

# FINANCING OF LITIGATION BY THIRD-PARTY INVESTORS: A SHARE OF JUSTICE?©

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This article addresses the issue of the funding of civil litigation within the framework of access to justice and the normative goal of increasing access to the civil justice system. The author critically analyzes and cautiously advances the case for the recent development of the financing of litigation by third-party investors. The argument is that investor financing has the potential to increase access to the civil justice system by ameliorating the economic barriers to litigation. The author evaluates investor financing against existing public and private models of financing litigation such as legal aid plans, litigation subsidy funds, and contingent fee arrangements. The doctrines against maintenance and champerty, which prohibit third parties from providing financial assistance to litigants, are reviewed and analyzed in order to assess the enforceability of financing agreements between plaintiffs and investors. The author then examines the market that is likely to develop for the financing of litigation and analyzes regulation that may be required to protect investors and plaintiffs. The author evaluates policy concerns in relation to the wide-spread availability of investor financing and concludes that such concerns are either misguided or can be addressed by implementing appropriate regulatory safeguards.

Cet article traite la question de financement de litige civil dans le cadre de l'accès à la justice et le but normatif visant à augmenter l'accès au système de la justice civile. L'auteure analyse de manière critique, tout en avançant avec précaution, le cas du développement récent du financement de litige civil par une tierce partie d'investisseurs. L'argument est que le financement par investisseurs a le potentiel d'augmenter l'accès au système de justice civile en améliorant les barrières économiques du litige. L'auteure évalue le financement par investisseurs contre les modèles publiques et privés de financement de litige tels que le plan d'aide légale, le fonds de subvention de litige et les frais contingents d'arrangements. Les doctrines contre les coûts de maintien et de promotion qui interdisent aux tierces parties de fournir une assistance financière aux plaideurs sont réexaminées et analysées afin d'estimer le renforcement des contrats de financement entre plaignants et investisseurs. L'auteure examine ensuite le marché qui est plutôt apte à se développer dans le financement de litige et analyse le règlement qui pourrait être requis pour protéger les investisseurs et les plaignants. L'auteure examine des questions relatives à la politique en rapport avec la disponibilité très répandue du financement des investisseurs et elle en conclut que de telles questions sont soit peu judicieuses soit qu'elles peuvent être résolues par l'implémentation de sauvegardes réglementaires.

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I. INTRODUCTION

The civil justice system is out of the reach of most Canadians, despite the fact that access to the courts for all citizens is a fundamental pillar of our society.<sup>1</sup> The primary economic barrier to pursuing a lawsuit is legal fees.<sup>2</sup> The Report of the Ontario Civil Justice Review modeled the legal fees of a typical civil case for a three day trial in the Ontario Court (General Division) and calculated a total cost of \$38,200 to the plaintiff.<sup>3</sup> Justice Cory of the Supreme Court of Canada noted in 1994 that “the total legal bills of all parties in an average General

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<sup>1</sup> See Ontario, *Report of the Ontario Legal Aid Review: A Blueprint for Publicly Funded Legal Services* (Toronto: Ontario Legal Aid Review, 1997) (Chair: J.D. McCamus) [hereinafter *McCamus Report*]; F.H. Zemans & P.J. Monahan, *From Crisis to Reform: A New Legal Aid Plan for Ontario* (Toronto: York University Centre for Public Law and Public Policy, 1997); and Ontario, *Civil Justice Review: First Report* (Toronto: Ontario Civil Justice Review, 1995) (Co-chairs: R.A. Blair & Sandra Lang) [hereinafter *Civil Justice Review*].

<sup>2</sup> *Civil Justice Review* *supra* note 1 at 145.

<sup>3</sup> *Ibid.* at 143-45. The model assumes a total of 191 hours at an hourly rate of \$200 including 30 hours of trial time, 30 hours of preparation for trial, and 25 hours for two days of discovery (including preparation time). The model excludes costs to taxpayers such as judges’ salaries and courthouse administration.

Division lawsuit (including those that settle before trial) may easily amount to between \$40,000 and \$50,000.”<sup>4</sup> Other costs include disbursements such as court filing fees, service of process fees, and fees relating to examinations for discovery. Expert testimony and reports, which have become increasingly common, also increase the costs of litigation significantly.<sup>5</sup>

These costs, although substantial in absolute terms, are even more significant in the context of the average income of Canadians. In 1996, for example, the average income of an unattached individual was \$24,433, and the average family income was \$56,629.<sup>6</sup>

In an empirical study of people’s attitudes on the issue of access to civil justice, W.A. Bogart and Neil Vidmar found that “a substantial majority thought that the cost of the system is too high and that it takes too long.”<sup>7</sup> They also found that of persons who had a problem but did not consult a lawyer, 17 per cent thought “a lawyer would cost too much.”<sup>8</sup>

Public sector initiatives such as legal aid and litigation subsidy funds and private sector initiatives such as contingent fee arrangements have developed over time to redress some of the cost barriers to litigation. A recent private sector development is the financing of litigation by third-party investors who provide the funds to litigate a claim in exchange for a share of the proceeds if the lawsuit is successful.

This article attempts to critically analyze and cautiously advance the case for investor financing of lawsuits. The argument is that investor financing has the potential to increase access to the civil justice system by ameliorating the economic barriers to litigation. Among the factors

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<sup>4</sup> Per Mr. Justice Cory, citing a paper by George Adams in *Coronation Insurance Co. v. Florence* (8 August 1994), (S.C.C.) [unreported] [hereinafter *Coronation Insurance*] as cited by Brockenshire J. in *Nantais v. Telectronics Proprietary (Canada) Ltd.* 28 O.R. (3d) 523 at 34 (Gen. Div.) [hereinafter *Nantais*]. See also G.W. Adams & N.L. Bussin, “Alternative Dispute Resolution and Canadian Courts: A Time for Change” (1995) 17 *Advocates’ Q.* 133 at 143, note 29.

<sup>5</sup> See M. Conrod, *Experts Have More Scope Following S.C.C. Ruling* *Lawyer’s Weekly* (12 December 1997) 17, in which Richard Bogoroch is quoted as saying a “trial has become a battle of the experts.” See also G.D. Watson & Mr. Justice C. Perkins, *Holmsted and Watson: Ontario Civil Procedure*, vol. 4 (Toronto: Carswell, 1984) at 57§4, 57§12 for a discussion of the costs of experts.

<sup>6</sup> See online: Statistics Canada <<http://www.statcan.ca/english/Pgdb/People/Families/famil05.htm>> (date accessed: 15 February 1999). Family refers to an “economic family,” which is defined as “a group of individuals sharing a common dwelling unit who are related by blood, marriage (including common-law relationships) or adoption.”

<sup>7</sup> W.A. Bogart & N. Vidmar, “Problems and Experience with the Ontario Civil Justice System: An Empirical Assessment” in A.C. Hutchinson, ed., *Access to Civil Justice* (Toronto: Carswell, 1990) 1 at 49.

<sup>8</sup> *Ibid.* at 33.

preventing the widespread adoption of investor financing is the uncertainty surrounding the prohibitions against champerty and maintenance and some aspects of securities regulation. These laws are analyzed and evaluated in light of the normative goal of increasing access to the justice system. Concerns about problems that might result from the widespread availability of investor financing are either misguided or can be addressed by existing or proposed regulatory safeguards.

Advancing the case for investor financing requires situating the issue of funding litigation within its social context and acknowledging some of the complexities surrounding the access to justice debate. First, it is acknowledged that access to the civil justice system does not necessarily equate with access to justice.<sup>9</sup> The development of investor financing calls for other initiatives to better align the civil justice system with justice, or alternatively, to find better methods than the civil justice system to resolve disputes that are more in line with our conception of justice.

Second, economic barriers are not the only barriers to accessing the civil litigation system. Non-economic barriers to litigating a claim can be significant and include the complexity of legal proceedings, the delay associated with taking legal action to redress one's rights, the psychological barriers relating to the formality of the judicial system, and language barriers.<sup>10</sup> Non-economic barriers have a tremendous impact on people's ability and willingness to access the justice system; much work is being done in this area to ameliorate these barriers.

Third, reducing the costs of litigation should be distinguished from financing litigation. A large body of academic literature exists, and many initiatives are underway, that focus on attempting to reduce the costs of litigation by simplifying procedural and substantive laws; encouraging the use of paralegals; widening the jurisdiction of small

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<sup>9</sup> For a discussion of the conflation of the term "access to justice" with "access to the courts," see M.J. Mossman, "Access to Civil Justice: A Review of Canadian Legal Academic Scholarship 1977-1987" in Hutchinson, ed., *supra* note 7, 53 at 54, 66-68; S.C. McGuire & R.A. Macdonald, "Small Claims Court Cant" (1996) 34 Osgoode Hall L.J. 509 at 510; and I. Morrison & J. Mosher, "Barriers to Access to Civil Justice for Disadvantaged Groups" in Ontario, *Rethinking Civil Justice: Research Studies for the Civil Justice Review* vol. 2 (Toronto: Ontario Law Reform Commission, 1996) (Chair: J.D. McCamus) 637 at 650 [hereinafter *Rethinking Civil Justice*].

<sup>10</sup> See Morrison & Mosher, *supra* note 9 at 650-63, where barriers to accessing the justice system are discussed.

claims courts; and even banning lawyers from certain fora.<sup>11</sup> The financing of litigation is similar to legal aid plans and contingency fees in that it takes the costs of litigation as a given, and redistributes the costs and risks of litigation away from the plaintiff to other stakeholders.

Having defined and positioned investor financing of litigation and the problem of funding civil litigation within the framework of increasing access to justice, Part II outlines the different models that exist to address the funding problem, and suggests that investor financing is similar to these other models and can complement them. Part III reviews the doctrines against maintenance and champerty which prohibit third parties from providing financial assistance to litigants. Part IV then applies the doctrines against maintenance and champerty to investor financing of litigation to assess the enforceability of agreements between plaintiffs and third-party investors; it advances the case for legislative abolition of these doctrines in order for investor financing to realize its potential to ameliorate economic barriers. Part V examines the market that is likely to develop for financing litigation and analyzes the regulation that may be required to protect investors and plaintiffs. Part VI makes the case for a more secure footing of investor financing, examines the real and imagined problems that might result from the widespread availability of investor financing of litigation, and proposes regulatory safeguards to deal with potential abuses. Finally, Part VII sets out the conclusions.

## II. MODELS OF FINANCING LITIGATION

Before endorsing investor financing of litigation as a means of promoting access to the courts, it is first necessary to evaluate it against three public and private sector models that have been developed to finance the costs of litigation. In what follows in Part II(A)-(D), below, it is suggested that while investor financing is very much akin to these models, these models are structurally limited in their ability to achieve access to the courts and that the gaps that they leave can be nicely plugged by a model of investor financing.

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<sup>11</sup> For recommendations which may have the effect of reducing the cost of litigation, see K. Roach, "Fundamental Reforms to Civil Litigation" in *Rethinking Civil Justice* *supra* note 9, 381; and I. Ramsay, "Small Claims Courts: A Review" in *Rethinking Civil Justice* *supra* note 9, 489.

### A. Legal Aid

Government sponsored legal assistance plans, otherwise known as legal aid, are designed to assist those without adequate financial means in accessing the justice system. Legal aid plans shift the cost and risks of litigation away from the plaintiff to the funders of the plans. The Ontario Legal Aid Plan is financed by the provincial and federal governments, the Law Foundation of Ontario, and contributions from lawyers and legal aid clients.<sup>12</sup>

### B. Public Litigation Subsidy Funds

The Ontario Class Proceeding Fund (“Fund”),<sup>13</sup> which came into existence on January 1, 1993 together with the *Class Proceedings Act, 1992*,<sup>14</sup> is a public fund established to subsidize the costs of class action litigation.<sup>15</sup> The Fund is operated by the Law Foundation of Ontario, and is endowed with \$500,000.<sup>16</sup> The Fund reduces the cost barriers to pursuing class actions by providing financial support for disbursements related to proceedings<sup>17</sup> and indemnification for costs in the event that an action is unsuccessful.<sup>18</sup> The representative plaintiff must, on behalf of the class, undertake to reimburse the Fund by providing 10 per cent of

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<sup>12</sup> See Morrison & Mosher, *supra* note 9 at 637.

<sup>13</sup> See *Law Society Amendment Act (Class Proceedings Funding), 1992*, S.O. 1992, c. 7 [hereinafter *Class Proceedings Funding*].

<sup>14</sup> S.O. 1992, c. 6.

<sup>15</sup> See Ontario, *Ontario Law Reform Commission Report on Class Action* (Toronto: Ontario Law Reform Commission, 1982) vol. 3 (Chair: D. Mendes Da Costa) at 711-14 [hereinafter *Report on Class Actions*]. Quebec also has a public fund to subsidize class actions. In Quebec, the fund is known as the “Fonds d’aide aux recours collectifs” and is administered by the government. Assistance is provided for lawyers fees in addition to disbursements. If the action is successful, the fund is reimbursed by the costs award, and the fund bears the loss if the action fails. See L. Ducharme & Y. Lauzon, *Le recours collectif Québécois* (Cowansville: Editions Yvon Blais, 1988); and J.A. Dufour, “Le financement de recours collectifs” in A. Prujinerand & J. Roy, eds., *Les recours collectifs en Ontario et au Québec* (Montréal: Editions Wilson & Lafleur, 1992) 103.

<sup>16</sup> *Class Proceedings Funding* *supra* note 13, s. 59.1. The Fund was endowed with \$300,000 in 1993. An additional \$200,000 was added the following year.

<sup>17</sup> *Ibid.* s. 59.1(2)1.

