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The Securities Law Disclosure Conundrum for Publicly Traded Litigation Finance Companies

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THE SECURITIES LAW DISCLOSURE CONUNDRUM FOR PUBLICLY TRADED LITIGATION FINANCE COMPANIES

Robert F. Weber[*]

ABSTRACT

The Article examines a peculiar legal dilemma—implicating securities law, legal ethics, and evidence law—that arises when litigation finance companies (LFCs) become public companies. LFCs provide funding to litigants and law firms for prosecuting lawsuits in exchange for a share of the lawsuit recoveries. In recent years, LFCs have significantly altered the landscape of the civil justice system in common law jurisdictions. But their assets, which are just rights to proceeds from lawsuits, are notoriously opaque—who really can predict what a jury will do when it comes to liability and damages? When LFCs go public, this opacity frustrates public investors' legitimate expectations to be able to understand the company's accounts and operations. The problem is exacerbated by the applicable accounting rules, which outsource the task of valuing the assets to the LFCs themselves, vesting them with significant discretion to build their own financial statements. The resulting lack of clarity about basic valuation matters undermines the two main objectives of securities law: investor protection and market integrity.

From a securities law perspective, the normal solution to an opacity problem is more and better disclosure. However, concerns over the possible waiver of evidentiary protections flowing from the attorney-client privilege and the work-product doctrine complicate matters for LFCs. To avoid the possibility of waiver of privileged, confidential information (which would, in most cases, undermine the cases underlying their assets), LFCs are circumspect when it comes to disclosing any details of the valuation models for their assets, much less relevant details about specific cases. The shadow of privilege waiver thus chills the entirety of LFC disclosure practice, foreclosing it as an effective corrective to the intrinsic opacity of LFC accounts.

After detailing the sources and extent of this opacity problem, the Article explores two case studies. The first, involving the 2015 failure of Juridica Investments, illustrates how opaque LFC accounts can undermine the investor protection objective of securities law. The second, involving the 2019 "short attack" by hedge fund Muddy Waters on litigation funder Burford Capital, shows how the opacity problem can also undermine the market integrity objective. The Article concludes by laying out a framework for reform.

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* Associate Professor of Law, Georgia State University. The author acknowledges the assistance of participants at workshops hosted by the Temple University Beasley School of Law and the 2021 National Business Law Scholars Conference. Maya Steinitz and Tony Sebok also deserve recognition for both lighting my way through some of the obscurer realms of litigation finance and commenting on earlier drafts of this article.

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INTRODUCTION

For the past decade and a half, litigation finance companies (LFCs) have altered the landscape of the civil justice system in common law jurisdictions. They have empowered thousands of business litigants to vindicate their legal rights, chipped away at inbuilt advantages in settlement negotiations favoring large and repeat players, and catalyzed reform initiatives in areas long considered third rails in professional regulation, such as fee sharing. The continuing evolution of litigation finance is a phenomenon that all lawyers should register. Litigation finance will increasingly shape the institutional arrangements of dispute resolution practices as well as the broader financial and labor economics and ethical regulation of the legal profession.

This Article shifts the lens away from the robust ongoing analysis of the civil procedure,[1] access to justice,[2] and legal ethics[3] implications of litigation finance to analyze, for the first time, how this burgeoning sec-

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1. *See* Anthony J. Sebok, *White Paper on Mandatory Disclosure in Third-Party Litigation Finance*, *in* MANDATORY DISCLOSURE RULES FOR DISPUTE FINANCING (N.Y. UNIV. SCH. OF L. CTR. ON CIV. JUST David Siffert ed., 2021); Maya Steinitz, *Follow the Money? A Proposed Approach for Disclosure of Litigation Finance Agreements*, 53 U.C. DAVIS L. REV. 1073 (2019) [hereinafter Steinitz, *Follow the Money?*]; Jonathan T. Molot, *Litigation Finance: A Market Solution to A Procedural Problem*, 99 GEO. L.J. 65 (2010).

2. *See* Matthew A. Shapiro, *Distributing Civil Justice*, 109 GEO. L.J. 1473, 1509–12 (2021); Maya Steinitz, *Incorporating Legal Claims*, 90 NOTRE DAME L. REV. 1155, 1161 (2015) [hereinafter Steinitz, *Incorporating Legal Claims*].

3. *See* Elayne E. Greenberg, *Hey, Big Spender: Ethical Guidelines for Dispute Resolution Professionals when Parties Are Backed by Third-Party Funders*, 51 ARIZ. STATE L.J. 131, 133 (2019); J. Maria Glover, *A Regulatory Theory of Legal Claims, A Regulatory Theory of Legal Claims*, 70 VAND. L. REV. 221, 289–93 (2017); Victoria Shannon Sahani, *Judging Third-Party Funding*, 63 UCLA L. REV. 388, 401 (2016); Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1323–25 (2011) [hereinafter Steinitz, *Whose Claim?*]; Anthony J. Sebok, *Betting on Tort Suits After the Event: From Champerty to Insurance*, 60 DEPAUL L. REV. 453 (2011).

tor intersects with the securities law regime.[4] When LFCs list their securities on public capital markets, they submit to a complex system of securities law and regulation—a regime oriented to two central objectives: the protection of investors and the preservation of market integrity.[5]

When LFCs go public, they encounter a conundrum resulting from the intrinsic opacity of litigation finance assets. Fundamentally, LFCs are in the business of advancing funds to litigants and their lawyers to finance the pursuit of litigation, in exchange for a return pegged to the proceeds of that litigation.[6] From the perspective of the LFC, a litigation finance asset can be considered a derivative contract where the underlying asset is a lawsuit.[7]

While there is arguably some room for classificatory discretion on the part of LFC accountants, most publicly traded LFCs take the (probably correct) position that the relevant accounting rules mandate that litigation finance assets be classified as "financial assets." This position, in turn, requires the use of so-called "fair value accounting" practices. Where the LFC cannot look to any direct market prices nor even any indirect proxy market prices, it must "mark" (or record the fair value of) its assets according to its own internal valuation models. These internal valuation models unavoidably entail some quantum of brute discretion on the part of company management and their accountants. Just as importantly, under applicable accounting rules these "fair value" adjustments, which initially appear as balance sheet phenomena, flow directly through to the income statement.

As such, LFCs wield significant discretion in recording and reporting their assets' value and operating income. Indeed, LFCs possess significantly more discretion than even other financial companies since adopting fair value accounting would require that *all* of their assets,

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4. Wendy Couture has analyzed the unrelated issue of whether litigation funding agreements might be considered "securities" for purposes of the U.S. securities laws. *See* Wendy Gerwick Couture, *Securities Regulation of Alternative Litigation Finance*, 42 SEC. REGUL. L.J. 5, (2014).

5. *See, e.g.*, H.R. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730 ("The overriding purpose of our Nation's securities laws is to protect investors and to maintain confidence in the securities markets, so that our national savings, capital formation and investment may grow for the benefit of all Americans."); INT'L ORG. OF SEC. COMM'NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION 3 (2017), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD561.pdf [https://perma.cc/75TM-EEDP].

6. *See* discussion *infra* Part II.A.

7. *See Litigation Finance Faces Ethical Quandaries*, THE ECONOMIST (Nov. 7, 2019) https://www.economist.com/finance-and-economics/2019/11/07/litigation-finance-faces-ethical-quandaries [perma.cc/8AVK-6YPA] (analogizing lawsuits to derivative contracts); *see* R. STAFFORD JOHNSON, DERIVATIVES, MARKETS, AND ANALYSIS ix (R. John Wiley & Sons, Inc., 2017) (explaining how a derivative contract derives value by a reference asset, referred to as the "underlying," which would be the lawsuit in this context).

lacking as they do any direct or indirect reference market prices, must be marked to internal valuation models. For perspective, it is common for publicly traded LFCs to have more than half of their reported income consist of subjective, discretionary fair value adjustments to their assets, frequently without the asset having yet realized any actual income from settlements or court judgments.[8]

According to the normal logic of the securities laws in the U.S. and elsewhere, the solution to an accounting opacity problem would be enhanced disclosure concerning the assets and the models used to value them. Investors in a publicly traded LFC might like to know about the company's specific valuations for particular assets, the company's assessment of the likelihood of success on the merits for some of its larger assets, the litigants' settlement negotiating leverage for those same assets, and so forth. However, LFCs not only possess uniquely opaque balance sheets, but they also are uniquely handicapped when it comes to producing clarifying, corrective disclosure to remedy that opacity.

This handicap results from concerns over the possible waiver of evidentiary protections flowing from the attorney-client privilege and the work-product doctrine. All of these desired disclosures are informed directly or indirectly by discussions, decisions, and consultations between the funded litigant and its attorneys, occasionally with the involvement of the LFC itself. To be sure, all public companies embroiled in material litigation face difficult trade-offs when balancing the competing directives of the securities laws (which usually demand greater disclosure) and the legal ethics rules and their evidence law adjuncts (which usually demand circumspection, if not outright silence).

The problem is particularly acute in the LFC context because virtually *everything* that is operationally relevant to an LFC revolves around active litigation—nearly every expected cash flow will originate from an active lawsuit. The risk here is that even a partial disclosure of privileged, protected information might open the door to court-ordered unveiling of materials that will materially prejudice and undermine the financed lawsuit—and the cash flows the LFC expects from it. As a result, concerns over privilege waiver cast a shadow over LFC disclosures, and this shadow chills efforts to speak frankly about LFC assets, even at the aggregate portfolio level.

Two recent episodes involving publicly traded LFCs serve as case studies for how these dynamics undercut the securities law norms of investor protection and market integrity. The first such case study focuses on the investor protection norm by recounting the collapse of Ju-

8. *See infra* notes 142-144 and accompanying text.

ridica Investments, Ltd. (Juridica), which in 2007 became the first LFC to go public. By 2015, Juridica had ceased making new investments and was liquidated a few years later. The immediate catalyst for the investor losses was Juridica's sudden announcement that it would take a total loss on its largest asset, a price-fixing antitrust lawsuit it had previously touted as a potential billion-dollar recovery. The asset, which Juridica had previously recorded at $30 million on a fair value basis, had apparently become worthless. As explained in the case study, Juridica's unraveling is not a story of fraud. Still, the episode demonstrates the high degree of discretion LFC management has in determining asset marks and the credulousness of both retail and institutional investors concerning those marks.

The second case study recounts the 2019 "short attack" mounted by hedge fund Muddy Waters Research LLC (Muddy Waters) against Burford Capital, Ltd. (Burford), the largest LFC by any metric then and now. This episode illustrates how opaque LFC accounts can undermine the market integrity objective of securities law. Specifically, it presents a (possible) case of a strategic effort to manipulate the market for an LFC's stock by sowing seeds of doubt about the accuracy of the company's fair value marks. In a published report, Muddy Waters highlighted the subjective nature of Burford's fair value marks, comparing the company to Enron, the posterchild for modern corporate accounting fraud.[9] The Muddy Waters report precipitated steep declines in the market prices of Burford stock and bonds, wiping fifty percent off the company's market capitalization in a single day.[10]

Only the future development of Burford's portfolio will deliver the final verdict on whether the substance of this short attack was well-founded, as some of Muddy Waters's past calls have been, or outright market manipulation, a term that some believe best describes Muddy Waters's general approach to capital markets.[11] (It bears mentioning that Muddy Waters made a handsome profit by selling Burford stock short just prior to publishing the report).[12] The fact that, even today, de-

9. *See* MUDDY WATERS CAPITAL LLC, MW IS SHORT BURFORD CAPITAL LTD. (2019), https://d.muddywatersresearch.com/tou/?redirect=/content/uploads/2019/08/MW_BUR_08072019.pdf [perma.cc/R829-MWYF] [hereinafter Muddy Waters Burford Report].

10. *See* Myles McCormick, *Muddy Waters v Burford Capital – The Claims and Defence*, FIN. TIMES (Aug. 8, 2019), https://www.ft.com/content/d06665de-b9e4-11e9-96bd-8e884d3ea203.

11. *See* Evan Hughes, *The Man Who Moves Markets*, THE ATLANTIC (Feb. 2, 2023), https://www.theatlantic.com/magazine/archive/2023/03/wall-street-muddy-waters-activist-short-sellers-tesla-gamestop/672774/ [https://perma.cc/C6FH-HZXP].

12. *See* Michael O'Dwyer & Harriet Russell, *Muddy Waters Boss Carson Block Dismisses Burford Capital's Response to Short-Selling Attack as "Exactly by the Playbook"*, THE TELEGRAPH (Aug. 9, 2019, 7:51 PM),

spite the wild gyrations in the market for Burford securities, this uncertainty persists, is evidence of the enduring and structural vulnerability of the sector to market manipulation.

