

# NY High Court Case Could Upend Litigation Finance Industry

By **Justin Ellis, Sara Margolis and Lauren Weinstein** (July 14, 2020, 12:42 PM EDT)

On June 23, the New York Court of Appeals accepted certification of questions that could have significant ramifications for litigation finance.

The court will address whether a litigation financing agreement would qualify as a loan — and thus be subject to New York usury laws — where the repayment obligation reaches attorney fees that the client's lawyer recovers in unrelated litigation.

## New York's Usury Statutes

New York has two usury statutes, one civil and one criminal. Both statutes apply to transactions between private parties and can be used as a defense in civil and criminal cases alike.

The consequences of finding a loan usurious are extremely harsh: The borrower is relieved of all duty to pay the loan, meaning that he or she can keep not just the usurious interest but also outstanding principal. As the Court of Appeals has recognized, "[i]n effect, the borrower can simply keep the borrowed funds and walk away from the agreement."<sup>[1]</sup>

The civil statute, New York General Obligation Law Section 5-501(1), makes void loans with interest rates higher than the rate prescribed in Section 14-a of the Banking Law — currently 16% per year. However, significant exceptions in the statute protect many loans from being voided as usurious.

The ban on civil usury does not apply to loans greater than \$250,000 — with the exception of residential mortgage loans. Moreover, corporations and LLCs cannot argue that a contract is invalid because it violates civil usury laws.

By contrast, New York's criminal usury laws — New York Penal Law Sections 190.40 and 190.42 — prohibit loans with interest rates in excess of 25% per year. Those restrictions do not apply to loans greater than \$2.5 million. In contrast to the civil usury statute, corporations and LLCs may bring a defense based on criminal usury laws.

The New York Court of Appeals has long held that the state's usury statutes, whether civil or criminal, apply only to loans and do not limit the interest that can be owed on investments.<sup>[2]</sup>

Accordingly, litigation funders have long argued that their financing deals with clients or attorneys are investments not subject to the usury laws because the funders will only be paid if the client prevails. But whether a transaction qualifies as a loan or an investment is judged by its character, not the parties' characterization.

## Fast Trak in the Ninth Circuit



Justin Ellis



Sara Margolis



Lauren Weinstein

Whether a litigation-funding transaction qualifies as a loan to which the usury statutes apply is precisely the question the New York Court of Appeals is now set to address in *Fast Trak Investment Co. v. Sax*. In an interesting procedural twist, the dispute first arose in the Ninth Circuit from a case filed in Oakland, California.[3]

Fast Trak is a Delaware limited liability company that, during the relevant time, maintained its principal place of business in New York. Fast Trak's primary business is litigation funding. Richard Sax, a California attorney, entered into a series of agreements with Fast Trak in which the company agreed to fund lawsuits brought by Sax. The agreements were executed by Fast Trak in New York.

The agreements consisted of primary and secondary contracts, each containing New York choice-of-law clauses.

The primary contracts were agreements between Fast Trak and one of Sax's clients, through which Fast Trak agreed to provide funds to the client in exchange for a portion of the future proceeds, if any, from the client's specific lawsuit.

The secondary contracts, however, differed substantially from typical litigation finance agreements. They were signed only by Fast Trak and Sax, and they expressly stated that their purpose was "to induce Fast Trak to enter" the primary contracts with Sax's clients.[4] In each secondary contract, Sax promised to pay Fast Trak his fees, earned in five to 10 unrelated cases, if the recovery in the primary case was insufficient to satisfy the payment due to Fast Trak under the primary contracts.

About three years after the agreements were executed, Sax filed for bankruptcy protection. When it discovered the bankruptcy filing, Fast Trak filed a claim for nearly \$500,000. Sax then moved to dismiss the bankruptcy voluntarily, and, in response, Fast Trak wrote to Sax's attorney asking for information about the cases in which they had invested. Sax then sent Fast Trak \$1,000 as payment towards his balance with Fast Trak. Unsatisfied with that paltry sum, Fast Trak filed a breach of contract lawsuit in the [U.S. District Court for the Northern District of California](#).