<sup>18</sup> *Ibid.* s. 59.1(2)2.

a successful award or settlement to replenish the Fund.<sup>19</sup> Funding is not automatic. The criteria for assessing applications include a consideration of the merits of the case and whether the plaintiff has made reasonable efforts to obtain funds from other sources. The Class Proceedings Committee may also consider whether the plaintiff has established appropriate financial controls to ensure that any funds granted are spent on their designated purpose and the extent to which the issues in the proceedings affect the public interest.<sup>20</sup>

### C. Contingent Fee Arrangements

Contingency fees are a private means of reducing economic barriers to litigation. Contingency fee arrangements transfer the risks of litigation to the lawyer retained to represent the plaintiff.<sup>21</sup> In a typical arrangement, the lawyer will obtain a percentage of the plaintiff's award if the lawsuit succeeds, in exchange for bearing the risk of no compensation if the lawsuit fails. Contingency fees were historically prohibited by common law and statute,<sup>22</sup> but are now accepted in all Canadian jurisdictions, except Ontario, where a modified contingency fee arrangement is allowed only in relation to class proceedings.<sup>23</sup>

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<sup>19</sup> *Ibid.* s. 59.5(1)(g) provides that the Lieutenant Governor in Council may make regulations "providing for levies in favour of the Class Proceedings Fund against awards and settlement funds in proceedings in respect of which a party receives financial support from the Class Proceedings Fund." O. Reg 771/92, s. 8(4)(c) sets out the 10 per cent requirement.

<sup>20</sup> *Ibid.* s. 59.3(4)(d) and O. Reg 771/92, s. 5.1.

<sup>21</sup> For an analysis of contingency fees, see M.J. Trebilcock, "The Case for Contingent Fees: The Ontario Legal Profession Rethinks its Position" (1989) 15 Can. Bus. L.J. 360; Roach, *supra* note 11; and R.W. Painter, "Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?" (1996) 71 Chi.-Kent L. Rev. 625. See also the following articles from the Symposium on Contingency Fee Financing: M. Galanter, "Anyone Can Fall Down a Manhole: The Contingency Fee and its Discontents" (1998) 47 DePaul L. Rev. 457; H.M. Kritzer, "The Wages of Risk: The Returns of Contingency Fee Legal Practice" (1998) 47 DePaul L. Rev. 267; and R.H. Mnookin, "Negotiation, Settlement and the Contingent Fee" (1998) 47 DePaul L. Rev. 363.

<sup>22</sup> See notes 69-71, *infra*, and accompanying text for a discussion of contingency fees constituting champerty and maintenance.

<sup>23</sup> *Class Proceedings Act, 1992* *supra* note 14, s. 33. The Ontario legislation allows lawyers to receive, subject to court determination, a multiplier of their hourly fee in the event of success of a lawsuit, rather than a flat percentage of the award. For a criticism of the modified contingency fee approach, see K. Roach, *supra* note 11 at 402-03. See, however, *Crown Bay Hotel Ltd. Partnership. Zurich Indemnity Co. of Canada* (1998), 40 O.R. (3d) 83 (Gen. Div.) in which Winkler J. held that a contingency fee based on a percentage of a settlement is within the contemplation of the *Class Proceedings Act*.

#### D. Comparison to Investor Financing

Investor financing is similar in many ways to the three models of financing litigation set out above. Legal aid models are akin to the financing of litigation by third-party investors in that the government, which has no direct stake in the lawsuit, funds the costs of the litigation. A key difference is that the third-party investor is motivated to provide the funds by an expectation of a positive return, while the government has no expectation of monetary return. Public litigation subsidy funds are also similar in structure and operation to financing by third-party investors. Contingency fee arrangements are simply a form of investor financing where the class of investors is limited to lawyers. The difference is that the lawyer retained provides services, rather than the funds necessary to procure such services, in exchange for a share in the lawsuit.

However, the scope of these funding models in redressing economic barriers to the civil justice system is limited, and investor financing could nicely complement them. Legal aid is not effective in reducing economic barriers to the civil justice system, even for the very poor.<sup>24</sup> First, the financial eligibility criteria are very restrictive, so only the *very* poor have access to legal aid. Second, the legal aid plan administrators prioritize legal claims and place emphasis on granting certificates for criminal matters. Of certificates issued in 1996-1997, 69 per cent were for criminal matters, 19 per cent for family, 7 per cent for immigration and refugee, and 5 per cent for “other civil”<sup>25</sup> matters. While “other civil” matters include tort, contract, consumer, administrative, landlord and tenant, social assistance, and workers’ compensation,<sup>26</sup> the 1997 Annual Report for the Ontario Legal Aid Plan states that “priority in ‘other civil’ law cases is limited to civil sexual assault, mental health, disability benefits, parole or prison matters and poverty law cases, such as Workers’ Compensation, Social Assistance

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<sup>24</sup> The legal aid crisis that occurred in Ontario recently is well documented, and various studies outline reforms, some of which have been accepted by the Law Society of Upper Canada and the Ontario government. See *McCamus Report*, *supra* note 1; and *Civil Justice Review* *supra* note 1.

<sup>25</sup> Law Society of Upper Canada, *Ontario Legal Aid Plan: Annual Report, 1997* (Toronto: Law Society of Upper Canada, 1997) at 5.

<sup>26</sup> *Ibid.* at 12. See, however, the *McCamus Report*, *supra* note 1 at 215-25, which recognizes that matters falling within the “other civil” category may involve legal issues that have “a serious impact on an individual” and recommends a number of options (including regulated contingent fee arrangements and a contingency legal aid fund) outside the traditional legal aid system to increase access to the civil justice system in these areas.

Review Board and landlord and tenant.”<sup>27</sup> As a result, there is little or no coverage for civil cases involving personal injury based on contract or tort. Ian Morrison and Janet Mosher note that as of October 1994, “legal aid coverage for all personal injury actions (motor vehicle, slip and fall, medical malpractice, etc.) was virtually eliminated.”<sup>28</sup> The ability of public litigation subsidy funds to achieve the goal of greater accessibility to the courts is similarly limited. First, by its definition, the Ontario Class Proceedings Fund is limited to financing class action litigation and thus many meritorious individual cases are excluded from receiving this public subsidy. Second, the Fund does not provide assistance with lawyers’ fees, which are much larger than disbursements and generally the largest economic barrier to litigation.<sup>29</sup> In contrast, third-party investors would provide funding for legal fees as well as disbursements. Third, the fact that reimbursement to the fund in the event of success is set at 10 per cent is inefficient because the strength of the particular action is not taken into account. Certain lawsuits might warrant a return of less than 10 per cent if the factual and legal issues are relatively straightforward, and thus settlement is almost guaranteed. Other lawsuits might warrant a higher return if the facts or legal issues are more complex, and thus success is not as certain. A scheme whereby third-party investors finance lawsuits, in contrast, would allow the parties to negotiate a reasonable return in light of the particular risks of the lawsuit. Finally, the Fund’s capital base is only \$500,000, which is not a large sum given the above discussion of the costs of litigation. From 1994 to 1997, the total amount awarded has only been \$121,832.<sup>30</sup> In comparison, it would appear that private investor financing can raise much more capital.<sup>31</sup>

Similarly, that contingency fee arrangements are only limited to lawyers has several disadvantages when compared with the wider potential class of private investors. Only lawyers who have an

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<sup>27</sup> *Supra* note 25 at 12.

<sup>28</sup> Morrison & Mosher, *supra* note 9 at 659.

<sup>29</sup> Note that the Quebec Fund, in contrast, provides assistance for lawyers’ fees. See *supra* note 15.

<sup>30</sup> \$9,884 was awarded in 1994; \$29,889 in 1995; \$82,059 in 1997; and no applications were awarded funding in 1996. See The Law Foundation of Ontario, *1995 Annual Report* (Toronto: The Law Foundation of Ontario, 1996) at 6; and The Law Foundation of Ontario, *1997 Annual Report* (Toronto: The Law Foundation of Ontario, 1998) at 4.

<sup>31</sup> See notes 97-99, *infra*, and accompanying text for a discussion of *Nantais*, in which \$350,000 was raised from a small handful of wealthy investors, more than two-thirds the total capital of the Fund.

entrepreneurial inclination and thus are willing to accept a significant degree of risk will agree to provide their services on a contingency basis. This limits the pool of lawyers significantly. Even those lawyers who are willing to work on a contingency fee basis will be selective in the cases they pursue since their livelihood is at stake. They are likely to take on cases that have a greater likelihood of success, and turn down those which might be meritorious but are less certain to be successful. In contrast, private investors may be less risk-averse in financing cases, because they will be investing from their savings. In addition, third-party investors may be better bearers of risk and better at risk diversification than lawyers or their law firms.<sup>32</sup> As a result, investors may be willing to finance cases that lawyers may not be prepared to accept on a contingency basis.<sup>33</sup>

The conclusion reached from the above comparisons is that investor financing may have a useful role to play by plugging the gaps left by established financing arrangements.

### III. MAINTENANCE AND CHAMPERTY

#### A. *Definition and History*

*Halsbury* defines maintenance and champerty as follows:

Maintenance may be defined as the giving of assistance or encouragement to one of the parties to the litigation by a person who has neither an interest in litigation nor any other motive recognized by the law as justifying his interference. Champerty is a particular kind of maintenance, namely maintenance of an action in consideration of a promise to give the maintainer a share in the proceeds or subject matter of the action.<sup>34</sup>

As a general matter, champertous agreements are void at common law and they are considered to be against public policy in Canada. In the late nineteenth century, Ontario codified the law

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<sup>32</sup> Lawyers acting on a contingent basis often experience cash flow problems and may have difficulty paying out disbursement and fixed monthly expenses; in these situations investors would be in a position to finance the litigation.

<sup>33</sup> The fact that lawyers may not be willing to assume the entire risk of loss associated with a case is highlighted in *Nantais*, in which the plaintiff's lawyer could have financed the entire litigation through a contingency fee arrangement, but instead preferred to shift a portion of the risk to private investors. See notes 97-99, *infra*, and accompanying text.

<sup>34</sup> Lord Hailsham of St. Marylebone, ed., *Halsbury's Laws of England*, vol. 9, 4th ed. (London: Butterworths, 1974) at 272, as cited in *Buday v. Locator of Missing Heirs Inc.*(1993), 16 O.R. (3d) 257 at 262 (C.A.) [hereinafter *Buday*].

relating to champerty in a statute which remains in full force and effect today.<sup>35</sup> *An Act Respecting Champerty* reads:

1. Champertors be they that move pleas and suits, or cause to be moved, either by their own procurement, or by others, and sue them at their proper costs, for to have part of the land in variance, or part of the gains.
2. All champertous agreements are forbidden, and invalid.<sup>36</sup>

Maintenance and champerty are also torts at common law, making the third party liable to the defendant to the action for special damages suffered as a result of the third party's financial assistance,<sup>37</sup> including the costs of defending the lawsuit.<sup>38</sup> The defendant to the action cannot move to stay the action on the basis of the third party's maintenance since the maintainer is not a party to the action before the courts, and maintenance is not considered a defence to the merits of an action.<sup>39</sup>

Maintenance and champerty were also common law criminal offences in Canada until 1953 when what is now section 9 was added to the *Criminal Code*<sup>40</sup> abolishing common law offences. The Criminal Code Revision Committee recommended their abolition on the basis that these crimes were "obsolete and archaic."<sup>41</sup>

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<sup>35</sup> The laws of maintenance and champerty are rooted in conspiracy and abuse of process, and originally invalidated the sale of land where title was in dispute. See P.H. Winfield, *The History of Conspiracy and Abuse of Legal Procedure* (Cambridge: Cambridge University Press, 1921) at 131-60; E.H. Bodkin, *The Law of Maintenance and Champerty* (London: Stevens and Sons, 1935); and M. Radin, "Maintenance by Champerty" (1935) 24 Cal. L. Rev. 48 for a history of the laws against maintenance and champerty.

<sup>36</sup> R.S.O. 1897, c. 327, ss. 1-2.

<sup>37</sup> *Oram v. Hutt*, [1914] 1 Ch. 98 (C.A.).

<sup>38</sup> See *Alabaster v. Harness*, [1895] 1 Q.B. 339 (C.A.), cited with approval in *Newswander v. Giegerich* (1907), 39 S.C.R. 354 [hereinafter *Newswander*] in which the Supreme Court of Canada stated at 359 [emphasis in original]: "That costs of defending a suit which has been *improperly* maintained may be recovered in an action of maintenance is true."

<sup>39</sup> See *Kroekerv. Harkema Express Lines Ltd.* (1973), 2 O.R. (2d) 210 (H.C.); and *Davey v. Tallon*, [1928] 3 W.W.R. 215 (Man. K.B.), aff'd [1929] 1 W.W.R. 171 (Man. C.A.).

<sup>40</sup> R.S.C. 1985, c. C-46, s. 9, amending S.C. 1953-54, c. 51, s. 8.

<sup>41</sup> A.J. McLeod & J.C. Martin, "Offences and Punishments Under the New Criminal Code" (1955) 33 Can. Bar Rev. 20 at 23-24. For case law on the criminal offence of champerty, see *Goodman v. The King*, [1939] S.C.R. 446, rev'g (1938), 66 B.R. 1 (C.A.) [hereinafter *Goodman*]; *R. v. Bordoff* (1938), 70 C.C.C. 35 (C.S.P.); and *Colville v. Small* (1910), 22 O.L.R. 33 (H.C.J.), aff'd (1910), 22 O.L.R. 426 (Div. Ct.).