This heightened potential for market manipulation raises obvious investor protection concerns, but its implications are broader. If LFCs present a structural risk of market manipulation, the first-order consequence to be expected is reduced access to public capital markets and lower overall capital inflows to the asset class. Second-order costs include higher bid-ask spreads for the sector, which can spread to other classes of new and existing securities, result in lower trading volumes, and ultimately feed into higher costs of capital and lower returns on investment in the litigation finance sector and neighboring alternative asset classes. In theory, these problems could even lead to less fixed capital spending and economic activity in other unrelated sectors.[13]

As the litigation finance industry grows, so too will the salience of these problems, intensifying the urgency of reform. Over the past decade, four LFCs have listed their shares on stock exchanges in the United States, the U.K., and Australia: Burford, Omni Bridgeway Ltd., Litigation Capital Management Ltd. (LCM), and Manolete Partners PLC (Manolete).[14] Today, the aggregate market capitalization of these companies approaches $3 billion.[15] We should expect more LFCs to look to public markets to meet their capital needs in this rapidly expanding sector. This Article presents not only the initial diagnosis of the problem, but also a framework for reform.

The Article advances six reform proposals, drawing attention to their respective advantages and disadvantages. Four of these proposals are more promising than the others: (1) mandatory direct involvement of external claims valuers in the production and verification of fair value marks; (2) greater deployment of claims valuation expertise in the context of the audit (either external or in-house audit expertise); (3) mandatory disclosure of portfolio-wide sensitivity analysis of the fair valuation marks; and (4) mandatory disclosure of details concerning material litigation assets with accompanying changes to the privilege waiver rules. The first three of these are not only promising, but they are also feasible; efforts to implement the fourth proposal should expect

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https://www.telegraph.co.uk/business/2019/08/09/muddy-waters-boss-carson-block-dismisses-burford-capitals-response/ [https://perma.cc/6P5W-FC9A].

13. *See* discussion *infra* Part III.

14. As mentioned above, a fifth LFC, Juridica, was publicly traded from 2007 until its 2018 liquidation.

15. As of April 26, 2023, the combined market capitalization of Burford Capital ($2.2 billion), Manolete ($131 million), LCM ($111 million), and Omni Bridgeway ($423 million) was $2.9 billion. *See infra* notes 53-55 and accompanying text (introducing these publicly traded LFCs).

greater headwinds. Two other reform ideas—requiring independent valuation committees for publicly traded LFC boards and promoting markets for litigation assets—are also considered but are likely to be of limited effectiveness, at least in the near term.

Part II introduces the litigation finance industry, focusing on the basic value proposition of litigation finance transactions and describing the sector's tremendous growth potential. Part II also introduces the publicly traded LFCs and outlines their motivations for accessing public capital markets. Next, Part III explains that the two fundamental objectives of modern securities law and regulation systems are investor protection and market integrity. Part III makes the preliminary case that publicly traded LFCs pose special threats to these objectives on account of the intrinsic opacity of their accounts and the significant discretion management deploys in their preparation and presentation.

Part IV guides the reader through the labyrinthine fair value accounting regime applicable to companies like LFCs that hold large amounts of opaque financial assets. Part IV also explains why the two LFCs adopting fair value accounting and therefore using internal valuation models (Burford and Manolete) are probably correct in determining that they are required to do so. It describes in detail how they implement those rules in practice. If Parts III and IV articulate the fundamental problem, Part V explains why legitimate concerns over privilege waiver prevent securities law from deploying its usual regulatory technology (i.e., more disclosure) as a corrective device. Part VI transitions from the abstract accounting, legal ethics, and evidentiary rules to the conundrum in its practical realities by presenting the Juridica and the Muddy-Watters-versus-Burford case studies. Part VII explores possible reforms, focusing on their respective advantages, disadvantages, and implementation challenges. Part VIII concludes.

II. Introducing the Litigation Finance Industry

Described in the broadest terms possible, LFCs provide financing for law firms and litigants to pursue costly litigation in exchange for a direct or indirect share in the economic proceeds of the litigation. The litigation finance industry is a rapidly growing sector within the broader alternative investment sector, itself part of a broader investment management industry.[16] LFCs thus link together the commercial litiga-

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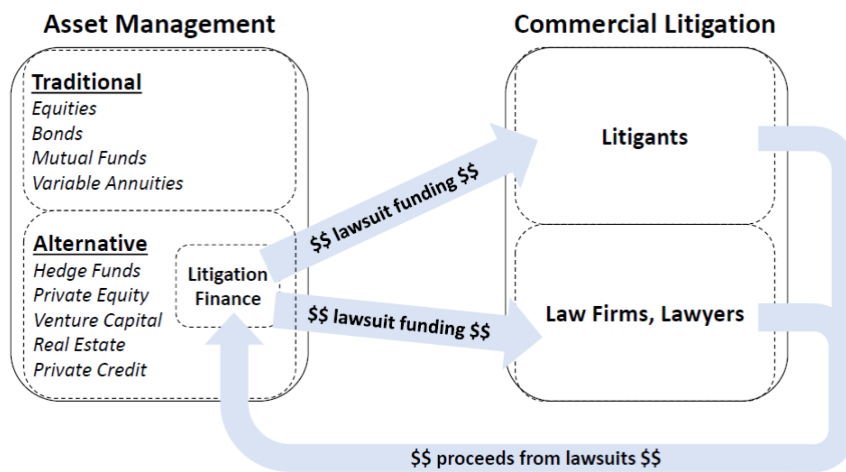
16. *See* Thomas Healey, Michael B. McDonald & Thea S. Haley, *Litigation Finance Investing: Alternative Investment Returns in the Presence of Information Asymmetry*, J. ALT. INV., Spring 2022, at 110.

tion world with the asset management world. Figure 1 below shows this relationship, with the provisos that (1) the lists of types of asset managers is illustrative and not exhaustive, and (2) LFCs and other alternative asset managers are an overlapping category, as many diversified alternative asset managers are also increasingly deploying capital in litigation finance markets.[17]

FIGURE 1



This Part will introduce the basic features of the litigation finance world. First, the basic value proposition of litigation finance is introduced: the inter-temporal management of a particular type of legal-financial risk. The second section provides a brief description of the sector's current market conditions, focusing on the present size of the market and the potential for future growth in the coming years. The third section introduces publicly traded LFCs, highlighting both their motivations for going public and previewing the dangers that arise when they do so.

17. *See* Steinitz, *Follow the Money?*, *supra* note 1, at 1075 ("This market in legal claims has attracted specialist firms, private equity, hedge funds, wealthy individuals, the public (through crowdfunding platforms), and sovereign wealth funds, among others, who are looking for high-risk high-reward investments . . . .").

A. *The Basic Value Proposition of Litigation Finance*

Litigation finance refers to the outside, usually non-recourse,[18] funding of lawsuits by third parties for a profit.[19] In its simplest terms, the basic market opportunity the LFCs exploit results from the temporal mismatch between *litigation-related events* and *litigation-related payouts*. Litigation-related events consist of the actionable conduct, the decision to pursue a legal dispute, the pleading stage, dispositive motions, trial, appeal, and so forth. Litigation-related payouts consist of settlements, judgments, and collections. This mismatch creates both risks and opportunity costs. From the litigation finance perspective, litigation is "just a process of moving money from one person to another. Just like any receivable, it has value."[20] The value proposition that LFCs offer is that they stabilize the inter-temporal risk exposure of litigation-related receivables—i.e., the risk inherent in bringing lawsuits with the expectation of an uncertain payout at an uncertain future date.

For example, a plaintiff might calculate that the expected payout, net of expected costs, from a patent infringement claim is $20 million, reflecting its estimation that the claim has a 50% likelihood of success on the merits, in which case it would be entitled to a net payout of $40 million. In the meantime, however, both the plaintiff and its law firm(s) incur direct and indirect expenses in connection with the lawsuit; in other words, those "costs" that we netted out in the first sentence still exist. Direct expenses include legal fees, expert witness fees, court fees, investigative costs, and fees of other specialized consultants brought into the litigation team, such as accountants, bankers, and doctors. Indirect expenses include the distraction to management, which will be diverted from their primary business responsibilities in the case of

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18. Non-recourse lending refers to extensions of credit in which the recourse of the creditor (in this context, the LFC) is limited to the collateral which secures the loan (in this context, a portion of the proceeds of the lawsuit). *See* HOWARD RUDA, ASSET BASED FINANCING: A TRANSACTIONAL GUIDE § 1.01[3] (2021). If the lawsuit fails to produce proceeds, the LFC has no claim against the litigant or law firm that received the funding.

19. *See* Maya Steinitz & Abigail C. Field, *A Model Litigation Finance Contract*, 99 IOWA L. REV. 711, 713 (2014); ALEX LEMPINER & SIMON WALSH, WOODSFORD LITIG. FUNDING, A PRACTICAL GUIDE TO LITIGATION FUNDING (2018); John Pierce & David Burnett, *The Emerging Market for Litigation Funding*, THE HEDGE FUND J. (June 2013), https://thehedgefundjournal.com/the-emerging-market-for-litigation-funding/ [https://perma.cc/WD5T-47XE]; AM. BAR ASS'N COMM'N ON ETHICS, WHITE PAPER ON ALTERNATIVE LITIGATION FINANCE 1 (2011) https://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111019_draft_alf_white_paper_posting.authcheckdam.pdf [https://perma.cc/NAY4-J2PT].

20. Elliot Wilson, *Capital Markets: Litigation Funding Finds Its Feet*, EUROMONEY (Dec. 14, 2020), https://www.euromoney.com/article/27vppy0icqztjnbtg6ww0/capital-markets/capital-markets-litigation-funding-finds-its-feet [https://perma.cc/GQE9-S2R8] (quoting Christopher Bogart, Burford's chief executive officer).

large-dollar lawsuits. Also, the plaintiff will incur opportunity costs insofar as the temporal mismatch means that the expected payout will materialize months or years later; in the meantime, the plaintiff is not yet in possession of its expected payout and is unable to invest the expected proceeds in the business.[21]

Absent third-party financing, the plaintiff finds itself in a bilateral monopoly game. A bilateral monopoly describes a market scenario with one buyer and one seller. Assuming there is a positive available surplus, it is in the interests of both parties to engage in a trade, but they can trade only with the other party.[22] In this hypothetical world without external financing, a plaintiff can only sell its claim to the defendant,[23] which quite frequently also has a greater ability to bear the risk of loss during the pendency of the litigation.[24] Accounting rules further complicate incentives for publicly traded commercial plaintiffs; they will recognize expenses associated with pursuing the lawsuit as short-term operating expenses, with no corresponding revenue increase during the pendency of the matter.[25] The expense drain can distort the picture of the company's operational realities. Complicating matters further, even when the litigation results in a payout, the economic impact is reported as non-recurring income and, therefore, liable to be disregarded by investors.[26]

Further, the law firms that represent the plaintiff usually assume a similar portfolio of risks. Most lawyers in the United States represent plaintiffs on a contingency basis—that is, they are paid out of the law-

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21. For instance, Burford recently developed a hybrid debt-equity financing that helped a venture backed tech company embroiled in a protracted patent and trade secret case against an industry giant. Burford touted the fact that the approach "reduced the company's litigation-related operating expenses to zero and increased its cash on-hand for growth . . . ." BURFORD CAPITAL, LTD., 2021 BURFORD CLIENT UPDATE & 2020 YEAR IN REVIEW 9 (2021), https://www.burfordcapital.com/media/2075/2021-burford-client-update-and-year-in-review.pdf?utm_source=blog&utm_medium=button&utm_campaign=2021clientupdate&utm_content=landing [https://perma.cc/P3Q2-B3PA].

22. *See* Geoffrey P. Miller, *Some Agency Problems in Settlement*, 16 J. LEGAL STUD. 189, 193 (1987) (specifying that the incentives to trade depend on there being a surplus in the form of a positive settlement range).

23. *See* Geoffrey P. Miller, Commentary, *On the Costs of Civil Justice*, 80 TEX. L. REV. 2115, 2115 (2002) ("A lawsuit is essentially a sale. The defendant buys a valuable asset from the plaintiff, in the form of a release of claims if the case is settled, or a verdict with res judicata effect if the case goes to a verdict.").

24. *See* Molot, *supra* note 1, at 70 ("Where a lawsuit pits a one-time plaintiff against a repeat-player defendant, we would thus expect the imbalance in the parties' risk preferences to favor the defendant and produce settlements below the mean [expected] damages award.").

25. *See* Bob Craig, Daniel Ryan & Larry Tedesco, *Litigation Finance 101—What You Need to Know*, THINKSET (Nov. 4, 2018), https://thinksetmag.com/issue-6/litigation-finance-101 [https://perma.cc/3YHP-MFE4].