Sax defended by arguing the contracts were unenforceable usurious loans. The district court rejected that defense. Both the primary and secondary contracts charged effective annual interest rates far above the thresholds for both civil and criminal usury in New York. Thus, the district court determined, the breach of contract claim turned on whether the funding agreements were loans or investments.

The district court held that they were investments because Fast Trak's repayment depended on Sax's clients recovering in the lawsuits in which Fast Trak had invested. In other words, "repayment could not be considered absolute." [5] The district court thus granted summary judgment in favor of Fast Trak on the breach of contract claim.

Sax appealed to the [U.S. Court of Appeals for the Ninth Circuit](#). That court, too, recognized that the dispositive question was whether the agreements qualify as loans rather than investments. Sax argued that the contracts were actually loans because he had "pledged his attorney fees in so many other unrelated cases" that payment to Fast Trak was "all but guaranteed." [6] Fast Trak urged that because its right to collect depended on a condition precedent — the receipt of sufficient proceeds by Sax or his clients — the arrangement could not qualify as a loan. [7]

The Ninth Circuit found that two arguments favor Sax's position.[8]

First, the court pointed to the possibility that Sax's obligation to pay Fast Trak was sufficiently guaranteed by the terms of the parties' agreements to render the agreements loans.[9]

In support of that possibility, the Ninth Circuit cited *Echeverria v. Estate of Lindner*, a 2005 decision from the Nassau County Supreme Court holding that a litigation funder's investment in a single case was a loan when there was "low, if any risk" of nonpayment.[10] The risk of nonpayment under the primary and secondary contracts might be so low, the Ninth Circuit explained, "that the financial agreement qualifies as a loan under New York law."[11]

The second and more colorable argument, the Ninth Circuit found, related to the real character of the agreements.[12] The court concluded that "there is a nonfrivolous argument that the 'real purpose' of these transactions is a loan rather than the purchase of contingent assets."[13]

Because the case turned on unresolved issues of New York law, the Ninth Circuit certified those issues to the New York Court of Appeals. Specifically, it certified:

(1) Whether a litigation financing agreement may qualify as a "loan" or a "cover for usury" where the obligation of repayment arises not only upon and from the client's recovery of proceeds from such litigation but also upon and from the attorney fees the client's lawyer may recover in unrelated litigation? (2) And, if so, what are the appropriate consequences, if any, for the obligor to the party who financed the litigation, under agreements that are so qualified?[14]

### **Potential Consequences of the New York Decision**

The New York Court of Appeals accepted certification. Its decision may have significant consequences for the litigation finance industry — and for borrowers and lenders in general.

For one thing, a ruling in Sax's favor may make portfolio lending deals difficult to access for small firms. In such deals — which have become increasingly common — companies and law firms seek funding across multiple matters, thus allowing both the funder and the attorney or company to hedge against the risks of any one specific case.

But if the Court of Appeals accepts Sax's argument, litigation funders may worry that any portfolio deal below the \$2.5 million threshold for criminal usury would carry the risk that the counterparty could claim usury to avoid repayment and walk away with the funding. That risk alone may deter funders from making relatively small portfolio deals. Even where funders remain willing to enter into such deals, the risk of facing usury defenses may increase the cost of that funding even further.

For another, a ruling in Sax's favor would permit other borrowers to try to avoid repaying litigation funders by arguing that the likelihood of recovery in the litigation was so high that the financing arrangement was actually a loan. This is especially likely if the Court of Appeals' decision agrees with the Nassau County Supreme Court's decision in *Echeverria*.

However, such an argument is only available where the transaction is valued at less than the \$250,000 and \$2.5 million limits for civil and criminal usury, respectively. If those borrowers challenge litigation finance arrangements in the future with any regularity, it

might drive up the costs of those smaller cases and, perversely, make it more difficult for those borrowers to access funding.