### B. *The Requirements of Maintenance and Champerty*

In determining whether an agreement falls within the definition of maintenance and champerty, motive is central. The fact that one is financing a lawsuit is itself insufficient to constitute maintenance. Similarly, the fact that there is an agreement to finance a lawsuit in exchange for a share of the proceeds is in itself insufficient to constitute champerty. “Motive is relevant and has been relied on by the courts in considering the common law rule (or definition) of champerty particularly in creating exceptions to its application.”<sup>42</sup> As the Privy Council put it in an 1860 decision: “[Champerty and maintenance] must be something against good *policy and justice, something tending to promote unnecessary litigation*, something that in a legal sense is immoral and to the constitution of which a bad motive in the same sense is necessary.”<sup>43</sup> Thus, both maintenance and champerty require proof of an improper motive in providing the financial assistance, whether it is malicious or officious intermeddling, a stirring up of strife (for vexation or delay), or some other impropriety,<sup>44</sup> and both contemplate an uninterested third party or a stranger becoming involved in the litigation of others.<sup>45</sup> It also appears that the third party, in addition to providing the financial assistance, must cause the action to be commenced, aggravated, or enlarged in some way. Proof that the plaintiff has already consulted with a lawyer, although not required, would indicate that the plaintiff was predisposed to pursuing a legal claim and that the third party was not intermeddling.<sup>46</sup>

### C. *Policy Justifications*

The original policy rationale against maintenance and champerty was an attempt to minimize abusive interference in litigation by wealthy and powerful members of society. The Ontario Law Reform

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<sup>42</sup> *S. v K.* (1986), 55 O.R. (2d) 111 at 116 (Dist. Ct.).

<sup>43</sup> *Fischer v. Kamala Naicher* (1860), 8 Moo. Ind. App. 170 at 187 (P.C.) [emphasis added], quoted by the Supreme Court of Canada in *Newswander*, *supra* note 38 at 360.

<sup>44</sup> *Buday*, *supra* note 34.

<sup>45</sup> See *American Home Assurance Co. v. Brett Pontiac Buick GMC Ltd. (No. 2)*(1992), 116 N.S.R. (2d) 319 (C.A.), rev’g (4 March 1992), Doc. S.H. 77076 (T.D.) [hereinafter *American Home Assurance*].

<sup>46</sup> See *Buday*, *supra* note 34 at 267; and *Goodman*, *supra* note 41 at 449.

Commission *Report on Class Actions* describes the historical roots of the doctrines against maintenance and champerty as follows:

Rules against maintenance and champerty were introduced over 700 years ago in response to abusive interference in the legal system by powerful royal officials and nobles. Although the particular abuses against which the prohibitions were directed had been cured by the time of the Tudors, the rules continued to survive. In modern decisions concerning maintenance, courts do not refer to the mediaeval origins of the doctrine, but justify its continued existence on the basis of public policy considerations. The antipathy of the courts to champertous agreements similarly is supported by policy concerns.<sup>47</sup>

More contemporary justifications of the doctrines focus on the perceived abuses to the administration of justice. As Lord Denning stated in *Re Trepca Mines Ltd. (No. 2)*

The reason why the common law condemns champerty is because of the abuses to which it may give rise. The common law fears that the champertous maintainer might be tempted, for his own personal gain, to inflame the damages, to suppress evidence, or even to suborn witnesses. These fears may be exaggerated; but, be that so or not, the law for centuries has declared champerty to be unlawful, and we cannot do otherwise than enforce the law.<sup>48</sup>

While this passage is a stark pronouncement of the abuses that will result if champertous agreements are recognized at law, judicial decisions do not appear to critically analyze the extent of these perceived abuses. As will be discussed in Part IV, below, these concerns appear to be overstated.

#### D. *Exceptions to the General Rule*

Recognizing competing and overriding public policies, courts have over time carved out numerous exceptions to the general rules against maintenance and champerty. The courts will not find a third party's financial assistance to be maintenance or champerty where the third party's motive can be characterized as proper or legitimate.

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<sup>47</sup> Ontario Law Reform Commission, *Report on Class Actions* vol. 3 (Toronto: Ministry of the Attorney General, 1982) at 717.

<sup>48</sup> [1963] Ch. 199 at 219 (C.A.).

## 1. Charity and compassion

An exemption to maintenance is recognized for the provision of financial assistance by third parties for charitable and compassionate reasons.<sup>49</sup> Kerwin J., in *Goodman v. R.*,<sup>50</sup> quoted approvingly from Lord Abinger's judgment in *Findon v. Parker* where he said:

I do not like to give an opinion upon an abstract case, and therefore am not desirous to consider it; but if a man were to see a poor person in the street oppressed and abused, and without the means of obtaining redress, and furnished him with money or employed an attorney to obtain redress for his wrongs, it would require a very strong argument to convince me that that man could be said to be stirring up litigation and strife, and to be guilty of the crime of maintenance; I am not prepared to say, that, in modern times, Courts of justice ought to come to that conclusion. However, I give no opinion upon that point.<sup>51</sup>

## 2. Legitimate common interest

Courts have also created an exception to maintenance for third parties such as near relatives<sup>52</sup> who have a legitimate common interest with the party to the lawsuit. However, where the third party receives a share of the proceeds, courts have held such agreements to be champertous.<sup>53</sup>

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<sup>49</sup> See *Newswander*, *supra* note 38 at 362; and *Carlson v. Chambers*, [1947] 1 W.W.R. 353 (Sask. K.B.). See also *Young v. Young* [1993] 4 S.C.R. 3 in which the Supreme Court of Canada held that a religious society financially supporting litigation of a member's divorce proceedings, involving freedom of religion and expression issues, did not constitute maintenance. It would be difficult, if not impossible, to argue charity in relation to a champertous agreement since the third party has negotiated a right to share in the proceeds of the litigation.

<sup>50</sup> *Goodman*, *supra* note 41 at 450.

<sup>51</sup> (1843), 11 M. & W. 675 at 682-83 (Ex. Ct.).

<sup>52</sup> See *Bradlaugh v. Newdegate* (1883), 11 Q.B.D. 1 at 11 (C.A.) per Lord Coleridge; assistance in paying for litigation costs is likely extremely common given that an individual will often turn to a family member to pay for the costs of the litigation. Bogart & Vidmar, *supra* note 7 at 33, examined problems and experience with the Ontario civil justice system and found that in 37 per cent of cases, legal fees were paid for by the concerned litigant or another member of their household. Members of one's household are likely to be members of one's immediate family. Thus, despite the rules against maintenance and champerty in the context of relatives, financial assistance by relatives is very frequent, and monitoring and enforcement of the common law rules very difficult. Since it appears that the issue of relatives maintaining lawsuits has not been applied in recent times and has not arisen before the courts in the last 100 years, the courts simply accept this arrangement as a reality of litigation.

<sup>53</sup> See *Hutley v. Hutley* (1873), L.R. 8 Q.B. 112.

### 3. Commercial interests

#### a) *Pre-existing commercial interest*

Under the rationale of a public policy which favours facilitating commercial transactions, courts have also upheld financing agreements where a third party can be characterized as having a genuine pre-existing commercial interest in the litigation.<sup>54</sup> The pre-existing business interest exception has, for example, justified various arrangements in the insurance industry, such as subrogation, which might otherwise be considered maintenance or champerty.<sup>55</sup>

Illustrative of the pre-existing commercial interest exception is the case of *American Home Assurance*<sup>56</sup>. The Appeal Division of the Nova Scotia Supreme Court, using this exception, held that Brett Pontiac, an automobile dealership, did not violate the doctrines against maintenance and champerty when it encouraged and assisted its customers in bringing lawsuits for unpaid repair claims against an extended warranty provider, American Home Assurance Co., on vehicles it had sold to them. The court reasoned that Brett Pontiac, having sold the extended warranties, had a genuine pre-existing interest in the outcome of the actions brought by its customers. In reaching its decision, the court also took into account the inequality of financial and bargaining positions between the individual customers and American Home Assurance Co. The court stated:

Having involved [its customers] with an administrator of service contracts which was no longer honouring claims, it was perfectly reasonable for [the car dealership] to step in to assist [them] in an *unequal contest with [an] international insurance corporation* which had insured the contracts.<sup>57</sup>

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<sup>54</sup> It is beyond the scope of this paper to assess whether this and other exceptions actually increase economic efficiency by maximizing general welfare or rather reflect special interest groups being favoured in rule-making.

<sup>55</sup> See *Societa Italiana Assicurazioni Trasporti v. Canadian Marine Underwriters Ltd* (1994), 26 C.C.L.I. (2d) 283 (Ont. Gen. Div.); and *Frederickson v. Insurance Corp. of British Columbia* (1986), 17 C.C.L.I. 194 (B.C.C.A.).

<sup>56</sup> *Supra* note 45.

<sup>57</sup> *Ibid.* at 326 [emphasis added].

b) *Legitimate business arrangement*

Courts have also carved out an exception for contracts where the third party can be characterized as having a legitimate business arrangement with the potential plaintiff. In *Buday v. Locator of Missing Heirs Inc.*,<sup>58</sup> the Ontario Court of Appeal relied on this exception to justify an agreement whereby Locator of Missing Heirs (“Locator”) agreed to assist the Ollmann family in establishing their rights in a mining claim in exchange for 30 per cent of their interest if successful. Locator was successful in establishing the Ollmanns’ claim. However, the Ollmanns refused to assign 30 per cent of their interest to Locator as agreed, and sought a declaration that the agreement was champertous. The court held that the agreement was not champertous because Locator did not stir up litigation; it simply entered into a *bona fide* business arrangement to assist the Ollmann family in establishing what they believed was a valid mining claim.

In determining whether a legitimate business arrangement existed between the parties, the court examined whether the exchange was mutually beneficial. It noted that the Ollmanns contacted Locator, that the principal of Locator had over thirty years’ experience in the industry, that the parties formalized their relationship in a written contract which they labelled a “joint venture” agreement, and that the Ollmann family obtained independent legal advice before signing the agreement. In reaching his decision, Griffiths J.A. also referred to the affidavit testimony of the president of Locator, Howes, concerning his motivations for assisting the Ollmanns. Griffiths J.A. wrote:

Howes was familiar with the Williams mine which is the largest gold mine in Canada. He was particularly interested in assisting the Ollmann family in proving their claim because, as he stated in his affidavit, “the Ollmann saga had a lot of real ‘human interest’ appeal to me, as my favourite cases are ones in which I can help economically disadvantaged people to obtain their rightful inheritances from large corporations.”<sup>59</sup>

The fact that the Ollmann family had voluntarily and knowledgeably entered into the agreement, and had received what they had bargained for, was significant in the court’s determination that the agreement was not champertous. The fact that the Ollmanns did not come to court with clean hands assisted in tilting the equities in favour of Locator and also likely had an impact upon the court’s determination. Thus, it appears

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<sup>58</sup> *Buday*, *supra* note 34.

<sup>59</sup> *Ibid.* at 261.

that the court examined the totality of the circumstances surrounding the transaction in deciding that the agreement was not champertous.

In *Pielak v. Crown Forest Industries Ltd.*<sup>60</sup> the legitimate business interest exception was used to uphold an arrangement to recover sales tax made between Crown Forest and Pielak, a (non-lawyer) tax expert, for which Pielak would retain 40 per cent of the recovery. The British Columbia Supreme Court held that the agreement was not champertous, reasoning that the purpose of the contract was to ensure that the appropriate amount of tax had been paid, and that such a purpose did not constitute officious intermeddling or the stirring up of strife. In reaching its decision, the court noted the commercial value of the exchange and stated that “the subject matter of the tax is a highly specialized area and the service offered by the plaintiff was needed by the defendants and so had a legitimate commercial value.”<sup>61</sup> The court also examined the relative bargaining power of the parties and concluded that both parties were “mature and sophisticated,”<sup>62</sup> so that Pielak’s remuneration was “likely to be fair and not oppressive”<sup>63</sup> to Crown Forest’s interests. On the whole, the court was satisfied with the fairness and reasonableness of the transaction.

However, in an earlier decision of the Ontario High Court, a similar agreement to that in *Pielak* was held to be champertous. In *Smythers v. Armstrong*<sup>64</sup> residential tenants entered into contracts with a third party who assisted the tenants in recovering rent in exchange for 50 per cent of the amount recovered. The court held that the third party’s motive was to “officiously intermeddle in [the] disputes of others.”<sup>65</sup> In quoting from the written agreement, the court noted a clause which made the third party the agent for the tenants and authorized him to accept any settlement that the agent “in his absolute discretion considers just or reasonable” and that this was binding on all parties.<sup>66</sup> The court appeared to be concerned that the tenants were dominated by the third party, and thus concluded that there was no legitimate business arrangement.

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<sup>60</sup> (1992), 64 B.C.L.R. (2d) 207 (S.C.) [hereinafter *Pielak*].

<sup>61</sup> *Ibid.* at 225.

<sup>62</sup> *Ibid.*

<sup>63</sup> *Ibid.* at 226.

<sup>64</sup> (1989), 67 O.R. (2d) 753 (H.C.J.) [hereinafter *Smythers*].

<sup>65</sup> *Ibid.* at 757.

<sup>66</sup> *Ibid.* at 756.

How does one reconcile *Smythers* with *Buday* and *Pielak*? As in *Buday* and *Pielak*, the court in *Smythers* analyzed the totality of the transaction. However, the court came to a different conclusion in *Smythers* because of its concern that the third party in question was taking advantage of its position *vis-à-vis* the tenants. It also appears that the court was concerned about the value added by the third party. Unlike the third-party experts in *Buday* and *Pielak*, the third party in this situation was not providing any special expert assistance.

#### 4. Legislative exceptions

In addition to judicially created exceptions, various legislative enactments have validated arrangements which might otherwise be considered maintenance or champerty. For example, assignments of choses-in-action and accounts receivable were legalized in order to promote commerce. Ontario passed *An Act to make Debts and Choses in action assignable at Law*<sup>67</sup> in 1872 to recognize such assignments. The business of factoring, which is the wholesale purchase and sale of a company's accounts receivables, and the process of securitization, which is the sale of a future income stream, would not have developed but for these legislative amendments.<sup>68</sup>

Another example is contingency fees. Contingency arrangements for legal work were historically prohibited by the common law definitions of champerty, statutory definitions of champerty, and legislation governing lawyers.<sup>69</sup> With the exception of Ontario, all the provinces have now legislatively permitted contingency fee arrangements between solicitors and clients in order to increase access to justice.<sup>70</sup> In Ontario, contingency fees were legalized only in relation to class actions in 1992 when the *Class Proceedings Act* was enacted.<sup>71</sup>

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<sup>67</sup> R.S.O 1877, c. 116, ss. 6-12, amending 1872, 35 Vic., c. 12.