26. *See id*.

suit's proceeds.[27] While contingency fee representation is relatively less prevalent in the business litigation context, it is becoming more common there as well, owing to pressures from corporate clients to reduce corporate legal spending.[28] The contingency fee arrangement operates as a risk-transfer mechanism by which the litigant client offloads some of its risk onto the law firm, which, because of its repeat-player status and professional expertise, is thought to be better positioned to bear the risk. Before the lawsuit generates any proceeds, the law firm must pay its expenses—employee salaries, insurance premiums, utility payments, lease payments, and anticipatory distributions of profits to partners (where appropriate). In other words, law firms face relatively high working capital demands and a deficit of patient risk capital to carry multi-year matters through to conclusion.

Hence the basic litigation finance value proposition: LFCs provide the longer-term capital required to bring the lawsuit to a successful conclusion. The funding can be directly provided to the litigants or their law firms. Investments by LFCs can be structured in multiple ways. Broadly speaking, however, corporate litigants usually obtain financing by agreeing to provide a return to the LFC tied to the success of the underlying claim or portfolio of claims, whether in the form of a right to a specified percentage of the payout,[29] or a more bespoke structured contractual arrangement. These arrangements are either undertaken as on-balance-sheet investments by the LFC or as off-balance-sheet investments where the LFC manages private investment funds on which it earns a customary management fee.[30]

On the other hand, law firms currently face restrictions on sharing fees with nonlawyers, which complicates efforts to provide litigation

27. *See* Stephen Daniels & Joanne Martin, *The Texas Two-Step: Evidence on the Link Between Damage Caps and Access to the Civil Justice System*, 55 DEPAUL L. REV. 635, 648 (2006).

28. *See* Dan Roe, *Demand for Contingency Fees in Business Litigation Grows Amid Pandemic*, LAW.COM (Nov. 20, 2020) https://www.law.com/2020/11/30/demand-for-contingency-fees-in-business-litigation-grows-amid-pandemic/ [https://perma.cc/53RL-7SCF].

29. Traditional prohibitions on champerty and maintenance of claims, which historically prevented third-party funders from sharing in claim recoveries, have been abandoned in many states, and, moreover, generally do not apply to business claims. *See* 14 AM. JURIS. 2D *Champerty, Maintenance, Etc.* §§ 1–15 (2021); Jay Greenberg, *Why Litigation Finance Transformed in the 2010s, and What 2030 Might Bring*, THE RECORDER (CAL.) (Mar. 16, 2020); Michael K. Velchik & Jeffery Y. Zhang, *Islands of Litigation Finance*, 24 STAN. J. L. BUS. & FIN. 1 (2019); Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61 (2011) [hereinafter Sebok, *Inauthentic Claim*].

30. When managing private funds, the LFC essentially is acting as a private equity fund manager, soliciting funds from investors, and investing them in litigation assets on behalf of the investors.

finance to law firms.[31] Frequently, LFCs maneuver around the prohibition on fee sharing by simply providing debt-like finance to law firms on a nonrecourse basis, with the firm agreeing to pay to the funder a contractually-specified return, secured by the law firm's contingency-fee receivables for a financed case or portfolio of cases.[32] As a general matter, lawyers face no professional restrictions on borrowing money. A recent trend to liberalize fee-sharing rules augurs greater acceptance of finance arrangements involving LFCs sharing in contingent legal fees directly.[33]

This description summarizes the financial and economic logic of litigation finance transactions. It bears note that many LFCs supplement and diversify their business by engaging in adjacent, related business lines such as asset recovery, proprietary strategic litigation seeking to obtain rulings favorable to the litigation finance industry, and financing/monetization of post-settlement litigation receivables.[34]

B. *A Snapshot of the Industry Today*

From its modest origins in Australia and the United Kingdom in the 2000s, to its slow-but-steady expansion in the United States in the sub-

31. *See* Steinitz, *Whose Claim?*, *supra* note 3, at 1291–92 (explaining chilling effect on litigation finance industry of the prohibition on fee splitting); MODEL RULES OF PRO. CONDUCT r. 5.4(a) (AM. BAR ASS'N 2020) ("A lawyer or law firm shall not share legal fees with a nonlawyer . . . .").

32. *See* Joan C. Rogers, *Litigation Funding on Rise in Big Cases, Panel Says*, BLOOMBERG L. (Mar. 23, 2017) https://news.bloomberglaw.com/us-law-week/litigation-funding-on-rise-in-big-cases-panel-says [https://perma.cc/2L28-PPU9].

33. For example, the District of Columbia and Arizona have both formally abrogated the ABA's Model Rule of Professional Conduct 5.4, which sets forth the prohibition on fee sharing. Relatedly, courts are increasingly agreeing to enforce such financing arrangements. *See, e.g.*, Hamilton Capital VII, LLC v. Khorrami, LLP, No. 650791/2015 22 N.Y.S.3d 137, 2015 WL 4920281, at *6 (N.Y. Sup. Ct. Aug. 17, 2015) (enforcing funding contract pursuant to which LFC advanced funds to law firm in exchange for a percentage of the law firm's gross revenues, with the latter obligation secured by the firm's accounts receivable, and noting that such an arrangement "helps provide victims their day in court"); Counsel Fin. Servs., LLC v. Leibowitz, No. 13-12-00103-CV, 2013 Tex. App. LEXIS 9252, at *28 (Tex. App. July 25, 2013) ("[T]here is a significant difference between sharing legal fees with a non-lawyer and paying a debt with legal fees."). The influential New York City Bar Association (NYBCA) formed a working group to study litigation finance, which in 2020 recommended that the NYCBA abrogate its Formal Ethics Opinion 2018-5, which had concluded that prototypical litigation finance arrangements would violate Rule 5.4. *See* WORKING GROUP ON LITIGATION FUNDING, N.Y.C. BAR ASS'N, REPORT TO THE PRESIDENT 20–24 (2020) http://documents.nycbar.org/files/Report_to_the_President_by_Litigation_Funding_Working_Group.pdf [https://perma.cc/7KG2-AVB2]; N.Y.C Bar Ass'n Comm. on Pro. Ethics, Formal Op. 2018-5 (2018) https://s3.amazonaws.com/documents.nycbar.org/files/2018416-Litigation_Funding.pdf [https://perma.cc/H2U6-JP9C].

34. *See* Burford Capital Ltd., Annual Report 10-11 (Form 20-F) (Mar. 24, 2021) [hereinafter Burford 2020 Annual Report].

sequent decades,[35] litigation finance has gradually emerged as a transformational phenomenon for the civil justice system.[36] The sector is growing, both in terms of the number of participants and revenue. One litigation finance brokerage currently estimates that litigation funders have over $11 billion either currently invested or ready to invest in U.S. commercial litigation.[37]

Furthermore, there is unanimous agreement that there is significant potential for the market to grow,[38] especially in the United States.[39] The total addressable market for litigation finance is difficult to estimate. In the first place, there are two distinct sources of revenue: claims on lawsuit proceeds (in the case of funded litigants) and claims on law firm revenues (in the case of funded law firms). In 2019, IMF Bentham, then a large publicly traded LFC,[40] attracted attention when it estimated in its Annual Report that the total addressable market for litigation finance in the United States was $85 billion.[41] This estimate was derived from the share of litigation expenses going to plaintiffs' lawyers, apparently on the theory that that entire amount could become financed.[42] This estimate is both conservative and exaggerated. It is conservative because it fails to capture financeable *defendant* opportunities[43] and, much more importantly, the *direct monetization* of claims by busi-

35. *See* Wilson, *supra* note 20 (describing litigation finance as "growing at a steady pace without ever quite catching fire"); Michele DeStefano, *Nonlawyers Influencing Lawyers: Too Many Cooks in the Kitchen of Stone Soup?*, 80 FORDHAM L. REV. 2791, 2819–22 (2012) (recounting origins in U.K. and Australia).

36. *See* Steinitz, *Follow the Money?*, *supra* note 1, at 1075 (characterizing litigation finance as "likely the most important development in civil justice of our time"); Sahani, *supra* note 3, at 392 n.10 (referring to litigation finance as a "paradigm shift in dispute resolution").

37. Jack Newsham, *The Power Players of the Booming Litigation Finance Industry*, BUSINESS INSIDER (May 26, 2021, 7:48 AM) https://www.businessinsider.com/power-players-of-the-booming-litigation-finance-industry-2021-5 [https://perma.cc/9HNQ-JNZW].

38. *See* Annie Pavia, *Are Boom Times Ahead for Litigation Finance?*, BLOOMBERG LAW (Nov. 13, 2022, 9:01 P.M.) https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-are-boom-times-ahead-for-litigation-finance [https://perma.cc/4WNT-HKAN].

39. Litigation funders attribute the relatively low degree of penetration in the U.S. market in large part to legal and business culture, as well as the durability of legal restrictions on maintenance and champerty that complicate efforts for non-lawyer third-parties to finance or own interests in legal claims.

40. IMF Bentham Ltd. and Omni Bridgeway Holdings B.V. merged in November 2019, and in February 2020 the combined entity changed its name to Omni Bridgeway Ltd. John Freund, *IMF Bentham to Become Omni Bridgeway*, LITIG. FIN. J. (Feb. 14, 2020) https://litigationfinancejournal.com/imf-bentham-to-become-omni-bridgeway/ [https://perma.cc/5S2C-5C4G].

41. IMF Bentham Ltd., Annual Report 2019, at 32 (2020).

42. *See id.* at 13.

43. *See* Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367, 377–80 (2009) (proposing that corporate defendants use litigation finance as source of capital to absorb litigation risk after the filing of a lawsuit).

ness litigants themselves.[44] On the other hand, it is exaggerated insofar as it is predicated on the industry maintaining a beneficial financial interest in *all* plaintiff attorneys' fees, which would hardly be advisable, if it were even possible at all.[45] While the precise scope of the market opportunity is uncertain, it is clear that litigation finance will remain a fixture, with significant room to grow.

In the meantime, Burford, the largest LFC by any metric, already counts 94 of the "AmLaw 100" law firms, and 90 of the 100 largest global law firms, as its clients.[46] The 2008–2009 recession provided a special impetus to the law firm finance market, which saw many law firms lose access to bank credit and face increased pressure from corporate clients to transition away from hourly billing as the predominant modality of attorney compensation.[47] Well aware of the global growth potential, the industry founded its own worldwide trade association in September of last year: the International Legal Finance Association (ILFA).[48]

So much for the demand side. The supply side, consisting of investment fund flows, is in plentiful supply as well, with even traditionally conservative investment institutions like university endowments starting to invest.[49] First, the low-rate environment has increased investor appetite for non-traditional investments. In this respect, the flow of savings into litigation finance investments is of a piece with investment flows to cryptocurrency, real estate, and commodities. A second factor stoking demand for litigation finance investment is the relatively low correlation of litigation finance returns with the broader

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44. *See* Dai Wai Chin Feman & Sean Thompson, *Claim Monetization: A Lesser Known Use of Litigation Finance*, CORP. COUNSEL (Feb. 14, 2019) (https://www.law.com/corpcounsel/2019/02/14/claim-monetization-a-lesser-known-use-of-litigation-finance/).

45. Other estimates based on law firm revenues hover in the same range. *See* Brian Baker, *In Low-Yield Environment, Litigation Finance Booms*, MARKETWATCH (Aug. 21, 2018, 10:59 AM) https://www.marketwatch.com/story/in-low-yield-environment-litigation-finance-booms-2018-08-17 [https://perma.cc/RC74-ZBYD] (reporting $50–100 billion estimate of Cindy Chen Delano, a litigation finance professional).

46. *See* Burford 2020 Annual Report, *supra* note 34, at ix.

47. *See* Eva Shang & Robbie Li, *Insight: Litigation Finance Could Be a Lifeline During Pandemic*, BLOOMBERG L. (May 26, 2020, 4:00 AM) https://news.bloomberglaw.com/us-law-week/insights-litigation-finance-could-be-a-lifeline-during-pandemic [https://perma.cc/2CY3-FDAM].

48. *See* Sara Merken, *Litigation Finance Firms Join Forces to Counter Skeptics in Lobbying, PR Push*, WESTLAW NEWS (Sept. 8, 2020, 6:30 PM) https://www.reuters.com/article/litigation-finance-firms-join-forces-to/litigation-finance-firms-join-forces-to-counter-skeptics-in-lobbying-pr-push-idUSL1N2G528Y [https://perma.cc/84CS-VMT7]. Even earlier, industry participants had formed jurisdiction-specific trade associations, such as the American Legal Finance Association and Association of Litigation Funders in the United Kingdom.

