisers. The benefit of an ATE policy is that it is flexible, can be crafted to support most types of dispute, and its use is not necessarily restricted to the UK courts.

ATE is available *after* a dispute has arisen, and proceedings have been, or are about to be, commenced. The insurer agrees to indemnify the insured in respect of legal costs in the event that the claim does not succeed, subject to an agreed limit of indemnity. The coverage includes potential liability for: (i) ***adverse costs*** i.e. the liability for an opponent's costs and disbursements if the case does not succeed (which could extend to adverse costs on interim applications); (ii) ***own costs***; and (iii) ***own disbursements*** including fees for Counsel and experts such as actuarial experts.

The ATE premiums may be ***deferred*** until the conclusion of the case and the premium is usually ***staged*** such that it becomes due in instalments during the course of the proceedings. This is the most cost-effective way of utilising ATE. The premium is typically ***conditional*** and is not payable if the claim does not succeed. If the claim does succeed and a favourable costs award is obtained then, in the English Courts, the premium is currently ***recoverable*** from the other party, subject to assessment by the court. Thus a party with ATE is in a ***win-win*** situation with regard to its legal costs.

At K&L Gates we have experience in assisting clients structure and obtain ATE products which suit their requirements. High value commercial cases require specialist ATE policies which can, if used appropriately, provide a ***tactical benefit*** and enable Trustees to ***reduce costs risk***. The regulations relating to ATE policies also serve to drive an early settlement in light of increasing liabilities on staged payment premiums.

Insurers will be keen to accept only those risk-profiles where there is a ***good prospect of success*** in the litigation. This will require a detailed legal analysis of the prospects of success. This rigour can provide a ***tactical benefit*** because an opponent who is put on notice that an ATE policy has been entered into is on notice that the claim has been accepted often after an independent analysis by a third party. This is particularly useful when a Pension Fund Trustee is litigating against an institutional defendant as it neutralises the perceived reticence of pension fund trustees to litigate or to risk the costs of a trial.

The definition of "***success***" is a key component in an ATE policy. If ATE cover is provided to a claimant, the definition of success will commonly include: (i) a settlement whereby the opponent accepts a liability to pay a money sum to the claimant; or (ii) a judgment/award whereby the opponent is ordered to pay a money sum to the claimant.

ATE does not generally provide a cash flow advantage as, save in the case of an adverse costs order on an interim application, payments are not made until the conclusion of the case. Pension Funds seeking to ***manage cash flow*** as well as risk may decide to enter into a conditional fee agreement with their legal advisors.

Conditional Fee Agreements ("CFAs")

K&L Gates have tried and tested experience of CFAs. We are happy to share risk with our clients in suitable cases using these agreements. They may contain the following elements: (i) an agreement to pay more than the solicitor's normal rate if the claim ***succeeds***; (ii) an agreement to pay a ***reduced rate*** if the claim does not succeed; or (iii) an agreement that a proportion of the reduced rate will be ***deferred*** until the conclusion of the case.

If the claim succeeds and a favourable costs award is obtained then any increased fee rate is currently ***recoverable*** from the losing party in the English courts, subject to assessment rules which are applied by the court.

CFAs can also be structured in a way which provides for the insurance of deferred solicitor-own client costs through an ATE policy. This may achieve a cash-flow saving on the ongoing costs of litigation, with the ultimate protection being that such costs are paid out by the ATE policy in the event the litigation is unsuccessful and they are not recovered from the other side. For example, under example (ii) above, if a claim protected by ATE does not succeed and provides for own cost cover, then the insurer pays the reduced rate (including any deferred portion) to the client's legal advisers. If the claim succeeds then a party can expect to recover at least some of its costs from the other party.

Barristers may also act on a CFA although this is still relatively uncommon at the commercial bar, largely because a barrister is a self-employed, sole practitioner and less able or willing to take the commercial risk. K&L Gates' experience however is that commercial barristers with the requisite expertise may enter into a CFA agreement in the latter stages of a case where the facts are clear and the time investment is limited and calculable.

Expert witnesses cannot have an interest in the outcome of the case and so cannot act on a CFA.

Third Party Funding

As an alternative to funding litigation with the help of an ATE policy, a potential litigant could seek finance from a third party funder. Hedge funds and private equity funds provide coverage for cases

Reducing Litigation Risk for Pension Funds

where there is a good chance of success and typically cover costs and disbursements in return for a percentage of the damages recovered. Third party funders will utilise ATE and CFAs to offset their litigation risk, in the same way as any other party to litigation.

The difference between ATE insurance and third party funding is fundamentally one of cost: a third party funder will require a substantial proportion of the damages by way of payment, usually around or above 30%, whereas an ATE policy has a fixed cost premium of around 30% of the costs liability insured. This reflects the fact that the third party funder pays ongoing costs and disbursements and the claimant is effectively allowed to run the litigation on a fully "risk free" basis. ATE policies providing a more limited form of protection may be preferable to Pension Funds because they sufficiently limit risk, yet facilitate a maximum recovery for the members.

The Future

Lord Justice Jackson's review into civil litigation costs published in January 2010 sought to address problems caused by alternative funding, largely in the personal injury sector. Draft legislation, which will affect all types of civil litigation, now seeks to end the recoverability of CFA success fees and the ATE premiums (save with limited exceptions) from a losing party. However solicitors will in future be allowed to enter into "damages-based agreements" (DBAs), more commonly know as contingency fees, in most civil litigation. It is likely that such legislation will not be effective until at least spring 2012.

Conclusion

Alternative funding mechanisms as currently constructed can facilitate the pursuit of litigation in a way which manages cost and risk, and gives rise to the possibility of making a claim where Scheme Assets might otherwise make such litigation imprudent. Pension Funds seeking to take advantage of alternative funding mechanisms should maximise the benefits by planning well-ahead. Alternative funding mechanisms enable a Pension Fund trustee to:

- effectively control dispute resolution costs;
- budget effectively;
- manage limited resources; and
- facilitate risk management.

The Authors:

Anne McCarthy
anne.mccarthy@klgates.com
+44.(0)20.7360.8174

Thomas Ross
thomas.ross@klgates.com
+44.(0)20.7360.8238

Clare Tanner
clare.tanner@klgates.com
+44.(0)20.7360.8258

Reducing Litigation Risk for Pension Funds

K&L GATES

Anchorage Austin Beijing Berlin Boston Brussels Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt Harrisburg Hong Kong London Los Angeles Miami Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh Research Triangle Park San Diego San Francisco Seattle Shanghai Singapore Spokane/Coeur d'Alene Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of 38 offices located in North America, Europe, Asia and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information about K&L Gates or its locations and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.