<sup>68</sup> See A.P. Bell, *Modern Law of Personal Property in England and Ireland* (London: Butterworths, 1989) at 364.

<sup>69</sup> See *Solicitor's Act* R.S.O. 1990, c. S-15, s. 28.

<sup>70</sup> See Canadian Bar Association, *Code of Professional Conduct* 1987 c. XI, para. 10.

<sup>71</sup> The *Class Proceedings Act* *supra* note 14, s. 33(1) reads:

Despite the *Solicitors Act* and *An Act respecting Champerty* being chapter 327 of Revised Statutes of Ontario, 1897, a solicitor and a representative party may enter into a written agreement providing for payment of fees and disbursements only in the event of success in a class proceeding.

### E. *Other jurisdictions*

In England, the torts of maintenance and champerty were abolished in the 1960s upon the recommendation of the Law Commission which concluded that an action for damages for maintenance and champerty no longer served any useful purpose. Maintenance and champerty were also abolished as criminal offences in England in the 1960s.<sup>72</sup> However, the common law doctrine invalidating champertous contracts continues to exist.<sup>73</sup>

A number of different approaches have developed in the United States to deal with maintenance and champerty. Some states such as Pennsylvania have maintained the common law prohibitions against champertous agreements, while the courts of other states like California have held that champertous agreements may be contrary to public policy.<sup>74</sup> Yet other states such as New York have adopted statutes declaring champertous agreements void.<sup>75</sup> Civil law jurisdictions including Puerto Rico and Louisiana have adopted an approach whereby if a plaintiff sells all or a portion of a lawsuit to a third party, the defendant may settle the litigation with the plaintiff by reimbursing the third party for the amount paid by him or her with interest and costs.<sup>76</sup>

## IV. APPLICATION OF MAINTENANCE AND CHAMPERTY TO INVESTOR FINANCING OF LITIGATION

### A. *Relevance to Investor Financing*

The current status of the doctrines against maintenance and champerty is relevant to the analysis of investor financing of lawsuits in relation to the enforceability of the contract between a plaintiff and

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<sup>72</sup> U.K., The Law Commission, *Proposals for Reform of the Law Relating to Maintenance and Champerty* (London: Her Majesty's Stationery Office, 1966) at para. 7.

<sup>73</sup> See *Hill v. Archbold*, [1968] 1 Q.B. 686 (C.A.).

<sup>74</sup> For a more detailed review of the approaches to modern champerty law in the United States, see A. Dobner, "Litigation for Sale" (1996) 144 U. Pa. L. Rev. 1529 at 1547-55; S. Lorde Martin, "Syndicated Lawsuits: Illegal Champerty or New Business Opportunity?" (1992) 30 Am. Bus. L.J. 485 at 488-89; and D.L. Abraham, "Investor-Financed Lawsuits: A Proposal to Remove Two Barriers to an Alternative Form of Litigation Financing" (1992) 43 Syracuse L. Rev. 1297 at 1303-05.

<sup>75</sup> Dobner, *supra* note 74 at 1548.

<sup>76</sup> *Ibid.* at 1552.

third-party investors. For example, a plaintiff to a lawsuit who enters into a financing agreement with a third-party investor, and is successful in the litigation, could refuse to pay the third-party investor a share of the proceeds by attempting to have the agreement between them declared champertous by the courts, and thus illegal and void. Additionally, the defendant to a lawsuit could not plead maintenance or champerty as a defence to the litigation, but could commence an action in tort against the third-party investor if special damages have been suffered as a result of the maintenance, although admittedly, these actions are rare.

These additional risks, in all probability, would increase the rate of return demanded by the investor financing a lawsuit. It is therefore an important question as to whether investor financing of lawsuits would be considered champertous, and thus invalid and unenforceable contracts.

#### *B. Application—Improper Motive or Justifiable Exception?*

Can an argument be made that the doctrines against maintenance and champerty would not invalidate contracts made between plaintiffs and investors to the litigation? The answer will depend upon whether the third-party investor's interference can be characterized as improper, or rather, as falling within a recognized exception to the doctrines against maintenance and champerty.

The charitable and compassionate exception would not be helpful in this context given the assumption that investors are financing lawsuits for economic gain. The legitimate common-interest exception for close relatives is too narrow to have widespread effect on the litigation landscape. The pre-existing commercial-interest exception would be equally impractical because it limits the class of investors that can finance a litigation, and thus is not helpful in achieving the goal of greater access to the civil justice system.

The broadest and most viable exception is the legitimate business interest exception. A strong argument can be made that the plaintiff and the third-party investor are involved in a mutually beneficial exchange whereby the plaintiff obtains the funds required to pursue the litigation and the third-party investor uses surplus funds with the expectation of a return for investing in the litigation. This reasoning was adopted by the courts in *Pielak* and *Buday*. Nevertheless, the *Smythers* decision indicates that this rationale will only be accepted by the courts after scrutinizing the circumstances surrounding the financing arrangement.

Thus, the analysis is not straightforward. An analysis of the case law suggests that courts will consider a number of factors, including the following:

- Merits of the plaintiff's lawsuit—the less meritorious the plaintiff's suit, the more likely the third party's financial assistance will be seen as intermeddling, as in *Smith*, below.<sup>77</sup>
- Fairness and reasonableness of the arrangement as between the plaintiff and the third-party investor—if the parties can be viewed as relative equals with respect to their ability to bargain, the greater the likelihood a court will find the third party's assistance as proper. Additionally, the courts will examine the actual bargain struck to ensure that it is not unreasonable, and that it is reflective of equality of information and bargaining power between the parties.
- Abuses in relation to champerty and maintenance—do the facts in the particular circumstances actually lead to the evils which the doctrines against champerty and maintenance are designed to avoid?
- Relative strength of the plaintiff and the defendant to the lawsuit—courts will consider the financial and other inequalities between the plaintiff and the defendant in favour of validating the arrangement between the plaintiff and the third party, as in *American Home Assurance*
- Third party's ostensible motive in providing financial assistance—courts are more willing to uphold agreements where a third party claims a motive of providing assistance to help the disadvantaged, as in *Buday*, despite recognition by the courts that the third party's primary motive is to profit from the financing.
- Who brought the action to have the agreement declared champertous—if the litigant after succeeding wishes to have the court declare the agreement invalid, the fact that the litigant is not going to court with clean hands, as in *Buday*, will have an impact upon the court's exercise of its equitable jurisdiction.

Although this list of factors can be extracted from the cases, there is no principled discussion in the decisions of the relevance of these factors to maintenance and champerty, and the weight to be accorded to each of them. Thus, any conclusion as to how the courts will decide whether investor financing of a lawsuit constitutes maintenance

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<sup>77</sup> See *infra* note 78.

or champerty must remain speculative. The outcome will depend on the facts and merits of the particular case and the conduct of the parties involved.

### C. Case Law on Investor Financed Litigation

While the case law discussed above involved third parties who provided services in exchange for a share of the proceeds of the lawsuit, the following cases involve third parties whose role is strictly to provide the monies necessary to finance the litigation in return for a share of any award.

In *Smith v. Canadian Tire Acceptance Ltd.*<sup>78</sup> the court was critical of investor financing of lawsuits. The Borrowers' Action Society ("Society") was established by Larry Whaley to organize and promote class action lawsuits on behalf of credit customers against Canadian corporations that were alleged to have contravened the *Interest Act*.<sup>79</sup> The Society decided to pursue its first case against Canadian Tire Acceptance Corporation. The Society solicited funds to finance the litigation from Canadian Tire credit card holders. Potential investors were invited to register with the Society and purchase shares in the class action for an initial fee of \$100, and subsequent shares for \$50 each.<sup>80</sup> The Society represented to investors that if the lawsuit was successful, they would receive a proportionate share of the contingent fee awarded by the court, above and beyond any damages award. The Society was to receive 10 per cent of the contingency fee award, as a promoter's fee, prior to any distribution to the investors.<sup>81</sup>

The Society promoted the financing scheme through radio, television, and newspaper advertisements, and a video infomercial presented in major cities throughout Canada.<sup>82</sup> The Society marketed the class action as the "Borrowers' Action Society's Billion Dollar Class Action"<sup>83</sup> and enticed potential investors by claiming: "Collect your

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<sup>78</sup> (1995), 22 O.R. (3d) 433 (Gen. Div.), aff'd (1995), 26 O.R. (3d) 94 (C.A.) [hereinafter *Smith (Motion for Costs)*]. See also G. Watson, "A 'Stocktaking' of Class Proceedings in Ontario: Is the Price Wrong?" (June 1998) [unpublished, archived at Osgoode Hall Law School] at 13-15 for an analysis of *Smith*.

<sup>79</sup> R.S.C. 1985, c. I-15.

<sup>80</sup> *Smith (Motion for Costs)* supra note 78 at 437.

<sup>81</sup> *Ibid.*

<sup>82</sup> *Ibid.*

<sup>83</sup> *Ibid.*

share of a Billion Dollar Reward.” One advertisement even stated that investors “can participate at no risk,”<sup>84</sup> while another asked: “Would you risk \$100 on the chance you will get back up to \$64,000? \$150 for a chance at double that? Sounds like a get-rich quick scam? It’s not, it’s a class action.”<sup>85</sup>

One thousand, seven hundred and fifty people registered with the Society.<sup>86</sup> The class action brought against Canadian Tire Acceptance Corporation was dismissed on a motion for summary judgment.<sup>87</sup> Canadian Tire Acceptance Corporation then moved for an order that the costs of the action be paid by Whaley and the Society, even though they were not named parties to the action. The court held that costs should be awarded against Whaley and the Society on a solicitor-client scale.<sup>88</sup> While the direct issue before the court was the award of costs against a non-party, the court commented that the conduct of Whaley and the Society amounted to maintenance and champerty. The court was critical of Whaley and the Society, and stated that “their conduct in instigating, promoting, controlling and raising funds to support this lawsuit was improper.”<sup>89</sup> The court was clearly disturbed by the fact that Whaley and the Society made extravagant claims with respect to the returns investors would receive without having obtained a legal opinion regarding the propriety of the scheme; and noted that scheme was tantamount to the marketing and selling of shares to the public in apparent violation of securities laws.<sup>90</sup> The court described Whaley and the Society’s conduct as “presumptuous” and “contumacious.”<sup>91</sup> In a tone of utter disapproval, the court concluded by stating: “This scheme was ill-founded and flawed both conceptually and in law. The promises of financial gain for registrants were irresponsible, and the conduct of the Society and Mr. Whaley in attempting to gain financially from the action was akin to maintenance and champerty.”<sup>92</sup>

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<sup>84</sup> *Ibid.* at 438.

<sup>85</sup> *Ibid.* at 439.

<sup>86</sup> *Ibid.* at 437.

<sup>87</sup> (1994), 19 O.R. (3d) 610 (Gen. Div.) [hereinafter *Smith (Summary Judgment)*].

<sup>88</sup> *Smith (Motion for Costs)* *supra* note 78 at 451.

<sup>89</sup> *Ibid.* at 440.

<sup>90</sup> *Ibid.* at 448.

<sup>91</sup> *Ibid.* at 450.

<sup>92</sup> *Ibid.* at 448.

Given that Whaley and the Society had conceded that they were selling shares, the fact that they had not complied with relevant securities laws by issuing a prospectus (since they were offering their shares to the public), appears to have weighed heavily in the court's decision. Had they complied with securities laws and provided full, fair and true disclosure with respect to the nature of the investment and its risks (in contrast to the substantial misrepresentations they appear to have made), the court, in all likelihood, would not have characterized their conduct as improper. Furthermore, the fact that the lawsuit was dismissed on a motion for summary judgment affected the court's decision because it indicated that the lawsuit lacked merit.<sup>93</sup> If the Society's lawsuit had merit, it is quite possible that the court, in addition to considering other redeeming factors, would not have been so critical of their actions. For these reasons, *Smith* should not be viewed as a determinative statement on the legality of investor financed lawsuits.

In addition, the precedential value of *Smith* on this issue is reduced by the existence of two decisions which support the financing of lawsuits by third-party investors. In *Wiegandv. Huberman*,<sup>94</sup> Berger J. of the British Columbia Supreme Court held that the borrowing of money to finance a lawsuit where the parties agreed that the loan would be repaid by a share in the proceeds of the litigation did not constitute champerty. The Hubermans required financial assistance to allow them to bring an oppression action against majority shareholders in companies in which they held shares. They sought the assistance of Wiegand, who provided them with \$31,500 in exchange for repayment of the loan and 10 per cent of the proceeds of the litigation. The Hubermans did not proceed with the litigation, and Wiegand sought the court's assistance to recover his loan. The court rejected the Hubermans' defence of maintenance and champerty by holding that there was no element of officiousness in Wiegand's actions. Berger J. stated:

[The third-party investor] did not stir up litigation. He financed it, at the request of the defendants. They had no funds; they would not have been able to pursue the litigation without financial assistance. It would be unjust to say that anyone who lent money to the [Hubermans] in these circumstances would have no right under the law to get his money back if the litigation failed or to insist upon his share of the proceeds if it succeeded.<sup>95</sup>

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<sup>93</sup> *Smith (Summary Judgment) supra* note 87 at 630.

<sup>94</sup> (1979), 18 B.C.L.R. 102 (S.C.).

<sup>95</sup> *Ibid.* at 104.