49. *See* Greenberg, *supra* note 29, at 2 (mentioning investments by the University of Michigan and Harvard University, which maintain two of the largest endowment funds in the world).

economy, which offers investors diversification benefits.[50] Litigation finance returns are a function of underwriting practices and court timelines rather than consumer spending, commodity prices, corporate investment, etc.[51]

C. *Publicly Traded LFCs*

Currently, more than forty specialized LFCs operate in the United States.[52] The worldwide number is undoubtedly greater. Yet, only four of these companies are publicly traded worldwide.[53] In descending order of current market capitalization, these firms are Burford, Omni Bridgeway, Manolete, and LCM. Burford is incorporated in Guernsey (a small island state in the English Channel that serves as a popular jurisdiction of incorporation) and is listed on the Alternative Investment Market (AIM)[54] of the London Stock Exchange (LSE) and, as of October 2020, the New York Stock Exchange (NYSE) as well. Omni Bridgeway and LCM are traded on the Australian Stock Exchange; the latter is also traded on the AIM. Manolete is traded on the AIM only. A fifth LFC, Juridica Investments Ltd. (Juridica), was traded on the AIM from 2009 until it was delisted in December 2018.[55] Together, these four public companies have an aggregate market capitalization as of September 2022 of just under $3 billion.

As with any industry, the public-private distinction has significant implications for how LFCs conduct business. Most obviously, publicly traded LFCs must comply with the periodic and episodic reporting regime imposed by the securities laws. Less straightforward, but equally as important, are the *governance* implications for an LFC transitioning from a fund model to a public company model. Private investment

50. *See* J.B. Heaton, *The Siren Song of Litigation Funding* 9 MICH. BUS. & ENTREPRENEURIAL L. REV. 139, 143–44 (2019).

51. *See Burford Capital: Class War Capitalist*, FIN. TIMES (Aug. 28, 2017), https://www.ft.com/content/cc46e274-54c6-11e7-9fed-c19e2700005f [https://perma.cc/6MH4-E5W5].

52. *See* WESTFLEET ADVISORS, THE WESTFLEET INSIDER: 2020 LITIGATION FINANCE MARKET REPORT 4 (2020) ("The number of litigation funders active in the U.S. market grew from 41 in 2019 to 46 in 2020, according to our research."); Andrew Langhoff, *An Overview of Litigation Finance Brokerage in the USA*, *in* CHAMBERS LITIGATION SUPPORT 2020: LEADING LITIGATION PROFESSIONALS WORLDWIDE 60, 60 (2020) https://complexdiscovery.com/wp-content/uploads/2020/07/Chambers-Litigation-Support-2020.pdf [https://perma.cc/6SGQ-BX8L].

53. Another LFC, Vannin Capital, abandoned a contemplated public listing in 2018 following an unfavorable development in its own portfolio and sector-wide valuation concerns. *See* Kate Beioley, *Vannin Capital Sold to Fortress a Year After Abandoning IPO*, FIN. TIMES (Sept. 6, 2019) https://www.ft.com/content/1288d980-d0ae-11e9-b018-ca4456540ea6 [https://perma.cc/AT7L-UHB7].

54. Burford initially listed on the AIM in 2009. Burford 2020 Annual Report, *supra* note 34, at 4.

55. *See* discussion *infra* Part VI.A (discussing Juridica's failure at length).

funds in the private equity, venture capital, and hedge fund sectors operate in an environment where transparency and disclosure expectations are lowered, investors are sophisticated or wealthy (or both), and trust is the predominant cultural norm.

By contrast, investors in public companies expect much more detailed financial and non-financial disclosures than investors in private funds. Moreover, public companies must accommodate the expectations of public market investors for earnings reporting and guidance. This, in turn, affects corporate governance practices. As the saying goes, "if you show me what you count, I'll show you what counts." Numbers and accounting practices play a constitutive role; they not only reflect the social world but also help shape it, bringing into existence new practices and routines.[56] Firms that are not normally in the practice of reporting periodic—and frequently asynchronous, when compared to their investment time horizon—earnings must suddenly not only produce that information, but devote internal resources to deliberating on and projecting future earnings. When Burford, Omni Bridgeway, LCM, and Manolete decided to go public, they opted into a new financial reporting regime and assumed a cluster of anticipated and unanticipated governance implications.

What drives management to take LFCs public? For the most part, the motivations driving LFC managers to list their companies' shares are the standard set of considerations for all public companies. Most obviously, listed companies have *ready access to debt and equity capital*.[57] As noted earlier, the sector is growing and requires capital to fund this growth.[58] In the LFC context, debt capital tends to fund growth,[59] and equity capital, being more patient, makes LFCs more resilient to potential liquidity mismatches that pose a threat to all financial institutions that lend long.[60] By going public, an LFC not only secures equity capital,

56. *See* Theodore M. Porter, *Making Things Quantitative*, *in* ACCOUNTING AND SCIENCE: NATURAL INQUIRY AND COMMERCIAL REASON 36, 46 (Michael Power ed., 1994) ("Quantification has an important constructive role. With numbers one can often make new things, or at least transform old ones.").

57. DAVID A. WESTENBERG, INITIAL PUBLIC OFFERINGS: A PRACTICAL GUIDE TO GOING PUBLIC § 1:2.1, at 1–4 (2d ed. 2012).

58. *See supra* Part II.B.

59. *See, e.g.*, Burford 2020 Annual Report, *supra* note 34, at 66.

60. *See* Manolete Partners PLC, Annual Report 2020 15 (2021) [hereinafter Manolete 2020 Annual Report] ("The IPO . . . has given us the financial firepower to take on a higher number of cases and larger cases, without fear of portfolio concentration risk."); Nick Rowles-Davies, *Why Litigation Finance Is Suited to Public Markets*, LITIG. FIN. J. (Aug. 28, 2019), https://litigationfinancejournal.com/litigation-finance-suited-public-markets/ [https://perma.cc/2D8Y-XJ8U].

but it also significantly facilitates the public sale of debt.[61] Further, publicly traded LFCs can freely use their stock as *acquisition currency*,[62] as Burford did in 2016 when it acquired litigation finance fund manager Gerchen Keller.[63] In this respect, public company status facilitates consolidation and revenue diversification. And publicly traded LFCs are more readily able to *compensate management* by issuing stock, stock options, and other securities, a practice that is thought to align the microeconomic incentives of managers and other security holders.[64]

An additional motivating factor applies with particular force in the litigation finance industry and provides an entry point into the problem considered in this essay. Specifically, some LFCs have touted the *corporate governance benefits* flowing from the added transparency that public company status entails. To be sure, securities market professionals have long touted the "branding" and signaling benefits that a company enjoys, particularly if it lists on a reputable exchange with exacting corporate governance listing standards.[65] However, this general objective assumes heightened importance in the LFC context. In the words of Nick Rowles-Davies, a former Burford executive and current LCM executive vice chairman:

> Being listed on any stock exchange ensures a level of regulation and transparency that the private markets do not. . . . As a constituent of a public market, there is pressure to ensure that standards of corporate governance are upheld. Natural checks exist to hold companies to account in the form of selling investors, analysts publishing negative research, and, at the most extreme level, activists or short sellers publicly targeting companies.[66]

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61. If a company is already subject to the securities law reporting regime on account of its equity securities being listed, it can access public debt capital markets without incurring any significant incremental compliance costs. *See* 15 U.S.C. § 78m (conditioning reporting company status on having a class of securities registered on a national securities exchange).

62. Stock is used as acquisition currency when a public company provides newly issued stock to the stockholders of a target company as full or partial consideration for the acquisition.

63. *See* Alison Frankel, *Burford, Gerchen Keller to Merge: Turning Point for Litigation Funding?*, REUTERS (Dec. 14, 2016) https://www.reuters.com/article/us-otc-burford/burford-gerchen-keller-to-merge-turning-point-for-litigation-funding-idUSKBN1432S4. [https://perma.cc/UUJ2-SLGP].

64. *See, e.g.*, Lucian Arye Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915 (2010); Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003).

65. *See* Onnig H. Dombalagian, *Exchanges, Listless?: The Disintermediation of the Listing Function*, 50 WAKE FOREST L. REV. 579, 581–83 (2015).

66. Rowles-Davies, *supra* note 60.

Thus, the stock exchange as an institution imposes "natural checks" on possible self-serving behavior on the part of the managers. Yet, this governance story is complicated by the fact that company management—now flush with liquid, tradable securities—has heightened incentives to engage in stock price and earnings management. That is, if stock prices are evaluated in large part by the use of relative valuation techniques like price-to-earnings (PE) ratios,[67] the incentive exists for management to, as Carson Block—head of the short-only hedge fund Muddy Waters—puts it, "juice the earnings and make up the E."[68]

Public company status, therefore, is characterized by a tension. On the one hand, the open spigot of liquid company securities to management heightens the temptation to engage in unethical behavior by artificially inflating earnings and other metrics. On the other hand, as Rowles-Davies emphasizes, public companies provide publicity and transparency and invite scrutiny from investment professionals—including activists and short sellers like Muddy Waters.[69]

To a significant degree, this tension is a general structural property of public securities markets; it is observable with all public companies and across all industries and sectors. However, the main argument here is that the intrinsic opacity of LFC financial accounting and reporting practices significantly destabilizes and problematizes the tension, undermining in the process the two main objectives of disclosure-based securities regulation.

III. PUBLICLY TRADED LFCS POSE THREATS TO THE TWO PILLARS OF SECURITIES REGULATION

The two main objectives of securities regulation are protecting investors and promoting fair, efficient, and transparent markets.[70] Efficient capital formation is sometimes added as a third objective, although it is usually thought to be derivative of these investor protection and market integrity *grundnorms*.[71] More recently, systemic risk is

67. *See* ASWATH DAMODARAN, INVESTMENT VALUATION 468 (3d ed. 2012) ("Earnings multiples remain the most commonly used measures of relative value.").

68. *Muddy Waters' Carson Block on Burford Capital Short* (CNBC television broadcast Dec. 13, 2019), https://www.cnbc.com/video/2019/12/13/muddy-waters-carson-block-on-burford-capital-short.html [https://perma.cc/2UPF-57KK].

69. *See* Rowles-Davies, *supra* note 60.

70. *See* INT'L ORG. OF SEC. COMM'NS, *supra* note 5, at 3.

71. Mainstream economics assumes that promoting fair and efficient securities markets will result in roughly efficient capital formation. *See* Merritt B. Fox & Kevin S. Haeberle, *Evaluating Stock-Trading Practices and Their Regulation*, 42 J. CORP. L. 897–903 (2017). Post-Keynesian econo-

sometimes invoked as an additional objective of the securities laws, although this desideratum has been a shared responsibility for all financial regulators for at least a decade, and is not properly thought of as the core bailiwick of securities regulators. The two central themes, then, of securities regulation over the past century have been investor protection and market integrity. On account of the opacity of their assets, publicly traded LFCs pose threats to both of these objectives.

As discussed in greater length below, litigation finance assets are difficult to value before they result in cash settlements or court judgments. There is no obvious method for how to account for a litigation asset that was purchased for $5 million and could possibly result in recovery scenarios ranging from $0 to $40 million. This uncertainty is even more pronounced when reasonable lawyers and litigation funders disagree about the likelihood of the total-loss and extraordinary-recovery scenarios, and all the alternative scenarios in between. And yet, from an investor's perspective, the LFC's enterprise value depends entirely on its ability to generate returns from these opaque assets.

The accounting profession responds to uncertainty of this sort with so-called fair value accounting, which—as discussed in greater detail below—requires reporting entities to report, or "mark," the values of assets like these according to internal valuation models. The use of such a model entails so-called *model risk*, which is helpfully defined and discussed by the Federal Reserve in terms that are generalizable even beyond the banking context:

> The use of models invariably presents model risk, which is the potential for adverse consequences from decisions based on incorrect or misused model outputs and reports. . . . Model risk occurs primarily for two reasons: (1) a model may have fundamental errors and produce inaccurate outputs when viewed against its design objective and intended business uses; (2) a model may be used incorrectly or inappropriately or there may be a misunderstanding about its limitations and assumptions. Model risk increases with greater model complexity, higher un-

mists dispute this basic premise. *See* L. Randall Wray & Eric Tymoigne, *Macroeconomics Meets Hyman P. Minsky: The Financial Theory of Investment*, *in* MACROECONOMIC THEORY AND MACROECONOMIC PEDAGOGY 234 (Giuseppe Fontana & Mark Setterfield eds., 2009).

certainty about inputs and assumptions, broader extent of use, and larger potential impact.[72]

Model risk, when defined in this manner, captures the strategic manipulation of well-designed models, the construction of poorly designed models, and the faulty implementation of all sorts of models. From the vantage point of securities regulation, the opacity and the accompanying model risk creates a twofold problem for the *publicly traded* LFC, which assumes heightened responsibilities when it comes to disclosure and transparency.