The Court of Appeals' opinion may also affect issues beyond those raised directly in the certified questions. For example, the Court of Appeals might also consider the extent to which litigation finance agreements violate New York's ban on fee-sharing between lawyers and nonlawyers. Like many jurisdictions, Rule 5.4(a) of the New York Rules of Professional Conduct contains a near-total prohibition on lawyers and law firms sharing legal fees with nonlawyers.[15]

The New York City Bar Association has controversially interpreted that rule to prohibit financing agreements in which the lawyer's payments to the funder are contingent on the lawyer's receipt of legal fees.[16] Although such an arrangement is not typical of most litigation finance transactions — where payments to the funder typically are contingent on the client's receipt of proceeds — the opinion has been criticized by litigation funders and other stakeholders.[17]

If the Court of Appeals chooses, it could wade into that controversy and address whether deals between lawyers and funders such as the deal Fast Trak and Sax struck implicates Rule 5.4(a). Such a ruling could have a substantial effect on the litigation finance industry.

In theory, the Court of Appeals' opinion may even affect contracts having nothing to do with litigation finance. An endorsement of Echeverria's conclusion that any investment carrying low, if any, risk qualifies as a loan to which the usury statutes apply could call any number of investments into doubt.

Any borrower who takes out nonrecourse money backed by a contingent event could argue the transaction was usurious because the contingent event was so certain. A borrower of credit default swaps, for example, could argue the swap was actually a usurious loan because the probability of default on the underlying loans was so high as to render the investment virtually risk-free. That could upend — and, in theory, criminalize — countless financing deals across multiple industries.

## **Conclusion**

At first glance, the certified questions seem narrow, relating only to unorthodox litigation funding arrangements. But the Court of Appeals' decision could have sweeping impacts on the industry. The court now has a chance to provide guidance and draw bright-line rules regarding what, if any, types of financing arrangements are implicated by the state's usury laws. At least one litigation funder has already urged that the court should rule that "[l]itigation finance investments are not loans subject to usury laws." [18]

Should the court wish to decide issues beyond those raised directly by the certified questions, it may seek supplemental briefing and it could appoint amici to help it understand the potential ramifications of any decision. The Fast Trak case provides the New York Court of Appeals the opportunity to provide clarity and predictability for the growing litigation finance industry. The court should take advantage of it.

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*Justin M. Ellis is a partner, Sara Margolis is an associate and Lauren M. Weinstein is a partner at MoloLamken LLP.*

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[1] [Seidel v. 18 E. 17th St. Owners Inc.](#), 79 N.Y.2d 735, 740 (1992).

[2] *Id.* at 744.

[3] [Fast Trak Investment Co. LLC v. Sax](#), 962 F.3d 455, 2020 WL 3092063, at \*1 (9th Cir. June 11, 2020).

[4] *Id.* at \*3.

[5] *Fast Trak Inv. Co., LLC v. Sax*, No. 4:17-CV-00257-KAW, 2018 WL 2183237, at \*5 (N.D. Cal. May 11, 2018).

[6] *Id.*

[7] *Id.*

[8] *Id.* at \*6.

[9] *Id.*

[10] *Id.* (citing [Echeverria v. Estate of Lindner](#), 7 Misc.3d 1019(A), 2005 WL 1083704, at \*8 (Sup. Ct. Nassau Cty. Mar. 2, 2005)).

[11] *Id.*

[12] *Id.*

[13] *Id.* at \*8.

[14] *Id.* at \*2.

[15] New York Rules of Professional Conduct 5.4(a).

[16] Formal Opinion 2018-5: Litigation Funders' Contingent Interest in Legal Fees.

[17] See, e.g., Anthony Davis and Anthony Sebok, "New Ethics Opinion on Litigation Funding Gets It Wrong," N.Y. L. J. (Aug. 31, 2018); Andrew Strickler, "Funders Decry NYC Bar's Litigation Finance Warning," Law360 (Aug. 10, 2018), Allison Chock et al., "Curiouser and Curiouser! A Review of the NYCBA's Ethics Opinion on Litigation Funding," [Bentham IMF](#) (Sept. 11, 2018).

[18] Wendie Childress & William Marra, "[Litigation Finance Investments Are Not Risk-Free Loans](#)," Law360 (June 15, 2020).