Berger J. also denounced the traditional policy justifications for champerty and maintenance discussed earlier, favouring instead a policy of access to the courts, and stated:

The old English cases indicate that the courts used to seek to discourage litigation. In Canada, while the courts do not seek to encourage litigation, they do not want to place any obstacles in the way of an aggrieved citizen bringing a lawsuit which on legal advice he wishes to bring. Given the costs of litigation, it may be necessary to obtain such assistance.<sup>96</sup>

In the recent decision of *Nantais v. Telectronics Proprietary (Canada) Ltd.*,<sup>97</sup> a class action lawsuit against the manufacturer of a defective pacemaker, the investor financing scheme had the apparent approval of the trial judge. A handful of wealthy individuals contributed a total of \$350,000 to assist in the financing of the lawsuit. The arrangement was that if the litigation succeeded, the investors were to receive re-payment of their initial investment as well as 20 per cent annual interest on their investment, with priority over all other parties, including the plaintiffs. If the lawsuit failed, the investors would have lost their entire investment. The case settled for \$23.5 million three years after commencement of the suit, and the investors were compensated according to the agreement. The investor financing scheme was given approval in *Nantais*, in contrast to *Smith*, likely because there was compliance with the relevant securities laws,<sup>98</sup> the return on the investment was reasonable to both the investors and the plaintiffs, and the lawsuit appeared to be meritorious.<sup>99</sup> In *Smith*, the conduct was so egregious that it was not difficult for the court to classify it as improper, unlike *Nantais*, which appears to have had more tempered facts.

#### D. U.S. Experience in Investor Financed Litigation

The United States has had more experience than Canada with the financing of litigation by third-party investors. For example, a number of savings and loan institutions have sold shares in litigation that

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<sup>96</sup> *Ibid.*

<sup>97</sup> *Supra* note 4. See V. Lawton, "Investors Betting Lawsuits Will Bring Big Payoffs" *The Toronto Star* (22 February 1998) A3.

<sup>98</sup> See Part V, below, for a discussion of applicable securities laws, and a discussion of the securities laws that likely applied to this decision.

<sup>99</sup> See Lawton, *supra* note 97; and *Nantais*, *supra* note 4.

is being pursued against the Government of the United States in relation to its alleged breaches of contract resulting from the 1980's savings and loan crisis.<sup>100</sup> These securities are listed on the NASDAQ and are known by various names including litigation tracking warrants, contingent payment rights, and contingent litigation recovery participation interests.<sup>101</sup>

Businesses that invest in litigation have also developed.<sup>102</sup> Several investment firms have opened up that finance patent litigation.<sup>103</sup> One such business, Refac Technologies, invests in disputed patent infringement litigation and is listed on the American Stock Exchange.<sup>104</sup> The courts have been reluctant to welcome Refac's entry into the litigation system. In one case in which Refac financed litigation, the court imposed sanctions of over \$200,000 on the basis that the appeal filed by Refac was frivolous.<sup>105</sup> In another case where it was held that the litigation was frivolous, the court ordered Refac to pay \$2.5 million for the defendants' attorney fees.<sup>106</sup>

#### E. Conclusion

The courts' fact-based inquiry of maintenance and champerty would appear at first to be sensible. However, the lack of predictability with respect to the courts' discretion imposes additional costs and risks on the parties involved in investor financed lawsuits. For investor financing to be viable, investors will want greater certainty regarding the enforceability of their financing arrangement. Otherwise, investors will demand a higher premium on their investment and the financing scheme

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<sup>100</sup> See P. Sweeney, "How to Win Big in Court and Never See a Lawyer" *New York Times* (1 November 1998) s. 3 at 10; and S. Labanton, "The Debacle that Buried Washington" *New York Times* (22 November 1998) s. 3 at 12.

<sup>101</sup> *Ibid.*

<sup>102</sup> See *Killian v. Millard*, 228 Cal. App. 3d 1601 at 1607 (1991) as cited in Dobner, *supra* note 74 at 1530.

<sup>103</sup> Such firms include Intellectual Property Reserve Corp., WBX Partners, Patent Protection Institute, Patent Enforcement Fund, and Intellectual Property Reserve. See L. Himelstein, "Investors Wanted—For Lawsuits" *Business Week* (15 November 1993) 78.

<sup>104</sup> See Dobner, *supra* note 74 at 1530.

<sup>105</sup> *Refac International, Ltd. v. Hitachi Ltd.*, 921 F.2d 1247 at 1256-57 (Fed. Cir. 1990) as cited in Dobner *supra* note 74 at 1530.

<sup>106</sup> *Refac International, Inc. v. IBM Corporation*, 710 F. Supp. 569 at 570, n. 1 (D.N.J. 1989) as cited in Dobner, *supra* note 74 at 1531.

will be an unattractive option for most plaintiffs. Thus, rather than subject parties to an *ex post* review of the transaction by the courts, a legislative pronouncement that such agreements are valid, subject to clearly specified safeguards, would be most desirable. This conclusion is reinforced by the fact that original public policy justifications for the doctrines no longer appear persuasive and, upon scrutiny, the more contemporary public policy arguments appear exaggerated. Furthermore, the countervailing public policy of ensuring access to the civil justice system outweighs any possible remaining force in the contemporary justifications for retention of the doctrines against maintenance and champerty.<sup>107</sup> Concerns about the particular exchange between the plaintiff and the third-party investor involving issues such as voluntariness, relative bargaining power, and unfairness can be dealt with under the equitable doctrine of unconscionability in contract law.<sup>108</sup> In the absence of any clear judicial pronouncement that agreements involving investor financing of lawsuits are valid and enforceable, the common law doctrine invalidating champertous agreements should be legislatively abolished, and the 1897 *Act Respecting Champerty*<sup>109</sup> repealed. At a minimum, legislation should be implemented permitting investor financed lawsuits, as was done in the area of contingency fees in the Ontario *Class Proceedings Act* specifically stating that such agreements are valid despite the 1897 *Act Respecting Champerty* and the common law doctrines.<sup>110</sup>

## V. REGULATION OF THE MARKET FOR FINANCING LITIGATION

### A. *Protection of Investors—Securities Regulation*

Securities laws are another potential regulatory barrier to the development of investor financed lawsuits. An analysis of whether investor financed lawsuits should require compliance with securities laws follows. I reach the conclusion, based on doctrinal analysis and a strong

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<sup>107</sup> *Ibid.*

<sup>108</sup> For a discussion of unconscionability, see generally, S.M. Waddams, *The Law of Contracts* 3d ed. (Toronto: Canada Law Book, 1993) at 434-546; and G.H.L. Fridman, *The Law of Contracts in Canada*, 3d ed. (Toronto: Carswell, 1994) at 313-40.

<sup>109</sup> *Supra* note 36.

<sup>110</sup> See *supra* note 71.

public policy favouring protection of the investing public, that funding of litigation by investors would be subject to securities laws, including the issuance of a prospectus, unless the financing can fit under an appropriate prospectus exemption. It is a legitimate question whether certain aspects of securities regulation ought to be made more cost-effective so that capital can be raised with greater ease. However, under current law, investor financing will be cost-effective and practicable only for lawsuits involving large claims, typically class actions, or alternatively where investment fund companies are set up to act as clearinghouses for individual claims.

### B. *The Prospectus Requirement*

A prospectus is a detailed disclosure document which must be provided to investors who purchase securities of a firm if securities legislation so requires. The *Ontario Securities Act* requires that a prospectus “shall provide full, true and plain disclosure of all material facts relating to the securities issued or proposed to be distributed.”<sup>111</sup> A prospectus must provide, among other facts, detailed and verifiable information about the business and affairs of the issuer, and the risk factors involved with the investment.

Section 53 of the *OSA* offers the mechanism for the regulation of the primary market for capital by the Ontario Securities Commission (osc). It provides that:

No person or company shall *trade* in a *security* on his, her or its own account or on behalf of any other person or company where such trade would be a *distribution* of such security, unless a *preliminary prospectus* and a *prospectus* have been filed and receipts thereof obtained from the Director.<sup>112</sup>

The definition of security is the most important provision in the *OSA* because all other sections are based on it. Thus whether a transaction between a plaintiff and a third-party investor falls within the prospectus requirement requires examining whether it would constitute a security.<sup>113</sup>

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<sup>111</sup> R.S.O. 1990, c. S-5, s. 56 [hereinafter *OSA*].

<sup>112</sup> *Ibid.* s. 53 [emphasis added].

<sup>113</sup> For a discussion of the definition of security, see M. Gillen, *Securities Regulation in Canada* (Toronto: Carswell, 1992) at 84-98; V.P. Alboini, *Securities Law and Practice* 2d ed. (Toronto: Carswell, 1984); D.L. Johnson & K. Doyle Rockwell, *Canadian Securities Regulation* 2d ed. (Toronto: Butterworths, 1998) at 25-34; and F. Iacobucci, “The Definition of Security for Purposes of a Securities Act” in P. Anisman, ed., *Proposals for a Securities Market Law for Canada* vol. 3

A broad definition of the concept of “security” is set out in section 1(1) of the *OSA*. The definition is sub-divided into sixteen paragraphs and is non-exhaustive in nature.<sup>114</sup> The broadest aspect of the definition of security is “any investment contract,”<sup>115</sup> a provision which has been interpreted with a purposive analysis.<sup>116</sup> Canadian regulators and courts have, in large part, accepted American jurisprudence on this issue, given the similarities underlying the legislative policies of Canadian and U.S. securities regulation<sup>117</sup> and the definition of security.<sup>118</sup> The two leading U.S. cases are *SEC v. W.J. Howey*<sup>119</sup> and *State of Hawaii v. Hawaii Market Center Ind*<sup>120</sup>

In *Howey*, the United States Supreme Court held that the definition of security ought to be broadly construed because of the policy of investor protection underlying the *Securities Act*. In attempting to define “investment contract,” the Court reasoned that any definition must permit the following:

[T]he fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of “the many types of instruments that in our commercial world fall within the ordinary concept of a security.” ... It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits.<sup>121</sup>

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(Ottawa: Consumer and Corporate Affairs Canada, 1979) 221.

While the definitions of trade and distribution are also relevant to the analysis of whether a prospectus is required, their defining characteristics are much less analytical and controversial than that of security.

Section 1(1)(e) of the *OSA* defines a “trade” as “any sale, encumbrance, ... and any act, advertisement, solicitation, conduct, negotiation in furtherance of any of the foregoing.” This broad definition results in practically any dealing with the transfer or potential transfer of a security constituting a trade under the *OSA*, with a notable exception being the purchase of a security. Section 1(1) of the *OSA* defines distribution as “a trade in a security by the issuer that has not been previously issued,” which includes initial offerings made by an issuer.

<sup>114</sup> For a criticism of the definition of security, see Anisman, *supra* note 113 at 33, where he states that the sub-sections in the *OSA* are a “heterogenous clutter” to which “the defining terms seem to have been added piecemeal, and without much justification.”

<sup>115</sup> *OSA*, *supra* note 111, s. 1(1)(n).

<sup>116</sup> See *Pacific Coast Coin Exchange of Canada Ltd. v. O.S.C.*, [1978] 2 S.C.R. 112 at 126, aff'g (1976), 8 O.R. (2d) 257 (C.A.), aff'g (1975), 7 O.R. (2d) 395 (Div. Ct.) [hereinafter *Pacific Coast*].

<sup>117</sup> *Ibid.*

<sup>118</sup> *Securities Act of 1933* 15 U.S.C.S. § 77b(1) (Law. Co-op. 1991) reads: “The term ‘security’ means any note, stock, ... investments contract, ... fractional interest in oil, gas, or other mineral right, ... .”

<sup>119</sup> 328 U.S. 293 (1946) [hereinafter *Howey*].

<sup>120</sup> 485 P. 2d 105 (Haw. 1971) [hereinafter *Hawaii*].

<sup>121</sup> *Howey*, *supra* note 119 at 299.

The Court defined investment contract by a four pronged test: (1) money has to be invested (2) in a common enterprise (3) with the expectation of profit (4) to be derived solely from the efforts of others. Subsequent case law has modified “solely” to “primarily.”<sup>122</sup>

In *Hawaii*, the Supreme Court of Hawaii criticized the *Howey* test for being overly mechanical, and devised a broader four-pronged test to define an investment contract which is commonly known as the “risk capital” test.<sup>123</sup> An investment contract exists when (1) an offeree furnishes initial value (money is invested), (2) a portion of this money is subject to the risks of enterprise, (3) the investor is induced into giving initial value by a promise or representation that the investor will make a profit as a result of the operations of the enterprise, and (4) the investor does not have the right to exercise actual or practical control over managerial decisions of the enterprise.<sup>124</sup> Like the *Howey* Court, the *Hawaii* court emphasized the policy of investor protection underlying the Act and the remedial nature of the legislation.

The leading case in Canada that speaks to the definition of investment contract is *Pacific Coast Coin*,<sup>125</sup> which accepted both the *Howey* and *Hawaii* tests. Pacific Coast sold silver coins on margin. It solicited investors mainly through newspaper advertisements, and emphasized that an investment in silver coins was “reliable” and an “almost perfect” protection against inflation. The margin agreement required the investor to initially pay only a portion of the purchase price. The investor could then elect to take delivery of the coins or sell the coins at the current market price using Pacific Coast’s services. The investors faced significant risks, including the uncertainty resulting from Pacific Coast not keeping a full inventory of coins purchased by investors,<sup>126</sup> meaning that the value of investors’ portfolio of silver coins fluctuated according to the market price. For these reasons, a majority of the Supreme Court of Canada held the scheme was an investment contract and thus a security within the meaning of the *OSA*.

In analyzing the *Howey* and *Hawaii* decisions, the Court acknowledged refinements to the *Howey* test that modified “solely” to “primarily,” and also reasoned that “common enterprise” in *Howey* referred to vertical commonality, so that the relationship between

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<sup>122</sup> Gillen, *supra* note 113 at at 92.

<sup>123</sup> See *Hawaii*, *supra* note 120; and Gillen, *supra* note 113 at 93.

<sup>124</sup> *Ibid.*

<sup>125</sup> *Supra* note 116.

<sup>126</sup> *Ibid.* at 125.

investors and the promoter, not investors *vis-à-vis* each other, is relevant. The decision, in effect, accepted the criteria in *Howey* and *Hawaii* as the tests to define an investment contract.