First, it undermines *investor protection* because the intrinsic opacity of LFC asset valuation complicates the detection of fraudulent or negligent financial reporting, which can lead to investor losses. These problems result from doctrinal considerations and the potential for the confusing presentation of results. As a doctrinal matter, the prevalence of fair value accounting practices among publicly traded LFCs neutralizes much of the accuracy-enhancing effects of securities law antifraud rules. The central feature of securities regulation is a non-waivable, credibly enforceable antifraud remedy that enhances the reliability of disclosure for all companies, leading to more accurate valuations and more efficient capital investment.[73] However, judicial insistence on proof of wrongful state of mind,[74] as well as case precedent restricting the application of the antifraud rules to opinion statements,[75] attenuate the effectiveness of the antifraud regime as a corrective for the opacity of litigation finance accounts. After all, model risk captures good-faith (and therefore unactionable) errors in judgment, and all valuation models involve the use of inherently subjective and contestable assumptions that are, in an important sense, opinions.

More subtly, the public company financial reporting rules requiring periodic "fair value" estimates of asset values might also cause some retail investors to underappreciate the inherent discretion managers ex-

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72. FED. RSRV. BD. OF GOVERNORS, SUPERVISION & REGUL. LETTER NO. 11-7: GUIDANCE ON MODEL RISK MANAGEMENT (2011), https://www.federalreserve.gov/supervisionreg/srletters/sr1107.htm [https://perma.cc/9NPR-5R37].

73. The classic expression of this view is FRANK H. EASTERBOOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 280–85 (1991).

74. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976) (clarifying that Rule 10b-5 plaintiffs must allege *scienter*—that is, a fraudulent intent on the part of defendants); James J. Park, *Rule 10b-5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 345, 386–87 (2010) (speculating that the strictness of the scienter requirement might "create a divergence between Rule 10b-5 and its goal of reducing misstatements that distort the efficiency of the markets").

75. *See* Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175, 190–91 (2015) (holding that opinion statements are actionable only where the speaker affirmatively disbelieves the matter as to which the speaker is stating their belief).

ercise in valuing assets—in good faith or otherwise—and thereby possibly overestimate the reliability of LFC financial statements. Sociologist Nicolas Rose notes that, in modern societies, "[n]umbers are resorted to in order to settle or diminish conflicts in a contested space of weak authority."[76] For Rose, the "power of a single figure" is "a rhetorical technique for 'black boxing'—that is to say, rendering invisible and hence incontestable—the complex array of judgments and decisions that go into a . . . number."[77]

It is possible to view fair value accounting generally as a second-best solution to the problem of accounting for asset values in highly uncertain environments. Following Rose, there are only "weak authorities" on which to base valuations, so recourse to internal valuation models is arguably necessary. However, reliance on the internal models, which yield single point estimates of value, might in the process "black box" and obscure the complex and ineradicable uncertainty concerning the value of the marked assets. Nassim Taleb has written on this theme in the financial context: "Once on a page or on a computer screen . . . [a] projection takes on a life of its own, losing its vagueness . . . and becoming what philosophers call reified, invested with concreteness; it takes on a new life as a tangible object."[78] The prospect of undue investor credulousness leading to investor losses is also part of the investor protection problem regarding opaque assets.

Second, the structural opacity of the company's valuation creates conditions ripe for *market manipulation* through strategies like so-called "short attacks" and "bear runs," as some believe happened recently with Burford and the hedge fund Muddy Waters. The reference to market manipulation here, and throughout this paper, is intended to capture strategic attempts to create and profit from disjoints between the intrinsic value and the market price of a firm's securities. What this definition perhaps lacks in specificity it compensates for in its capaciousness. Over a century ago, financial journalist Albert Atwood noted that manipulation "is more easily seen than defined," but that it "almost invariably conveys the idea of *artificiality*."[79]

This notion of artificiality requires further elaboration. Two central meanings of "artificiality" should be distinguished. On the one hand, a price could be artificial in the sense that it results from artificial tinker-

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76. NIKOLAS ROSE, POWERS OF FREEDOM: REFRAMING POLITICAL THOUGHT 208 (1999).

77. *Id.* (internal quotation marks omitted).

78. NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE 158 (2d ed. 2010).

79. ALBERT W. ATWOOD, THE EXCHANGES AND SPECULATION, *in* 20 MODERN BUSINESS 253 (Joseph French Johnson ed., 1918) (emphasis added).

ing with perceptions and records of supply and demand—from falsely modifying the order flow out of which the price emerges, or is said to be passively "discovered" by market forces. For instance, a group of traders might manipulate a stock price by "spoofing" or "layering" non-bona fide buy orders that they intend to cancel, so as to give the false impression of a surge in demand for a security.[80] On the other hand, a price could be artificial in the sense that it diverges from what would have been the price absent a flood of bona fide sell orders that were entered solely to affect the security's market price, with no consideration of fundamental, intrinsic value of the security. An artificial price in this second, broader sense is a price that moves away from its previous level on account of strategic action on the part of the manipulator. It is this latter sense of artificiality that is intended to be captured by the capacious formulation of manipulation adopted here, which is sometimes referred to as "open-market manipulation."[81]

The prohibition on market manipulation in American securities law has been interpreted by courts more restrictively, consistent with a strict interpretation of manipulation and artificiality requiring the stoking of false perceptions about actual supply and demand.[82] As such, practices like short selling, even when accompanied by aggressive press publicity in the financial press, are legal absent exceptional circumstances.[83] In the European Union and the United Kingdom, the Market Abuse Regulation similarly focuses on supply and demand as its overarching principle.[84] Thus, the sense used here is not only broader, it is also more colloquial and lay than the specialized legal term of art.

80. *See* Andrew Ceresney, Dir., Div. of Enf't, U.S. Sec. & Exch. Comm'n, Market Structure Enforcement: Looking Back and Forward: Speech at SIFMA Compliance & Legal Society New York Regional Seminar (Nov. 2, 2015), https://www.sec.gov/news/speech/ceresney-speech-sifma-ny-regional-seminar.html [https://perma.cc/3KTL-468M].

81. *See* Gina-Gail S. Fletcher, *Legitimate Yet Manipulative: The Conundrum of Open-Market Manipulation*, 68 DUKE L.J. 479, 501 (2018); *see also* Maxwell K. Multer, *Open-Market Manipulation Under SEC Rule 10b-5 and its Analogues: Inappropriate Distinctions, Judicial Disagreement and Case Study: FERC's Anti-Manipulation Rule*, 39 SEC. REG. L.J. 97, 100 (2011).

82. *See, e.g.*, ATSI Communications, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 100 (2d Cir. 2007) (noting that actionable market manipulation is present only where "investors are misled to 'believe that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators'"); GFL Advantage Fund, Ltd. V. Colkitt, 272 F.3d 189, 211 (3d Cir. 2001) (observing that a plaintiff "must present evidence that [a defendant] engaged in some other type of deceptive behavior in conjunction with its short selling that either injected inaccurate information into the marketplace or created artificial demand for the securities").

83. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 750 (9th ed. 2020).

84. *See* Commission Regulation 596/2014, art. 12, 2014 O.J. (L 173) 1, 30 (EU); *see also* SIMMONS & SIMMONS, MARKET ABUSE REGIME AFTER BREXIT (Dec. 1, 2021) https://www.simmons-simmons.com/en/publications/ck3syn2ankauk0b48d8k8hbzb/market-abuse-regime-after-brexit [https://perma.cc/TZF8-YHQA] (noting that post-Brexit U.K. market abuse regime is substantially similar to the E.U. regime).

The special threat to market integrity arises because the intrinsic opacity of litigation finance assets enables efforts by would-be manipulators to sow seeds of doubt concerning the quality of company accounts. Usually, the sort of "tail risk" represented by Enron-style accounting fraud is remote from the imagination of most investors. However, the more opaque a publicly traded company's asset portfolio, the easier it is to sow these doubts, making investor fears about tail risk more proximate.

A skeptic of the argument presented here might ask: "Sure, you call it 'manipulation,' which sounds mischievous, but where, exactly, is the problem here?" The skeptic might note that litigation finance companies assess the net pros and cons of public company status, including the possibility of a short attack or similar market-manipulative episode. If the company persists in listing, it knowingly assumes this possible downside risk, but impliedly has determined that the benefits outweigh said risks. Framed in this manner, that hardly presents a policy conundrum. However, the specter of market manipulation results in negative externalities from the perspective of the broader capital market.

Consider the following possible series of events. Becoming aware of the structural opacity of LFC fair value accounts, a speculator undertakes to sell the stock short, publicizing its inauthentic "belief" that the LFC's fair value marks are overly optimistic. In such a circumstance, it can be rational for other investors to sell their shares, creating a positive feedback loop the net result of which is a decline in the price of the LFC firm.[85] This decline in price can also lead to a decline in intrinsic value, as the price declines operate to increase the firm's cost of capital and affect its investment policies, in effect ratifying the initially pretextual description of the company's accounts.[86] For example, an investment promising an internal rate of return of 20% will be greenlighted by a firm with a weighted average cost of capital (WACC) of 18%, but will be declined by a firm with a WACC of 22% whether the WACC is established on an efficient market or is the result of market manipulation on the part of strategic short sellers.

The effects of market manipulation of this sort reverberate throughout capital markets. Tony D'Aloisio, the former chair of the Australian securities market regulator, lists the parade of horribles that might result from market manipulation of this sort:

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85. A similar phenomenon could result from herd-like creditor behavior. *See* Xuewen Liu, *Short-Selling Attacks and Creditor Runs*, 61 MGMT. SCIENCE 814, 822 (2015).

86. *See* Pingyang Yao & Pierre Jinghong Liang, *Informational Feedback, Adverse Selection, and Optimal Disclosure Policy*, 51 J. ACCT . RES. 1133 (2013); *see also* Itay Goldstein & Alexander Guembel, *Manipulation and the Allocational Role of Prices*, 73 REV. ECON. STUD. 133 (2008).

> Conceptually, the public cost of . . . market manipulation can be expected to be seen in the first instance in a widening in the bid–ask spreads for all trading in the securities in question. This can spill over into widening bid–ask spreads in the market for all securities, an increase in the cost of capital and a reduction in the market price of securities—not only for new and existing issues of the security in question but also for other securities. A reduction in market depth (reflecting reduced willingness to trade) and reduced trading volumes would also be expected. In a dynamic analysis, these higher costs of capital and costs of trading would feed into lower returns on investment, less fixed capital spending and less potential and actual economic demand and activity over the economic cycle.[87]

Despite the evident costs for investors, the incentives persist for would-be manipulators. Unless enforcement is both forthcoming and effective, market manipulators do not themselves incur these economic costs.[88]

These twin injuries to investor protection and market integrity would not pose an acute policy conundrum in the private fund context. In that setting, we might expect that informal norms, reputational considerations, and formal contracts would regulate and manage the uncertainty and opacity that saturates LFC accounts. But once these firms list their securities on public markets, they submit to a new regulatory regime, the objectives of which they can then potentially undermine.

Still, this argument that publicly traded LFCs present heightened risks to investors and market integrity hinges on an important premise: *that LFC financial statements are inherently opaque and the product of a higher-than-normal degree of managerial discretion*. While some further standardization might be expected in the medium- or long-term, particularly with the advance of predictive legal analytics,[89] the reality is that today there exists no consensus on how to value litigation finance assets. The following Part will shed light on the significant degree of subjective discretion involved in most LFC asset valuation practices, as well as the potential for abuse that such discretion inevitably entails.

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87. Tony D'Aloisio, Chairman, Austl. Sec. & Inv. Comm'n, Insider Trading and Market Manipulation, Speech at Sup. Ct. of Victoria L. Conf. (Aug. 13, 2010), at 3–4, https://download.asic.gov.au/media/1347296/speech-insider-trading-market-manipulation-August-2010.pdf [https://perma.cc/8PLU-ZUYT].

88. *See id.* at 4.

89. *See* Robert F. Weber, *Will the "Legal Singularity" Hollow out Law's Normative Core?*, 27 MICH. TECH. L. REV. 97, 105–19 (2020).

IV. LFC ASSETS AND FAIR VALUE ACCOUNTING

The securities disclosure complications for LFCs result primarily from the application of fair value accounting rules to litigation finance assets. This Part will guide the reader through the application of those fair value accounting rules. Accounting rules, along with scripture, are perhaps the only volumes of lexical rule systems that lawyers can push off to another profession. Even for a lawyer, tracing through labyrinthine accounting rules can be vexatious. Nevertheless, all *securities* lawyers eventually learn that they cannot avoid engaging with the accounting rules from time to time.