Like the *Howey* and *Hawaii* courts, the Court also analyzed the case from a public policy standpoint, and noted that the policy of the legislation is “clearly the protection of the public”<sup>127</sup> so as to “replace the harshness of *caveat emptor* in security related transactions.”<sup>128</sup> The Court also relied on *Re Ontario Securities Commission and Brigadoon Scotch Distributors (Canada) Limited*<sup>129</sup> in which the Ontario High Court said that “the basic aim or purpose of the *Securities Act* 1966, ... is the protection of the investing public through full, true and plain disclosure of all material facts relating to securities being issued.”<sup>130</sup> The majority opinion then stated that “[s]uch remedial legislation must be construed broadly, and it must be read in the context of the economic realities to which it is addressed. Substance, not form, is the governing factor.”<sup>131</sup>

Laskin J., in dissent, criticized the majority’s opinion on the basis that it used Pacific Coast’s potential insolvency as determinative of whether the scheme constituted a security. He found that the risks associated with the investment were not determined by Pacific Coast’s conduct but rather by the market. He stated that courts should not be too quick to enlarge the scope of statutory control if the legislature deliberately did not define a term to include a particular transaction.

An investment in a lawsuit is not specifically enumerated as a security under the *OSA*. Nevertheless, it is capable of falling within the broad concept of “investment contract,” thus requiring the issuance of a prospectus. An application of the common enterprise test set out in *Howey* would result in investor financed litigation being considered an investment contract. The first prong is met in that there will be an investment of money by the third-party investor. Under normal circumstances, services can be provided in lieu of cash as consideration for an investment. However, in the context of investor financed lawsuits, the plaintiff’s most significant service requirement will be legal services. The provision of legal services in exchange for a share in a lawsuit is merely a contingency fee arrangement, which is outside the scope of the

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<sup>127</sup> *Ibid.* at 126.

<sup>128</sup> *Ibid.* at 132.

<sup>129</sup> (1970), 3 O.R. 714 (H.C.J.).

<sup>130</sup> *Ibid.* at 717, cited in *Pacific Coast supra* note 116 at 126.

<sup>131</sup> *Supra* note 116 at 127.

definition of an investment contract, as will be analyzed when discussing the fourth prong of the *Howey* test.

The second prong of common enterprise (more particularly, vertical commonality) is satisfied because the third-party investor's "fortunes ... are interwoven with and dependent upon the efforts and success of those seeking the investment."<sup>132</sup> The third prong of the test will be satisfied because the investors will have an expectation of profit.<sup>133</sup> The fourth prong would also likely be satisfied in that the expectation of profit depends largely on the efforts of others, in particular, the lawyers retained by the plaintiff. On the other hand, one can pose an argument based on Laskin J.'s dissent in *Pacific Coast* that the success of a lawsuit is governed largely by the facts at issue and the applicable laws. If this argument is accepted, an investment in a lawsuit would not be considered a security and a prospectus would not be required. However, the majority's position in *Pacific Coast* will likely prevail because the reputation and skill of an advocate cannot be underestimated, particularly at the trial level. In any event, the investor has no part to play in the profit-making of the scheme, thereby satisfying the fourth prong of the *Howey* test.<sup>134</sup>

An application of the risk capital test prescribed in *Hawaii* leads to a similar result. The third-party investor invests in the lawsuit to finance the costs of litigation, realizing that the investment is subject to risk of loss if the lawsuit fails, but expecting a return on the investment. Most importantly, the fourth prong of the test will be satisfied in that the third-party investor will not under most circumstances exercise control over the litigation, in developing legal theories and strategy, determining which witnesses to call, and making or accepting settlement offers, for example. At the very least, these elements of substantial control will not be at the investors' discretion.

An examination of the primary policy underlying securities legislation, that is, protection of the investing public, confirms that the

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<sup>132</sup> *Ibid.* at 129.

<sup>133</sup> This requirement will not be met if the investor is providing the investment capital for reasons of social interest, such as the funding of public interest litigation, where the investor's motivation is not the expectation of personal monetary gain. This situation will not arise in our scheme because the purpose of this scheme is to solicit investment capital from investors who see promise in the litigation and hope to profit from such an investment.

<sup>134</sup> A contingency fee arrangement between a solicitor and a client is not a security because the efforts of the lawyers are instrumental in determining the success of the lawyer's investment in the case. Also, the policy underlying the *OSA* would suggest that the lawyer as investor does not need to be protected in the circumstances.

proposed scheme would constitute a “security.”<sup>135</sup> Like any other business venture where capital is subject to negative as well as positive fluctuations, investment in lawsuits can be a very risky proposition simply because if the lawsuit fails, the investment fails. The investor will lose the entire investment. The following is a partial list of the factors that may be considered relevant to a third-party investor in determining the risks of a particular lawsuit and that would be required to allow for full, true and plain disclosure:

- A description of the litigation, including a legal opinion on the strength of the causes of action and potential defenses;
- A description of the legal teams for the plaintiff and defendant, including their background, reputation and experience on similar cases;
- A detailed break-down of the amount claimed;
- A detailed break-down of the expected costs of the lawsuit, including legal fees and significant disbursements;
- Details of how the investment funds will be used in the litigation and an estimate of the proceeds of the securities issue;
- A description of the nature of the investment (equity or debt, rate of return, priority, and control features such as voting rights);
- The length of time expected until final resolution; and
- Underwriters’ and promoters’ fees.

One could argue that disclosure of information of this kind about litigation is confidential and could be detrimental to the plaintiff’s case should the opponent get access to it. However, other parties engaged in the raising of public funds are also subject to disclosure requirements which may expose sensitive information to competitors. There is no reason to distinguish investor financed lawsuits from these ventures, given the investor protection mandate underlying securities regulation. Without prospectus disclosure, the theory is that some information would not be produced and it would be difficult for a market to accurately and efficiently price lawsuits.<sup>136</sup>

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<sup>135</sup> It is worthwhile to bear in mind as well that s. 10 of the *Interpretations Act* R.S.O. 1990, c. I-11, states that a statute should be interpreted to achieve its objectives. Since a primary objective of the *OSA* is to protect the investing public, definitions under the *Act* ought to be interpreted in a manner consistent with this objective.

<sup>136</sup> J.G. MacIntosh, *Legal and Institutional Barriers to Financing Innovative Enterprise in Canada* (Kingston: Government and Competitiveness, School of Policy Studies, Queen’s University, 1994) at 115-22.

Based on a doctrinal and public policy analysis, it appears that a prospectus will need to be issued if the plaintiff wishes to obtain the capital of public investors to finance the litigation, unless the financing can fit into an exemption from the prospectus requirement.

### *C. Exemptions from the Prospectus Requirement*

A number of possible exemptions are available from the prospectus requirement that might be practicable in relation to lawsuit financing, including the following:

#### 1. Exempt institutions

Certain institutions, such as banks, trust companies, and insurance companies are exempt institutional purchasers<sup>137</sup> because it is assumed that these institutions have the knowledge, or the ability to gather the necessary information, to make informed investment decisions.<sup>138</sup>

#### 2. Exempt institutional purchaser

Certain institutional purchasers other than exempt institutions as listed above, can apply to the OSC for a discretionary exemption from the prospectus requirement.<sup>139</sup> The OSC will consider the degree of sophistication of the institution in deciding whether to grant the exemption.<sup>140</sup>

#### 3. Seed capital exemption

An exemption from the requirement to issue a prospectus is also available where a limited number of potential investors are solicited (a maximum of fifty of which twenty-five may purchase); the investors have sufficient net worth and investment experience (or access to it) so as to

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<sup>137</sup> OSA, *supra* note 111, s. 72(1)(a).

<sup>138</sup> See Gillen, *supra* note 113 at 191.

<sup>139</sup> OSA, *supra* note 111, s. 72(1)(c).

<sup>140</sup> See Gillen, *supra* note 113 at 193.

evaluate the prospective investment; and each purchaser is provided with substantially the same information that would be contained in a prospectus.<sup>141</sup> This last requirement has been interpreted as requiring the issuance of an offering memorandum, containing prospectus-like disclosure, to which civil liability attaches for misrepresentations.

#### 4. \$150,000 “Private placement” exemption

An exemption exists when an investor purchases more than \$150,000 of the securities of an issuer.<sup>142</sup> The rationale is that such a purchaser will have a greater incentive to seek advice with respect to the investment, and will be in a position *vis-à-vis* the issuer to obtain relevant information required to analyze the investment.<sup>143</sup>

#### 5. Close bonds exemption

When the investor is the spouse, parent, brother, sister or child of a senior officer or director of the issuer,<sup>144</sup> there is an exemption from the prospectus requirement. The rationales are that the issuer will not exploit these individuals and that these individuals will have access to material information about the issuer as a result of their relationship with the issuer.

#### 6. Private company exemption

The private company exemption<sup>145</sup> allows an issuer to sell securities without a prospectus if its shares are subject to restrictions on their transfer, the shares are not owned by more than fifty people, and the shares have not been distributed “to the public.” The meaning of “to the public” is set out in the leading cases of *Securities and Exchange*

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<sup>141</sup> See Johnson & Doyle Rockwell, *supra* note 113 at 113.

<sup>142</sup> *OSA*, *supra* note 111, s. 72(1)(d), modified by *OSA* Reg. 1015, s. 27.

<sup>143</sup> Gillen, *supra* note 113 at 194; and J. MacIntosh, *Regulatory Barriers to Raising Capital for Small Firms* (Toronto: Faculty of Law, University of Toronto, Canadian Law & Economics Association, 1994) at 10 [hereinafter *Regulatory Barriers*].

<sup>144</sup> *OSA*, *supra* note 111, ss. 72(1)(p)(ii)(B)-(D).

<sup>145</sup> *Ibid.* ss. 73(1)(a), 35(2)(10).

*Commission v. Ralston Purina Co!*<sup>146</sup> and *R. v. Piepgrass*<sup>147</sup> The use of the term “to the public” allows courts and regulators to consider the situations in which investors would need protection. In *Purina*, the United States Supreme Court articulated the “need to know” test, which asks whether the potential investors would need to know the information that would be contained in a prospectus.<sup>148</sup> In *Piepgrass*, the Alberta Court of Appeal articulated a different test, the common bonds test, which asks whether the potential investors are friends or associates of the promoter, or persons having common bonds of interest or association with the promoter.<sup>149</sup>

#### 7. Socially desirable activity

An exemption is available for securities sold by an issuer organized exclusively for “educational, benevolent, fraternal, charitable, religious or recreational purposes and not for profit.”<sup>150</sup>

#### 8. Discretionary exemption order

The issuer can obtain an exemption order from the osc when the transaction does not fit under a recognized exemption but where it can be demonstrated that the goal of investor protection would not be sacrificed. The osc has the power to grant an exemption order if it is satisfied that to do so would not be “prejudicial to the public interest.”<sup>151</sup>

#### 9. Application

Most of the exemptions discussed in the preceding sections are either not available or not cost-effective. The exemption for socially desirable activity would not be available because investors would be

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<sup>146</sup> 73 S. Ct. 981 (1953) [hereinafter *Purina*].

<sup>147</sup> (1959), 29 W.W.R. 218 (Alta. C.A.) [hereinafter *Piepgrass*].

<sup>148</sup> *Purina*, *supra* note 146 at 984-85.

<sup>149</sup> *Piepgrass*, *supra* note 147 at 227.

<sup>150</sup> *OSA*, *supra* note 111, ss. 73(1)(a), 35(2)(7).

<sup>151</sup> *Ibid.* s. 74.

investing with the expectation of profit.<sup>152</sup> The close bonds exemption would not have much practical benefit, given its limited scope. While banks and insurance companies would be able to rely on the exemption for institutions, they have not historically invested in lawsuits and are unlikely to do so given the real and perceived risks to which they may be exposed.

The seed capital exemption is limited because of the restrictions on advertising which necessitate the plaintiff soliciting funds from known sources. In addition, this exemption may not be appropriate for lawsuit funding because it was initially crafted to provide financing for businesses in the early stages of their life-cycle, whereas litigation does not fit neatly into this model.

A discretionary exemption order might be available if the investment does not fit neatly into one of the exemptions enumerated in the *OSA*.<sup>153</sup> However, its viability will depend upon the size of the legal claim because the cost of applying for this exemption will amount to several thousand dollars.<sup>154</sup>

The three most viable exemptions are the \$150,000 exemption, the private company exemption, and the institutional purchaser exemption, primarily because no disclosure is mandated by the securities legislation, and thus minimal costs are required to utilize these exemptions. The \$150,000 exemption is an option for sophisticated investors willing to invest in the lawsuit. The private company exemption would be available if either of the *Purina* or *Piepgras* tests is met. The *Purina* test would be satisfied if a sophisticated investor can be found. The benefit of the *Purina* test as compared to the \$150,000 exemption is that the former does not require a minimum investment, thus allowing for a larger class of potential investors. The *Piepgras* test would be available but likely too narrow to have any significant impact. However, a recent OSC decision interpreted "to the public" as requiring that both the *Purina* and *Piepgras* tests be met so that the close friends must also be sophisticated investors.<sup>155</sup> If the OSC's interpretation is

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<sup>152</sup> Since the investor of a socially desirable activity likely does not expect a return or profit on the investment, it seems that such investments would not even constitute a security within the meaning of the *OSA*.

<sup>153</sup> See Gillen, *supra* note 113 at 219-20 for discussion of when a discretionary exemption order might be granted.

<sup>154</sup> See *ibid.* at 220; and Johnson & Doyle Rockwell, *supra* note 113 at 129.

<sup>155</sup> See *Regulatory Barrier*, *supra* note 143 at 12 where he analyzes the implications of the OSC's decision.

correct, it places too great a burden on plaintiffs who wish to use this exemption.

The institutional purchaser exemption may be the most viable of the available exemptions. A litigation investment fund could be established for the purpose of financing lawsuits. Potential plaintiffs would have their legal claims assessed by the fund's staff of lawyers and could potentially obtain the financing necessary to pursue their respective litigation. The establishment of such a fund would dispense with the need for prospectus-like disclosure on the part of each potential plaintiff so long as the fund meets the criteria required to employ the institutional purchaser exemption. Such criteria would include the ability to analyze the merits of potential plaintiffs' claims, assess the likelihood of success, determine the quantum of a possible award, estimate the costs of the litigation, and finally, calculate whether the expected award is greater than the estimated costs and thus a viable investment.