Doing so here reveals a state of uncertainty regarding whether fair value rules do or do not apply to litigation finance assets, with the better argument probably lying in the affirmative position. Next, the Part examines in detail how the publicly traded LFCs that adopt fair value accounting structure their fair value process and explain it to investors. It highlights in particular the unavoidable quantum of brute discretion that persists in that system, notwithstanding companies' efforts to center the "objectivity" of their accounts.

A. *How Fair Value Accounting Works Generally*

One of the principal dilemmas in modern accounting is deciding whether to account for income and asset values by reference to cash flows and historical costs or by reference to current fair values.[90] The former approach is thought to privilege clarity and certainty at the cost of some economic realism. The latter is thought to privilege economic realism at the cost of introducing discretion and the possibility of strategic manipulation and abuse. Two of the four publicly traded LFCs—Burford and Manolete—classify their litigation finance assets in a manner that requires fair value treatment.

Three of the publicly traded LFCs (Omni Bridgeway, LCM, and Manolete) are subject to the International Financial Reporting Standards (IFRS) regime maintained by the International Accounting Standards Board (IASB).[91] The other (Burford Capital) reported in accordance with

90. *See* CTR. FOR EXCELLENCE IN ACCT. & SEC. ANALYSIS, PRINCIPLES FOR THE APPLICATION OF FAIR VALUE ACCOUNTING 2 (2008) [hereinafter FAIR VALUE PRINCIPLES] ("The issue of *when*, rather than *how*, to apply fair value measurements—as a matter of principle—is unresolved, even though fair value reporting has been required for selected financial assets and liabilities for some time.").

91. *See* Manolete Partners PLC, Annual Report and Accounts 2022, at 27 (2022); LITIGATION Capital Management Ltd., 2021 Annual Report 36 (2021); Omni Bridgeway Ltd., 2021 Annual Report 55 (2021).

IFRS until 2022, when it voluntarily elected to present its 2021 financial statements in its annual report in accordance with the U.S.-based Generally Accepted Accounting Principles (GAAP) accounting regime, maintained by the Financial Accounting Standards Board (FASB).[92] Given the predominance of IFRS reporting in the industry as presently constituted, this Article focuses on the applicable IFRS rules.

However, fair value accounting is one arena where IFRS and GAAP have substantially converged over the past decade.[93] In fact, the IFRS fair value regime applicable to the current cohort of publicly traded LFCs is in most respects substantively identical to that of the GAAP regime, set forth in Topic 820 of the FASB's Accounting Standards Codification system.[94] So the U.S.-based reader, likely more accustomed to thinking about accounting in terms of the GAAP regime, is relieved of the burden of wondering how these issues play out in GAAP terms. For purposes of the specific issue with which this Article is concerned—fair value accounting for so-called Level 3 assets—no significant differences

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92. In general, public companies listed on U.S. stock exchanges must comply with GAAP. *See* RAJ GNANARAJAH, CONG. RSCH. SERV., IF10701, INTRODUCTION TO FINANCIAL SERVICES: ACCOUNTING AND AUDITING REGULATORY STRUCTURE, U.S. AND INTERNATIONAL 1 (2021), https://crsreports.congress.gov/product/pdf/IF/IF10701/7 [https://perma.cc/2U2V-LAMU]. However, the U.S. Securities and Exchange Commission also accepts IFRS preparation for so-called "foreign private issuers" (FPIs). *See* Form 20-F, Item 17(c). Burford, the only U.S.-listed LFC, historically prepared its financial statements consistent with IFRS. The ability of a U.S.-listed public company organized outside the United States to continue to do so depends on it maintaining its FPI status. *See id.* at gen. instr. A(a). Exchange Act Rule 3b-4(c) defines FPI to include all non-governmental foreign issuers that are not both (1) majority owned (in terms of voting securities) by U.S. residents and (2) linked significantly to the United States in one or more of the following ways:

(a) a majority of executive officers or directors as U.S. residents;
(b) a majority of assets located in the United States; or
(c) a principal place of business administration located in the United States.

See 17 C.F.R. § 240.3b-4 (2021). Burford takes the position that it still is an FPI, but nevertheless elected voluntarily to transition to GAAP. *See* Burford Capital Ltd., 2021 Annual Report 5, 148 (Form 20-F) (2022) [hereinafter Burford 2021 Annual Report].

93. *See* Press Release, Fin. Acct. Standards Bd., IASB and FASB Issue Common Fair Value Measurement and Disclosure Requirements (May 12, 2011), https://www.fasb.org/cs/ContentServer?cid=1176158544944&d=&pagename=FASB%2FFASBContent_C%2FNewsPage [https://perma.cc/W98Q-JMYE].

94. *See* FIN. ACCT. STANDARDS BD., FAIR VALUE MEASUREMENT (TOPIC 820): AMENDMENTS TO ACHIEVE COMMON FAIR VALUE MEASUREMENT AND DISCLOSURE REQUIREMENTS IN U.S. GAAP AND IFRS (2011), https://asc.fasb.org/imageRoot/00/7534500.pdf [https://perma.cc/6642-MJ79] [hereinafter GAAP Fair Value Rules: Topic 820]; FIN. ACCT. STANDARDS BD., FAIR VALUE MEASUREMENT (TOPIC 820): DISCLOSURE FRAMEWORK—CHANGES TO THE DISCLOSURE REQUIREMENTS FOR FAIR VALUE MEASUREMENT (2018), https://asc.fasb.org/imageRoot/81/118196181.pdf. [https://perma.cc/2Y8C-JNCK].

exist between GAAP and IFRS. Burford acknowledged as much when it reported its first GAAP-compliant results in early 2022.[95]

The accounting treatment of future contingent cash flows from litigation finance assets begins with "recognizing" the cash flows. This taxonomic project begins with IFRS 9, which governs the accounting treatment of financial instruments, including "financial assets." IFRS 9 incorporates the definition of "financial asset" from IAS 32,[96] which includes, among other instruments, any "contractual right . . . to receive cash or another financial asset from another entity . . . ."[97] If an LFC "recognizes" its litigation finance assets as financial assets, IFRS 9 next makes the precise accounting treatment depend on how the LFC "classifies" the asset.[98] Chapter 4 of IFRS 9 clarifies that the proper classification of a financial asset, in turn, is a function of the contractual cash flow characteristics of the financial asset.[99]

For litigation finance assets, the relevant provision of Chapter 4 is paragraph 4.1.4. The provision requires that financial assets be measured at fair value through profit and loss where the cash flows related to the asset do not consist exclusively of "payments of principal and interest [on specified dates] on the principal amount outstanding."[100] In accounting practice, this means that the assets are periodically revalued, with the incremental changes reflected as profit (in the case of an upward fair value adjustment) or loss (in the case of a downward fair value adjustment) on the income statement for the period in which the fair value adjustment occurs. This is significant and potentially confusing, for it means that the idiosyncratic, non-standardized features of litiga-

95. *See* Burford 2021 Annual Report, *supra* note 92, at 26.

96. *See* INT'L ACCT. STANDARDS BD., INTERNATIONAL FINANCIAL REPORTING STANDARD 9 app. A (2020), https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards/english/2022/issued/part-a/ifrs-9-financial-instruments.pdf?bypass=on [https://perma.cc/7CX5-T5RP] [hereinafter IFRS 9].

97. INT'L ACCT. STANDARDS BD., INTERNATIONAL ACCOUNTING STANDARD 32 ¶ 11(c)(i) (2020) [hereinafter IAS 32].

98. *See* IFRS 9, *supra* note 96 ¶ 3.1.1.

99. *See id.* ¶ 4.1.1. Technically, the specific fair value accounting treatment is a joint function of both the cash flow characteristics and the business model pursuant to which the entity holds the financial asset. However, this latter criterion is only relevant where the relevant cash flows consist exclusively of interest and principal, and therefore do not come into play in the litigation finance context.

100. *See id.* ¶¶ 4.1.4., 4.1.2. Both of the publicly traded LFCs classifying their assets as "financial assets" report fair value adjustments through profit and loss. *See* Manolete 2020 Annual Report, *supra* note 60, at 46; Burford 2020 Annual Report, *supra* note 34, at 61. Where, on the other hand, the financial asset gives rise to cash flow rights consisting exclusively of principal repayment and interest payments on specified dates, then the instrument should be either reported at amortized cost (if it is held within a business model whose objective is to hold financial assets) or at fair value through other comprehensive income (if it is held within a business model that contemplates the sale of financial assets). *See* IFRS 9, *supra* note 96, ¶¶ 4.1.2-4.1.2A.

tion finance assets are responsible for fair value movements that directly impact the financial statement responsible for reflecting the operational realities of the business—that is, the income statement.

The specific rules for *how* to perform fair value accounting are set forth in IFRS 13, which defines fair value, sets out a framework for measuring fair value, and requires disclosures about fair value measurements. IFRS 13 applies when another IFRS standard—e.g., IFRS 9 as discussed above—requires or permits fair value measurements. IFRS 13 defines fair value in terms of a hypothetical exit price:

> Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (ie an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.[101]

IFRS 13 sets up a tripartite "fair value hierarchy," with each "level" corresponding to the available set of informational price inputs.[102] The general principle animating IFRS 13 is that fair valuation techniques "shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs."[103] Specifically, Level 1 inputs consist of quoted market prices, the most reliable fair-value exit price approximation; they are of the highest priority, meaning that an entity *must* measure its financial assets according to market prices where such prices are available.[104] Level 2 inputs consist of information other than quoted market prices that are directly or indirectly observable for the asset—for instance, quoted prices for similar assets in active markets.[105] These inputs are of middle priority, and should be used as the basis for measuring financial asset values where they exist, but quoted market prices do not. Finally, Level 3 inputs consist of unobservable information and are the lowest priority; they should be used only where no observable inputs exist.[106]

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101. INT'L ACCT. STANDARDS BD., INT'L FIN. REPORTING STANDARD 13—FAIR VALUE MEASUREMENT ¶ 24 [hereinafter IFRS 13]. When measuring fair value, an entity must use the assumptions that market participants would use when pricing the asset or the liability under current market conditions. As a result, an entity's own intentions to hold the asset or to settle or fulfill the liability are not relevant when measuring fair value.

102. *See id.* ¶¶ 72–90.

103. *See id.* ¶ 67.

104. *See id.* ¶ 72.

105. *See id.* ¶ 82(a).

106. *See id.* ¶¶ 86-90.

Implicit in this "fair value hierarchy" is the judgment that unobservable inputs are inherently less reliable than observable ones. In the context of Level 3 assets, the term "fair value accounting" is quite ambiguous. It is straightforward enough to determine there are no observable market prices to which an entity might look to value its assets. Still, it is quite different to be able to build an internal, objective informational system as a credible alternative. The same factors resulting in the absence of observable *external* market inputs—i.e., the absence of reliable market price signals—complicate the generation of reliable, objective *internal* inputs concerning the value of these assets. When a reporting entity uses internally-generated unobservable inputs to value Level 3 assets—as with internal, proprietary financial models—the risk of strategic manipulation is also heightened.

Unfortunately (but perhaps inevitably), IFRS 13 provides little guidance to reporting entities concerning the production and use of unobservable inputs in fair-value models. It limits itself to insisting that the unobservable inputs, whether generated internally or externally, reflect the assumptions that market participants would use when pricing the asset or liability.[107] But that "guidance" amounts to a tautology; so much was already implicit in the IASB's specification that fair valuation should seek to approximate an exit sale.[108]

In the absence of observable market data, an entity adopting fair value accounting possesses a higher-than-normal degree of discretion that is cabined only by a hypothetical limit set by what other market participants would do: "An entity shall develop unobservable inputs using the best information available in the circumstances. . . . In developing unobservable inputs, an entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data . . . ."[109]

Whereas IFRS 13 fails to adopt a prescriptive approach concerning the use of unobservable inputs into fair value models for Level 3 assets, it leans on disclosure principles to provide the context for management's discretionary choices. Its paragraph 91 sets forth a general principle requiring reporting entities to disclose information that helps users of its financial statements assess the valuation techniques and measurements, as well as the "inputs used to develop those measurements."[110] The principle also provides that entities marking Level 3 assets—i.e., using significant unobservable inputs—must also provide

107. *See id.* ¶ 87.
108. *See supra* note 101 and accompanying text.
109. IFRS 13, *supra* note 101, ¶ 89.
110. *Id.* ¶ 91.

disclosure that explains and contextualizes the effects of the fair value measurements on the entity's income statement.[111]

Following the skeletal paragraph 91, paragraph 93 fleshes out just what is required. For example, an entity must include a "description of the valuation technique(s) and the inputs used in the fair value measurement."[112] This description must address how an entity decides its valuation policies and procedures and analyzes changes in fair value measurements from period to period.[113] For Level 3 assets, the description should provide quantitative information about the significant unobservable inputs used in the fair value measurement.[114]

Sensitivity analysis[115] is also required, with reporting entities to set forth a "narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement."[116] Further, "if changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose the effect of those changes."[117] The entity must also "disclose how the effect of a change to reflect a reasonably possible alternative assumption was calculated."[118]

B. *Applying Fair Value Accounting to Litigation Finance Assets*

If an LFC recognizes its litigation finance assets as "financial assets" under IAS 32, then we have seen how IFRS 9 mandates that they be accorded fair value accounting treatment. Specifically, these litigation finance assets are to be accounted for through the income statement because the cash flows are not exclusively interest and principal payments.[119] Once classified as fair-value assets in this manner, the

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111. *Id.* ¶ 91.