#### D. *The Costs of Compliance with Securities Regulation*

As noted earlier, the primary purpose of securities regulation is investor protection.<sup>156</sup> The 1997 Ontario Securities Commission Annual Report describes the mission statement of the osc as follows: "To protect investors from unfair, improper or fraudulent practices and to foster fair and efficient capital markets and confidence in their integrity."<sup>157</sup> This rationale assumes market failure in that information asymmetries exist between firms offering securities and purchasers of securities, and firms will exploit these asymmetries and systematically take advantage of purchasers to their detriment. Thus, disclosure of information has been mandated by legislation to correct this market failure.

However, regulation entails costs. While the osc recognizes the "need to balance investor protection against the need for companies to raise capital from the public at a cost which is not prohibitive,"<sup>158</sup> current disclosure requirements can be criticized for not being cost-effective. For example, the requirement to supply a prospectus to all purchasers of securities imposes significant costs but does not achieve its

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<sup>156</sup> See the discussion in *Pacific Coast* at notes 127-131, *supra*, and accompanying text.

<sup>157</sup> Ontario Securities Commission, *1997 Annual Report: A Changing Commission for a Changing Market* (Toronto: Ontario Securities Commission, 1997) at 5.

<sup>158</sup> *Ibid.*

primary goal, since it is widely known that most individual investors do not read them.<sup>159</sup> Even the exemptions from the prospectus requirement, which were designed to allow firms to raise capital with greater ease (both in terms of regulation and cost), still contain requirements that impose significant costs without furthering the goal of investor protection. Jeffrey MacIntosh argues in favor of various reforms to the exemptions to allow small firms to raise capital with greater ease without significantly detracting from the protection of investors.<sup>160</sup> The Ontario Securities Commission Report on Small Firm Financing has recommended that the exemptions be reconstructed and simplified, and that, in particular, the requirement for an offering memorandum in relation to the seed capital exemption be eliminated.<sup>161</sup> These proposals have not yet been enacted by the legislature.

#### E. Conclusion

The above analysis suggests that a prospectus will be required unless an appropriate exemption can be found. The requirement to make disclosure through a prospectus is costly and onerous. Thus, it appears that the issuance of a prospectus will be cost-effective only in litigation involving significant expected awards, particularly class action lawsuits. For most other lawsuits, an exemption from the requirement to issue a prospectus will be required to make investor financing of litigation practical. Given the cost barriers imposed by some of the exemptions, they ought to be re-evaluated and made more cost-effective so that investor financing of litigation can have wider application. While it is not certain that investor financed litigation would fall into the OSC Task Force's proposals for small firm financing, enactment of their recommendations would be a step in the right direction, as they strike a better balance between the goal of investor protection and the costs of regulation than current laws.

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<sup>159</sup> See *Regulatory Barriers*, *supra* note 143 at 25-33.

<sup>160</sup> See *ibid.*

<sup>161</sup> Ontario Securities Commission, *Task Force on Small Business Financing: Final Report* (Toronto: Ontario Securities Commission, 1996) at 1-15.

*F. Protection of the Plaintiff—Towards a Regulatory Framework*

An appropriate regulatory structure should be devised to address concerns about the potential exploitation of unsophisticated plaintiffs by savvy and knowledgeable investors, promoters and investment funds. While Part VI, below, discusses specific issues in relation to protecting plaintiffs, such as who controls the litigation and conflict of interests, a choice will have to be made among a number of regulatory instruments in attempting to achieve this goal. Clear and specific legislative provisions would have the benefit of providing parties with greater certainty as to their relationship; a requirement of judicial or administrative approval would have the benefit of increased flexibility, although this would come with additional costs; a third option would be a modification of Michael Trebilcock's recommendation in relation to contingency fees that disclosure of any investors financing litigation be mandated, a database be set up, and details of financing arrangements be publicly available.<sup>162</sup>

**VI. PUBLIC POLICY CONSIDERATIONS**

The policy arguments for and against investor financing of litigation are identified and evaluated below. The greatest benefit of investor financed litigation is the potential for increased access to the justice system. A secondary benefit is behaviour modification. The fact that established models of financing litigation are limited in their ability to achieve these dual goals further amplifies the benefits of investor financing.

In what follows, it is suggested that critics will argue that investor financed lawsuits will increase frivolous litigation, decrease settlement, and encourage the manipulation of witnesses and evidence. Arguments to the contrary are that these claims are exaggerated and overstated, and the concerns raised therein are addressed by existing procedural safeguards. Possible critiques that this development is morally questionable and that it reinforces a rights-oriented society are also addressed. The conclusion reached below is that the advantages of this development outweigh the costs, and that in sum, the interests of justice are served by allowing investors to finance lawsuits.

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<sup>162</sup> See Trebilcock, *supra* note 21.

A. *The Case for a More Secure Footing for Investor Financing*

The financing of lawsuits by third-party investors will increase access to the civil justice system for individuals who have meritorious claims but who lack the financial resources to pursue them. Upon comparison of the average costs of litigation to the average salary of Canadians (as set out above<sup>163</sup>), it is not controversial to conclude that many meritorious claims are not currently litigated.<sup>164</sup> It is undesirable that the costs of litigating claims often prevent meritorious claims from being pursued. Only individuals of some wealth in our society can undertake litigation. This is a significant problem for the administration of civil justice. As Mr. Justice Cory of the Supreme Court of Canada stated in *Coronation Insurance*, “[l]egal rights are illusory and no more than a source of frustration if they cannot be recognised and enforced.”<sup>165</sup>

The financing of lawsuits by third-party investors will also provide a greater incentive than now exists to potential wrongdoers to abide by legal rules.<sup>166</sup> In the absence of investor financing, many meritorious claims are not pursued because they are not economically viable. Potential wrongdoers, aware of this reality, may flout the law, rationally calculating that their wrongdoing may not result in a lawsuit. The availability of investor financing, however, may deter potential wrongdoers from violating the law, because of the greater likelihood that they will be sued if their actions result in injury to others.<sup>167</sup> Despite the increased likelihood of being sued, wrongdoers may nonetheless violate legal rules if the benefit of violating the rule is greater than the cost of so doing, including the amount that might be recovered from the

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<sup>163</sup> See notes 3-6, *supra*, and accompanying text.

<sup>164</sup> See Dobner, *supra* note 74 at 1552.

<sup>165</sup> As quoted in *Nantais*, *supra* note 4 at 534.

<sup>166</sup> My argument works off the premise that behaviour modification or deterrence is one of the goals of the civil justice system. For a discussion on the continuing philosophical debate as to the proper purpose(s) of civil litigation (conflict resolution and/or deterrence), see *Report on Class Actions*, *supra* note 15 at 140-46; and Roach, *supra* note 11 at 394.

<sup>167</sup> A similar rationale was provided in the context of class actions. See *Report on Class Actions*, *supra* note 15 at 140-46.

plaintiff.<sup>168</sup> Nevertheless, the public policy favouring the internalization of the costs of an individual's behaviour is strengthened.

A comparison of investor financing with other models of funding litigation reinforces the benefits of this development, particularly upon analysis of the limitations of the existing models. As discussed in more detail in Part II, above, legal aid plays a very limited role in funding civil litigation, even for the very poor. Similarly, public litigation subsidy funds are limited in their ability to achieve the goals of accessibility and deterrence because of their focus on class actions to the exclusion of individual claims, their inability to provide assistance for legal fees, the pre-set reimbursement rate of 10 per cent resulting in inefficient allocation of funds, and the small capital base. In contrast, investor financing would be available in theory to fund individual and class actions, provide assistance for legal fees as well as disbursements, tailor an individualized rate of return appropriate to the risks of the particular litigation, and have the potential to provide and raise much more capital. Similarly, investor financing can nicely complement contingency fee arrangements because third-party investors may be less risk averse and better bearers of risk than lawyers and as a result, they may be willing to finance cases that lawyers may be unwilling to take on. The fact that lawyers may not be willing to assume the entire risk of loss associated with a case is highlighted in *Nantais* in which the plaintiff's lawyer could have financed the entire litigation through a contingency fee arrangement, but instead preferred to shift a portion of the risk to private investors.

#### *B. Addressing Problems Associated with Widespread Availability of Investor Financing*

##### 1. Encourage frivolous litigation

An argument against investor financing of lawsuits is that it will encourage frivolous and vexatious litigation and thus backlog the courts. While any increase in litigation will place additional demands on an

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<sup>168</sup> See generally R. Coase, "The Problem of Social Cost" (1960) 3 J.L. & Econ. 1; and B.R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford: Clarendon Press, 1997) where Cheffins states, at 25, that Coase's "reasoning suggests that whenever people encounter legal rules which do not suit their interests, they may well negotiate around those rules and formulate a mutually advantageous and socially optimal solution."

already backlogged court system, there are three responses to this concern.<sup>169</sup>

First, an increase in *meritorious* lawsuits should be expected and applauded given that a goal of this development is to increase access to the civil justice system for individuals who are currently unable to afford the costs of litigation. Second, the proportion of frivolous lawsuits to meritorious lawsuits will not increase under this development because the rules of civil procedure filter out frivolous and vexatious claims early in the trial process. For example, a defendant can bring a motion for summary judgment to strike out a claim when there is no genuine issue for trial.<sup>170</sup> Thus, it is unjust to prohibit all investor financed lawsuits, including ones that are meritorious, on the basis that some claims that are financed by investors may be frivolous, given that wealthy individuals are permitted to pursue any and all claims regardless of merit, subject only to summary judgment rules.

In fact, the proportion of frivolous lawsuits to meritorious lawsuits will in all likelihood decrease under this development. This is because of the nature of investment. A frivolous and vexatious lawsuit is one that lacks merit and is commenced for the purpose of harassing, intimidating or irritating the defendant. Rational investors, being interested only in monetary return, will be unwilling to advance funds to finance frivolous lawsuits. In fact, investors will seek out those lawsuits which appear to be most meritorious, because they will have the greatest probability of success. Thus, rather than encouraging frivolous and vexatious lawsuits, investors will actually serve as a private screening mechanism to sift out non-meritorious claims.<sup>171</sup>

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<sup>169</sup> See M.J. Trebilcock & K. Roach, "Private Enforcement of Competition Laws" (1996) 34 Osgoode Hall L.J. 461 for a similar discussion in relation to the case for private enforcement of competition laws where they also reject the claim that private enforcement will increase the percentage of frivolous and vexatious claims, if a variety of appropriate procedural rules and constraints are in place.

<sup>170</sup> *Ontario Rules of Civil Procedure*, R.R.O. 1990, Reg. 194, Rule 20, as amended to O. Reg. 333/96, which deals with motions for summary judgment.

<sup>171</sup> Because investor financing will be a private order mechanism and will be dictated by private tastes, lawsuits involving violations of constitutional rights, or demanding injunctive relief, may not get funding as easily as suits involving damage awards. Thus, this financing method will likely not change the state of current laws, but will simply allow greater access to the courts for more people.

## 2. Discourage settlement

Another argument against investor financed lawsuits is that they will discourage settlement. Currently, only about 5 per cent of actions that are commenced reach trial.<sup>172</sup> A large proportion of the remaining actions are resolved by non-adjudicative techniques, such as mediation or negotiation.<sup>173</sup> Encouraging settlement is indeed a laudable policy goal and in the best interests of the administration of justice because it substantially reduces the costs of running the court system. If all actions that are commenced were to see their day in court, our court system would come to a stand-still. However, the claim that private investor financing of lawsuits will result in fewer claims being settled requires scrutiny.

It is possible that this development may lead to fewer claims being settled. This should not be perceived as a disadvantage. In this context, less settlement may actually serve the interests of justice. While ideally, lawsuits settle because the parties perceive the settlement to be fair and reasonable, the ideal and the reality do not always resemble one another. In reality, whether parties settle, and on what terms, is “a function of the resources available to each party to finance the litigation, and those resources are frequently distributed unequally.”<sup>174</sup> The financially weaker party may lack the information required to make an informed decision about the merits of the case, may settle because of an inability to afford prolonged litigation, and may be pressured into settling because of a need to receive an award sooner rather than later.<sup>175</sup> Studies show that a significant percentage of parties who settle do not consider their settlements to be “fair” or “adequate.”<sup>176</sup> As Marc Galanter and Mia Cahill write:

It is often asserted that parties are more satisfied with settlements than with adjudicated outcomes. This is plausible insofar as one associates settlement with greater party

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<sup>172</sup> This figure appears to be more anecdotal than empirical. See G. Watson *et al.*, *Civil Litigation Cases and Materials* 4th ed. (Toronto: Emond Montgomery, 1991) at 11; and M. Galanter & M. Cahill, “Most Cases Settle’: Judicial Promotion and Regulation of Settlements” (1994) 46 *Stan. L. Rev.* 1339.

<sup>173</sup> *Ibid.*

<sup>174</sup> O.M. Fiss, “Against Settlement” (1984) 93 *Yale L.J.* 1073 at 1076. See also various articles from the Symposium on Contingency Fee Financing, *supra* note 21.

<sup>175</sup> See Fiss, *supra* note 174 at 1076-78.

<sup>176</sup> See D. Caplovitz, *Consumers in Trouble: A Study of Debtors in Default* (New York: Free Press, 1974) at 245, where only 53 per cent of 314 debtors who settled debt out of court viewed their settlement as fair.

participation and control, the possibility of individualizing outcomes to suit the needs of the parties, and so forth. But even so, significant numbers of those who settle are not very happy with the outcome.