112. *Id.* ¶ 93(d).

113. *See id.* ¶ 93(g).

114. *Id.* ¶ 93(d).

115. *See* Cass R. Sunstein, *The Limits of Quantification*, 102 CALIF. L. REV. 1369, 1373 n.17 (2014) (describing how sensitivity analysis is an analytical tool that is "used to see how relevant numbers would shift when different assumptions are used (and thus tests how sensitive such numbers are to particular assumptions)").

116. IFRS 13, *supra* note 101 ¶ 93(h).

117. *Id.* ¶ 93(h)(ii).

118. *Id.* ¶ 93(h)(ii).

119. *See supra* note 100 and accompanying text.

LFCs must look to IFRS 13 for instructions concerning the required fair value techniques and disclosures.[120]

Because litigation finance assets are lawsuit-specific or lawsuit-portfolio-specific,[121] there are no quoted market prices or other indirect observable inputs concerning their fair value. Therefore, IFRS 13 will require them to be classified as Level 3 assets.[122] In that circumstance, IFRS 13 opens up a significant discretionary space for LFC management to fashion their own valuation models and, in effect, make their own marks. Paragraph B36 of IFRS 13 sets forth some guidance for Level 3 fair value measurements for certain categories of assets, but litigation finance assets are not included.[123] Instead, IFRS 13 merely reiterates the default principle that fair value measurements should approximate an exit price.[124]

Note that the foregoing discussion has proceeded on the assumption that LFCs are recognizing their litigation finance assets as "financial assets" under IAS 32 and accounting for them using fair value accounting. Indeed, two of the four publicly traded LFCs—Burford and Manolete—do just that. However, the other two LFCs—LCM and Omni Bridgeway—do not recognize their litigation finance assets as financial assets and, accordingly, do not accord them fair value treatment. Instead, LCM and Omni Bridgeway rely on more tenuous interpretations of IFRS standards that result in accounting treatments favoring more conservative, cash-based accounting over fair value determinations.

LCM, for instance, classifies its assets as *contracts with customers*, which are covered by IFRS 15. That standard governs the reporting of revenues and cash flows from contracts with customers,[125] defined as contracts "to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration."[126] IFRS 15 and IFRS 9 operate in mutually exclusive fields of application; that is, where one applies, the other by definition cannot.[127] Therefore, determining whether to apply IFRS 15 or IFRS 9 to litigation finance assets is a highly consequential matter. If an LFC applies the latter, then fair value accounting will apply. If an LFC applies the former, then the LFC will use more conservative cash-based accounting methods where litigation fi-

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120. *See supra* note 101 and accompanying text.

121. *See supra* text accompanying notes 29, 32 (discussing portfolio litigation finance).

122. *See supra* note 106.

123. *See* IFRS 13, *supra* note 101, appx. B ¶ B36.

124. *Id.* ¶ 87.

125. INT'L ACCT. STANDARDS BD., INT'L FIN. REPORTING STANDARD 15 REVENUE FROM CONTRACTS WITH CUSTOMERS ¶ 1 [hereinafter IFRS 15].

126. *Id.* ¶ 6.

127. *See id.* ¶ 5(c); IFRS 9, *supra* note 96 ¶ 2.1(j).

nance assets are recognized at historical cost and revenues are recognized only upon final disposition of the matter.

The appropriateness of an IFRS 15 classification depends on the applicability of a carve-out. The carve-out excludes from the scope of IFRS all contracts in which counterparties "share in the risks and benefits that result from [an] activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of . . . ordinary activities."[128] Although their public disclosure does not spell out their classificatory rationale, by using IFRS 15 (and not applying this carve-out) LCM implicitly disclaims that its litigation finance assets involve the sharing of risks and benefits. That determination seems dubious in light of the basics of the litigation finance business model, not to mention LCM's own description of its value proposition:

> By providing our customers with financing solutions to pursue matters which would otherwise be costly, therefore *taking on their risk* and preserving their capital to pursue their own business opportunities. On successful completion of litigation cases we recover our investment and *earn revenue through share of proceeds*, performance and management fees.[129]

For its part, Omni Bridgeway avoids fair value accounting through a different taxonomic sleight, classifying its assets as "intangible assets" under IAS 38. This treatment results in the most conservative accounting treatment of all the publicly traded LFCs. IAS 38 sets forth the accounting treatment of intangible assets that are not governed by other specifically referenced standards, including IFRS 15 (LCM) and IAS 32 (Burford and Manolete).[130] The most important consequence of the classification as intangible assets under IAS 38 is that the assets are carried at cost, with gains recognized on the income statement only at the disposal of the asset.[131] Omni Bridgeway takes the position that a "disposal" of a litigation finance asset occurs (and a gain is recognized) when the financed litigation reaches "successful completion."[132]

Furthermore, this classification requires periodic impairment analysis for intangible assets with indefinite useful lives.[133] Impairment op-

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128. IFRS 15, *supra* note 125 ¶ 6.

129. Litigation Capital Management Ltd., 2020 Annual Report 7 (2021) (emphasis added).

130. INT'L ACCT. STANDARDS BD., INT'L ACCT. STANDARD 38 ¶¶ 3(e), 3(i) [hereinafter IAS 38].

131. *See id.* ¶ 113.

132. *See* Omni Bridgeway Ltd., 2020 Annual Report 77–78 (2021) [hereinafter Omni Bridgeway 2020 Annual Report]. Omni Bridgeway defines "successful completion" as when "the litigation has been finally determined in favour of the client or a positive settlement has been agreed." *Id.* at 78.

133. *See* IAS 38, *supra* note 130 ¶¶ 107–08.

erates as a one-way ratchet, with *downward* fair value adjustments being made as necessary in light of regular, periodic assessments, with no provision for accompanying upward adjustments.[134] As a result, Omni Bridgeway's accounting treatment is much more conservative than that of Burford and Manolete, and even more conservative, on account of the impairment process, than LCM's.

In its annual report, Omni Bridgeway explains why it believes IFRS 15 and IAS 32 are inappropriate. As for IFRS 15, it explains that its assets "are not considered contracts with customers as they are collaborative arrangements and there is no vendor-customer relationship established in the contract."[135] For reasons discussed above, Omni Bridgeway has the better argument on this score; a typical litigation finance contract provides for too much risk-sharing and revenue-sharing to meet the "contract with customer" definition. As for IAS 32, Omni Bridgeway takes the position that its litigation finance assets are not financial contracts under that standard—which, again, prescribes the treatment for contractual rights to receive cash or other financial assets[136]—because the assets might give rise to proceeds that consist in part of non-financial assets.[137] Notwithstanding the technical possibility of non-cash consideration, if litigation finance assets are anything, they are "contractual rights to receive cash or another financial asset from another entity," which should trigger the application of IAS 32 and the fair value rules.[138] In fact, it is fair to wonder whether the LFCs adopting alternative classifications are doing so due to their repeatedly emphasized strategic preference for more conservative, less discretionary cash accounting systems, notwithstanding the tenuousness of the textual fit between the asset and their preferred IFRS reporting modality.

Table 1 below summarizes the respective accounting conventions and their underlying rationales and ramifications.

134. *See* INT'L ACCT. STANDARDS BD., INT'L ACCT. STANDARD 36; Omni Bridgeway 2020 Annual Report, *supra* note 132, at 79 (explaining its impairment testing process).

135. Omni Bridgeway 2020 Annual Report, *supra* note 132, at 77.

136. *See supra* text accompanying note 97 (discussing IAS 32's definition of "financial asset").

137. *See* Omni Bridgeway 2020 Annual Report, *supra* note 132, at 77 ("The litigation funding contract does not give rise to an unconditional right to receive cash. Rather, it provides the Group with a right to a share of litigation proceeds which may be in the form of cash or other non-financial assets.").

138. *See supra* text accompanying note 130; IAS 32, *supra* note 97, ¶ 11.

TABLE 1: SUMMARY OF PUBLICLY TRADED LFC FAIR VALUE
CCOUNTING PRACTICES

Company	**IFRS Classification of Assets**	**Applicable Standard**	**Rationale for Classification**	**Resulting Accounting Treatment**	**Overall Assessment**
Burford	"Financial Assets" [IAS 32]	IAS 32 ¶ 11(c)(i)	LF assets are "contractual rights to receive cash or another financial asset from another entity"	FV through profit and loss	Not conservative, but arguably more useful
Manolete	(same as Burford)	(same as Burford)	(same as Burford)	(same as Burford)	(same as Burford)
LCM	"Contracts with Customers"	IFRS 15 ¶ 6	LF assets are "contracts to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration"	Cash-based accounting with no FV impairment	Conservative, but arguably less useful
Omni Bridgeway	"Intangible Assets" [IAS 38]	IAS 38 ¶¶ 3(e), (i); 8	LF assets are intangible assets (i.e., "identifiable non-monetary assets without physical substance") that are not classifiable as "financial assets" or "contracts with customers"	Cash-based accounting with FV impairment	Very conservative, but arguably less useful

That the four publicly traded LFCs settle on three mutually exclusive accounting treatments for their assets is a testament to the relative novelty and idiosyncrasy of litigation finance as an asset class. One thing to watch for in the coming years is whether a roughly uniform consensus concerning the classification and valuation of these assets emerges within the accounting profession as it becomes more familiar with the asset class.

C. *Implementing Fair Value Accounting in the LFC Context: Burford and Manolete as Case Studies*

The two publicly traded LFCs that have classified their litigation finance assets as "financial assets" and therefore adopted fair value accounting—Burford and Manolete—have adopted a constrained fair value approach, revaluing assets only upon the occurrence of certain "objective" verifiable events pertaining to the litigation. Otherwise, they report assets on the balance sheet at their historical cost[139] unless and until marks are adjusted to reflect the effect of an objective event.[140] Consequently, not all assets are adjusted to fair value; some are reported at historical cost. Relatedly, Manolete and Burford recognize two sources of revenue: (1) unrealized upward fair value adjustments to litigation finance assets based on the objective criteria and (2) actual realized revenue upon the conclusion of litigation finance assets (via settlement or adjudication).[141]

For the publicly traded LFCs adopting fair value accounting, the fair value component of earnings is significant. In 2020, Burford reported $339 million of total income related to balance sheet litigation finance assets,[142] 46 percent of which ($151 million) consisted of upward fair value marks.[143] For Manolete, unrealized fair value revaluations comprised

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139. IFRS 9 does not permit historical cost accounting treatment for financial assets. Nevertheless, IFRS 13 does clarify that the initial acquisition price of a financial asset is usually the appropriate fair value estimate of the asset at that moment—a process that results, in practice, in a sort of backdoor *initial* historical cost accounting treatment. *See* IAS 38, *supra* note 130 ¶¶ 57–60.

140. *See infra* text accompanying note 153.

141. *See* Manolete 2020 Annual Report, *supra* note 60, at 43 ("Revenue comprises two elements: the movement of fair value of investments and realised consideration."); Burford 2020 Annual Report, *supra* note 34, at 126 (disaggregating $340 million of total capital provision income into $205 million of "realized gains" and $152 million of "fair value adjustment," with other de minimis adjustments).

142. Burford refers to its balance sheet litigation finance assets as "capital provision assets." Burford 2020 Annual Report, *supra* note 34, at 13, 156.

143. *See id.* at 126. For 2019, the proportion of fair-value marks was even higher. *See* Kate Burgess, *Burford Capital's US listing Will Test Its Fair Value*, FIN. TIMES, (July 7, 2020), https://www.ft.com/content

an even larger percentage of income, comprising 58 percent ($10.9 million) of the company's total reported 2020 income of $18.7 million.[144] Burford argues that its marks are conservative by pointing out that only 22 percent of its total *realized* profits have been previously registered as fair value gains.[145] However, it bears emphasis that in recent periods Burford's *unrealized* fair value gains have been concentrated in its so-called "YPF-related assets,"[146] a cluster of claims arising out of the Argentine government's partial renationalization of the Argentine energy giant YPF S.A. Since 2015, the company has recognized $876 million in unrealized gains related to its YPF portfolio,[147] nearly all of which still awaits an event that would require Burford to recognize the realized gain.[148] In other words, the 22 percent figure does not consider the YPF portfolio, which represents the preponderant part of the company's unrealized fair value gains.