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[T]he mere occurrence of settlement (or trial) does not establish that the parties prefer the process or that they regard the outcome as optimal. ... This is especially so for unsophisticated, "one-shot" parties. These limitations should caution us against equating party choice to settle or to litigate with an informed affirmation of the quality of the selection process.<sup>177</sup>

Investor financing of lawsuits will alleviate the pressures discussed above because a financially weaker plaintiff will now have the funds to take an action to court if a defendant refuses to settle on reasonable terms. This is a commendable result despite the potential of increased costs to the taxpayer and strain on the court system.

In particular circumstances, the development of investor financing may lead to faster and more settlements. Currently, wealthier defendants may hold out from settling because of their knowledge that the plaintiff cannot afford continued litigation. Under a scheme of investor financing, defendants who are aware that the plaintiff's financial pressures have been, or can be, alleviated will have greater incentives to settle.<sup>178</sup>

Finally, there is a second argument suggesting that settlement rates will not decrease. Private investors who control litigation<sup>179</sup> will be subject to rules of civil procedure that encourage settlement. The rules provide incentives in the form of cost sanctions for parties who do not accept reasonable offers made by an opponent. For example, Rule 49 of the Ontario *Rules of Civil Procedure* states in part that if one party to a lawsuit makes a written offer to settle which is not accepted and then at trial receives a better result than that proposed in the offer, the party that rejected the offer may be subject to significant cost sanctions.<sup>180</sup> Presumably, an investor controlling a lawsuit, like any litigant, will rationally calculate the advantages and disadvantages of making or accepting an offer to settle given these cost incentives.

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<sup>177</sup> Galanter & Cahill, *supra* note 172 at 1353, 1358-59.

<sup>178</sup> See Dobner, *supra* note 74.

<sup>179</sup> It is not necessarily the case that private investors would control the direction, settlement, and strategy of a lawsuit by the mere fact of financing it. See Part VI(B)(4), below.

<sup>180</sup> *Rules of Civil Procedure* *supra* note 170, Rule 49.10(1)-(2). See also Watson *et al.*, *supra* note 172 at 26.

### 3. Manufacturing evidence and suborning of witnesses

Another argument against investor financed litigation is the fear that a third-party investor in a lawsuit will have irresistible temptations to suppress or produce evidence or to suborn witnesses. In *Pielak*, the court stated, “Champerty has attracted condemnation because of the supposed temptation for the champertous maintainer to suppress or manufacture evidence or even suborn witnesses for his own special gain.”<sup>181</sup>

The concern that *any* party having an interest in a lawsuit might tamper with evidence or suborn witnesses is well-founded, but this concern should be no greater when the party in question is a third-party investor as opposed to the plaintiff to a lawsuit.

In fact, it is plausible that a plaintiff to a lawsuit has a greater incentive than a third-party investor to tamper with evidence or witnesses, because in addition to having the same financial interest in a lawsuit as would a third-party investor, the plaintiff may also be motivated by revenge or personal satisfaction. Economic analysis of corporate law also suggests that the plaintiff to a lawsuit would have a greater incentive to engage in such activity than third-party private investors, particularly if the investors hold small stakes in the lawsuit.<sup>182</sup> Shareholders who hold small stakes in corporations do not have the economic incentives to engage in monitoring of management because their expected gains are small as compared to the costs of monitoring. This effect is known as shareholders’ rational apathy. Such shareholders would prefer to free ride on the efforts of others, and because of collective action problems, shareholders will not pool their resources to monitor collectively.<sup>183</sup> Similarly, it would not be economically viable for an investor with a small interest in a lawsuit to expend the cost and time required to tamper with evidence or suborn witnesses because the effort will result in a relatively small personal gain and other investors and the

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<sup>181</sup> *Pielak*, *supra* note 60 at 609.

<sup>182</sup> See generally F.H. Buckley, M. Gillen, & R. Yalden, *Corporations: Principles and Policies* 3d ed. (Toronto: Emond Montgomery, 1995) at 533-37; J.S. Ziegel *et al.*, *Cases and Materials in Partnerships and Canadian Business Corporations*, vol. 2, 3d ed. (Toronto: Carswell, 1994) at 389-98; and R.C. Clark, *Corporate Law* (Boston: Little and Brown, 1986) at 390-96.

<sup>183</sup> However, a shareholder’s incentive to monitor management increases as stakeholding in the corporation increases. The rise of institutional investors reflects this phenomena. See J.G. MacIntosh, “The Role of Institutional and Retail Investors in Canadian Capital Markets” (1993) 31 *Osgoode Hall L.J.* 371; and B.S. Black, “The Value of Institutional Investor Monitoring: The Empirical Evidence” (1992) 39 *UCLA L. Rev.* 895.

plaintiff will free ride on this effort. For example, if an investor has a 10 per cent stake in a lawsuit which will yield a total expected return of \$100, the investor stands to gain \$10. If the cost of tampering with evidence is greater than the expected gain for the investor, the investor will not tamper with the evidence (*e.g.*, a cost of tampering of \$30 would result in a loss to the investor of \$20). If the cost of tampering is less than the investor's expected gain, but the gain is significantly reduced because the cost is relatively high, then the investor will not tamper with the evidence (*e.g.*, a cost of tampering of \$8 would result in a gain to the investor of \$2). If the cost of tampering is less than the investor's expected gain and the gain is not significantly reduced, it is conceded that an investor may indeed tamper with evidence (*e.g.*, a cost of tampering of \$1 would result in gain to the investor of \$9). Nevertheless, the above analysis suggests that a plaintiff who will retain the largest stake in the lawsuit would have the greatest incentive to engage in such activity.<sup>184</sup>

In any event, concerns about evidence and witness abuse are overstated given that they are addressed by Part IV of the *Criminal Code* which deals with Offences Against Law and Justice. The offences of fabricating evidence,<sup>185</sup> obstructing justice,<sup>186</sup> perjury,<sup>187</sup> and witnesses giving contradictory evidence<sup>188</sup> would appear to provide strong disincentives for such misconduct, whether by the plaintiff or the third-party investor.

#### 4. Strip plaintiff of control

A concern can be raised that investors involved in financing a lawsuit will strip the plaintiff of control over the direction of the lawsuit. Whether an investor would have any control over the direction of a lawsuit could be left to negotiation between the plaintiff and the investor. However, as a policy matter, it may be prudent to keep control over key decisions in the plaintiff's hands. The investors will seek compensation for their lack of control over key decisions by demanding

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<sup>184</sup> Apart from general collective action problems, the investor cannot collect from the other investors because of the illegal nature of the undertaking, and the inherent riskiness involved in forming a cartel.

<sup>185</sup> *Criminal Code*, *supra* note 40, s. 137.

<sup>186</sup> *Ibid.* s. 139.

<sup>187</sup> *Ibid.* s. 131(1).

<sup>188</sup> *Ibid.* s. 136(1).

a greater return on their investment. This approach is analogous to the situation when founding shareholders in a corporation seek funds for growth but desire to retain control of the corporation. Rather than issuing common shares that have the right to vote, preferred shares with no voting rights are issued for a fixed and higher rate of return.<sup>189</sup>

#### 5. Increased rights-oriented society

A further critique of investor financing of lawsuits may be that it will reinforce a rights-oriented society and further entrench the adversarial system for dispute resolution. Critics of the adversarial system argue that alternative dispute resolution mechanisms, such as mediation and arbitration, are less costly, foster a better process (in that they are more community oriented and attempt to preserve relationships), and lead to better results (because of the ability to fashion creative solutions).<sup>190</sup> With respect to the issue of costs, Morrison and Mosher write that “there is no empirical literature which establishes any necessary cost savings to the disputants (indeed A.D.R. may render the proceedings more expensive if it becomes an additional and necessary pre-condition to accessing a decision-maker).”<sup>191</sup> Therefore, if the costs of alternative dispute resolution mechanisms act as a barrier to utilizing such processes, investors could also theoretically finance disputes to be resolved through these mechanisms.

#### 6. Morally questionable

Critics also argue that this development is morally questionable because it will allow third parties to profit from other people’s injuries.<sup>192</sup> However, it would seem perverse to maintain the *status quo* and thereby allow wrongdoers to profit from the plaintiff’s inability to pursue a legal claim. Thus, if investors are prevented from financing meritorious claims, potential defendants will be allowed to retain a

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<sup>189</sup> See Buckley, Gillen & Yalden, *supra* note 182 at 201-02.

<sup>190</sup> See G.W. Adams & N.L. Bussin, “Alternative Dispute Resolution and Canadian Courts: A Time for Change” (1995) 17 *Advocates’ Q.* 133; and D.P. Emond, ed., *Commercial Dispute Resolution: Alternatives to Litigation* (Aurora: Canada Law Book, 1989). However, see also Morrison & Mosher, *supra* note 9 at 659.

<sup>191</sup> See Morrison & Mosher, *supra* note 9 at 659.

<sup>192</sup> See Lawton, *supra* note 97.

windfall gain as a result of their wrongdoing. An investment in a lawsuit is analogous to an investment in the stock of a pharmaceutical company. Rather than viewing the ownership of stock in a pharmaceutical company solely as an attempt by the investor to profit from the illnesses of others, the overall effect of the investor's decision is to allow for the pharmaceutical company to conduct research for the development of potentially life-saving drugs. Second, it appears unjust to prohibit the owner to sell or assign a portion of a legal claim given that those who own real or personal property generally have unrestricted rights of alienation. Third, the perceived repugnancy of this development appears to be related to the potential abuses rather than to a moral statement that lawsuits should not be subject to market forces. If so, potential safeguards to remedy the abuses have been outlined in this paper which should satisfy such concerns.

#### 7. Lawyer's conflict of interest

Critics of the development may also argue that lawyers representing the plaintiff may find themselves in a conflict between the plaintiff's interest and the investors' interests, particularly if the lawyer is involved in locating the investors and negotiating the terms of the investment with them. This concern can be addressed by requiring lawyers acting for plaintiffs to advise investors to seek independent legal advice as to the merits of the investment and the nature of the contractual arrangement.

#### 8. Adverse costs award

Another issue raised by this development is whether the plaintiff or the investor is responsible for an adverse costs award. Courts have legislative authority to award costs against the unsuccessful party to a litigation for a portion of the legal expenses incurred by the successful party.<sup>193</sup> Courts also have an inherent jurisdiction to award costs against non-parties where there has been improper conduct, as in *Smith*.<sup>194</sup> A reasonable argument can be made that investors should be responsible

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<sup>193</sup> See Watson *et al.*, *supra* note 172 at 418-37, 511-21; M. Orkin, *The Law of Costs* (Aurora, Ont.: Canada Law Book, 1994); and the *Courts of Justice Act* R.S.O. 1990, c. C-43, s. 131.

<sup>194</sup> However, if the doctrines of maintenance and champerty are abolished as has been recommended, then investor financing will not be construed as improper conduct.

for costs awards where they control the direction of a lawsuit, and in essence take the place of the plaintiff, as occurs when claims are subrogated to insurance companies. However, an investor who only provides funding and does not retain any control over the litigation, as proposed in this paper, ought not to be subject to cost sanctions.

Critics may insist that third-party investors should be subject to cost sanctions in any event, since the policies underlying cost awards are intended to deter marginal claims and compensate the successful party, and thus control is irrelevant. If so, it will have to be determined whether investors will be jointly and severally liable with the plaintiff and other investors, or whether a cost award will be awarded on a proportionate basis to the investment. Drawing from the rich academic literature on the limited liability of shareholders, wealthy individuals will have a disincentive to finance lawsuits under a rule of joint and several liability because defendants will pursue those persons with the deepest pockets in collecting the award.<sup>195</sup> However, this concern can be eliminated by establishing a liability rule where the investor is responsible for a proportionate share of the costs.

### *C. Conclusion*

In sum, the benefits of allowing investors to finance lawsuits appear to outweigh the costs. While the arguments against investor financing are legitimate, the balance tips in favour of investor financed litigation because of its ability to further the goals of access to justice and behaviour modification. The framework of procedural safeguards discussed above would minimize potential abuses.

## VII. CONCLUSION

This article has analyzed and attempted to cautiously advance the case for the financing of lawsuits by third-party investors. I have reviewed the doctrines against maintenance and champerty, argued that the existing rules and exceptions are fairly incoherent, and that the justifications are ancient and anachronistic and hold little force in contemporary society. I have applied the doctrines to the issue of

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<sup>195</sup> See generally P. Halpern, M. Trebilcock & S. Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 U.T.L.J. 117; and F.H. Easterbrook & D.R. Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991).

investor financing and found that there is tremendous uncertainty as to whether agreements to finance lawsuits would violate these doctrines and thus result in investors demanding higher rates of return on their investments. For all the above reasons, I have argued that the prohibitions against maintenance and champerty should be legislatively abolished. At a minimum, an exception ought to be legislated so that investors can finance lawsuits with the certainty that their agreements will be enforceable. Turning the focus to the protection of investors, the financing of lawsuits by third-party investors would be subject to securities laws, thus requiring the issuance of a prospectus unless an appropriate exemption can be used. Finally, I concluded that the benefits of this development outweigh the costs and that the related concerns can be addressed.

Given that the justice system is a fundamental institution in our society, the ideal solution to ameliorate the economic barriers to accessing the civil justice system would be to require better funding from governments. However, governments across Canada have shown little political will to infuse funds into the justice system.<sup>196</sup> In fact, the federal and provincial governments have recently been cutting back on social spending in favour of balancing budgets and reducing taxes.<sup>197</sup> Given these harsh practical realities, it is more pragmatic to adopt a regulated private sector regime of investor financing. Despite its limitations, the financing of litigation by third-party investors has the potential to significantly increase access and allow ordinary Canadians to pursue meritorious claims which were hitherto uneconomical.

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<sup>196</sup> See, for example, *McCamus Report* *supra* note 1; and *Zemans & Monahan*, *supra* note 1.

<sup>197</sup> For an excellent account of this phenomena, see L.C. Philipps, "The Rise of Balanced Budget Laws in Canada: Legislating Fiscal (Ir)responsibility" (1996) 34 *Osgoode Hall L.J.* 681.