Hence, over recent reporting periods, we see that these companies' reported earnings are largely a function of the fair value adjustments that result from internal valuation models. This state of affairs gives rise to the twofold securities disclosure problem introduced earlier. Earnings and cognate concepts like EBITDA are the basis for some of the most popular valuation methodologies.[149] Fair value adjustments impact the balance sheet no less than they affect earnings, with upward adjustments accreting the amount of total assets and, ceteris paribus, stockholders' equity and book value. This dynamic means that fair value accounting affects other popular valuation methods that use book value multiples. The clear linkages between earnings and book value metrics to popular, widely-used valuation methods underscore the potential dangers to securities law objectives posed by opaque accounts.

To be fair, Burford does not include unrealized gains in its calculation of internal rate of return (IRR) and Return on Invested Capital (ROIC), the primary pro forma metrics by which it touts its financial track record to investors.[150] Over time, an LFC will develop a historical

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/f9f63567-9a46-499d-833e-8739520979fd [https://perma.cc/QJ4J-78GM] ("In 2019, half of Burford's £356m in revenues were unrealised gains.").

144. *See* Manolete 2020 Annual Report, *supra* note 60, at 47.

145. Burford 2020 Annual Report, *supra* note 34, at 62.

146. *See id.* at 63–64.

147. *Id.* at 64.

148. *See id.* at 9 (explaining how, absent fair value adjustment, Burford's default mode of revenue recognition is to report income/revenue when "there is no longer any litigation risk on a matter"). The "nearly all" qualifier is necessary because Burford has already offloaded a portion of its YPF-related assets for $144 million to third-party investors in a series of transactions resulting in realized gains. *See id.* at 63-64.

149. *See supra* note 67.

150. Burford 2020 Annual Report, *supra* note 34, at 15.

track record of *actual realizations* that can be compared to its unrealized fair-value marks. However, because most of the companies in this sector, whether public or private, are corporate adolescents, their historical realizations data is relatively unreliable.[151] As with any investment firm primarily engaged in deploying capital to achieve returns, realized historical returns on invested capital are the most relevant metrics to which sophisticated investors will ultimately look—but only when there is enough of an operating history to make that data reliable. As these adolescent LFCs mature and demonstrate track records of success in funding lawsuits and generating returns on invested capital, their investors should be more willing to abstract away from any individual assets, however large, and focus instead on the underwriting record itself. The investor will underwrite the LFC itself and have little motivation to separately consider the underwriting decisions pertaining to the portfolio assets. In the meantime, however, fair value marks and flow-through income assume heightened importance.

These problems will be discussed in greater detail below, but their basic features are straightforward. First, the discretion that managers enjoy in Level 3 fair value accounting regimes renders especially problematic their inherent incentive to manage earnings and other financial metrics in an effort to boost their own financial position. Second, this first problem, in fostering the perception of ambiguous accounts, is grist for the mill of would-be market manipulators, who can profit by sowing seeds of doubt regarding the integrity of LFC accounts.

These problems are magnified by the opacity of the fair value modeling process. Burford cautions investors that "[t]he estimation of fair value is inherently uncertain" because "[a]wards and settlements are hard to predict and have a wide range of possible outcomes." Manolete strikes a similar cautionary note, warning that because:

> [l]itigation is inherently uncertain . . . . it is reasonably possible, on the basis of existing knowledge, that outcomes within the next financial year that are different from the assumptions [used in the valuation models] could require a material adjustment to the carrying amount of the . . . investments disclosed in the balance sheet.[152]

151. *See* Healey et al., *supra* note 16, at 3.
152. Manolete 2020 Annual Report, *supra* note 60, at 47.

Perceiving the tension between the opacity of the valuation process and the goal of transparent disclosure, Burford repeatedly emphasizes in its 2020 annual report the *objectivity* of its fair value accounting policy:

> We hold legal finance assets at initial fair value, which is equivalent to deployed funded cost, until there is some *objective event* in the underlying litigation that would cause a change in value, whereupon we are required under IFRS to reflect the impact (up or down) of that *objective event* through a fair value adjustment.[153]

And later on, Burford informs investors that:

> We operate under a valuation policy that relies on *objective events* to drive valuation changes. For the vast majority of our legal finance assets, the objective events considered under the fair value policy . . . relate to the litigation process. When the *objective event* in question is a court ruling, Burford discounts the potential impact of that ruling commensurate with the remaining litigation risk.[154]

Manolete, for its part, makes similar assurances about objectivity, informing investors that it "adjust[s] case fair values depending upon objective case developments, for instance: an offer to settle, mediation agreed, positive or negative legal advice."[155]

For Burford, the "objective events" giving rise to valuation changes are familiar to all lawyers: rulings on dispositive pre-trial motions, judgments, appellate results, exhaustion of rights to appeal, and the issuance of arbitral tribunal awards.[156] Further, Burford sometimes sells portions of its litigation finance assets before their resolution by objective events, and takes into account these transaction prices as Level 3 inputs.[157] After all, the objective of fair value measurement of assets under IFRS is to approximate a hypothetical exit sale at the measurement date from the perspective of a reasonable market participant.[158] Where there are *actual* exit sales, those prices are obviously relevant. Indeed, most of Burford's un-

153. Burford 2020 Annual Report, *supra* note 34, at 60 (emphasis added).
154. *Id.* at 61 (emphasis added).
155. Manolete 2020 Annual Report, *supra* note 60, at 46.
156. *See* Burford 2020 Annual Report, *supra* note 34, at 118.
157. *See id.* at 142.
158. *See supra* text accompanying notes 101–124.

realized fair value gains result from Level 3 markups predicated on these dispositions.

And yet, Burford's disclosure is unavoidably Janus-faced on this score. Notwithstanding all the talk of objectivity, the company also acknowledges that its Level 3 fair value measurements, despite being the current best estimates, are "inherently *subjective*."[159] At one point, the company, in seeming exasperation, justifies its valuation policies in terms of a lack of alternatives:

> The aggregate of the fair values selected falls within a wide range of reasonably possible estimates. In the Group's opinion there is no useful alternative valuation that would better quantify the market risk inherent in the portfolio and there are no inputs or variables to which the values of the assets are correlated.[160]

Why does Burford's disclosure close with this ambiguous message that its inherently *subjective* marks are based on *objective* markers? And why do publicly traded LFCs using fair value accounting not disclose particularities concerning their valuation models, at least with respect to their highest value assets?

The disclosure and accounting ambiguities referenced so far apply with equal force to all Level 3 fair value accounting systems. To appreciate the answers to the questions posed above, it is necessary to appreciate the further layer of opacity obfuscating publicly traded LFC accounts resulting from privilege and work product rules.

V. THE LONG SHADOWS OF THE ATTORNEY-CLIENT PRIVILEGE AND THE WORK-PRODUCT DOCTRINE

All the while these fair value accounting rules command LFC management to engage in an inherently subjective and discretionary exercise of judgment, the legal ethics and evidence rules command circumspection or even outright silence when it comes to explaining how publicly traded LFCs are exercising that judgment in practice. This dilemma results from waiver concerns under the evidentiary rules relating to the attorney-client privilege and the attorney work product doctrine.[161] These

159. Burford 2020 Annual Report, *supra* note 34, at 143 (emphasis added).

160. *Id.*

161. Throughout this Article, references to privilege waiver cover both attorney-client privilege and work-product doctrine, even though the latter is not, strictly speaking, a privilege under

concerns significantly restrict the scope of disclosure to public LFC investors.

The focus here is on the United States, but the privilege issues attending LFC disclosure apply similarly in other jurisdictions,[162] especially in common law jurisdictions such as the United Kingdom and Australia. To underscore the special force of the waiver issue in the publicly traded LFC context, this Part will compare the waiver risk these companies face with the risks facing two other categories of actors that are similar, but different in crucial respects: *private LFCs* and *non-LFC public companies*. This Part will begin with a brief and general summary of the evidentiary protections flowing from the attorney-client privilege and the work-product doctrine. Next, it will present the comparative analysis referred to above and then conclude with some illustrations of how these protections affect the disclosure practices of publicly traded LFCs.

A. *A Brief Introduction to Privilege Waiver*

To appreciate the structuring importance of this privilege issue, a basic understanding of the relevant rules is necessary. The attorney-client privilege is an evidentiary rule providing that neither a client nor the client's lawyer may be required to testify or otherwise to provide evidence that reveals the content of confidential discussions and disclosures of information between the client and the lawyer in the course of seeking or rendering legal advice.[163] For its part, the attorney work product doctrine shields from discovery all "tangible material or its intangible equivalent in unwritten or oral form, other than underlying facts, prepared by a lawyer for litigation then in progress or in reasona-

evidence law. This convention is adopted to obviate the cumbersomeness that would otherwise require references to both protections in almost all cases. For purposes of the arguments presented here, the two evidentiary rules have the same effect: they both limit the LFC's ability to provide public disclosure concerning litigation assets.

162. *See* Joseph Pratt, *The Parameters of the Attorney-Client Privilege for In-House Counsel at the International Level: Protecting the Company's Confidential Information*, 20 NW. J. INT'L L. & BUS. 145, 159 (1999) ("[N]early every country in the world recognizes some form of the attorney-client privilege.").

163. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 68 (AM. L. INST. 2000) [hereinafter RESTATEMENT]. Although the lawyer's ethical obligations have always imposed a sacrosanct and affirmative obligation to protect confidences, the modern justification for the evidentiary privilege focuses on the instrumental goal of encouraging parties that those confidentiality obligations will be respected. *See also* Liesa L. Richter, *Corporate Salvation or Damnation? Proposed New Federal Legislation on Selective Waiver*, 76 FORDHAM L. REV. 129, 142 (2007).

ble anticipation of future litigation."[164] Two reporters for an American Bar Association Task Force on the Attorney-Client Privilege pithily distill the two protections in the following terms:

> It is widely recognized that the attorney-client privilege protects confidential communications between lawyer and client, while the work product doctrine provides qualified protection to writings embodying an attorney's factual investigations, research, impressions, opinions and conclusions in anticipation of litigation. The attorney-client privilege encourages clients to make disclosures necessary to obtain legal assistance, while the work product doctrine allows lawyers to investigate, prepare and develop strategy relating to litigation without worrying about adversaries obtaining their work and using it against their clients.[165]

When litigants disclose confidential information otherwise protected by these rules, they risk waiver of the protections.[166] The upshot of waiver is severe: the otherwise confidential materials may be subject to discovery by adverse parties, such as the adverse defendants[167] in the cases underlying the litigation assets.

Of course, no LFC investor is asking for public disclosure of the central strategy memos written by the lawyers litigating the cases in which the LFC has invested. But the scope of a waiver can be broader than the initially disclosed information that triggers the waiver in the first place. Whenever a client discloses confidential communications to third parties, the disclosure may waive protections not only with respect to the disclosed communication, but also any other communications relating to the same subject.[168] Although the prospect of a broad "subject matter"

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164. RESTATEMENT, *supra* note 163 § 87; *see also* N.Y. C.P.L.R. §§ 3101(c), (d)(2) (McKinney 2015) (providing that the work product doctrine protects an attorney's "mental impressions, conclusions, opinions or legal theories," as well as materials "prepared in anticipation of litigation or for trial by or for another party, or by or for that other party's representative").

165. Bruce A. Green & David C. Clifton, *Feeling a Chill*, A.B.A. J., Dec. 2005, at 61–62, https://www.abajournal.com/magazine/article/feeling_a_chill#google_vignette [https://perma.cc/JXV4-QCCD].

166. In general, parties waive the attorney-client privilege if they disclose a privileged communication to any third party, and they waive the work-product protection when sharing protected materials in circumstances in which there is a significant likelihood that the materials will be obtained by an adversary. *See* RESTATEMENT, *supra* note 163 §§ 79, 91. Of course, public disclosure of the sort contemplated here would meet both of those predicates.

167. The adverse parties in LFC-funded lawsuits are usually, but not always, defendants.

168. DAVID M. GREENWALD & MICHELE L. SLACHETKA, PROTECTING CONFIDENTIAL LEGAL INFORMATION: A HANDBOOK FOR ANALYZING ISSUES UNDER THE ATTORNEY-CLIENT PRIVILEGE AND THE

waiver of this sort is more remote in the work-product context than the attorney-client privilege context,[169] the waiver rule creates a strong incentive for all litigants to take effective steps to protect against even partial disclosure of privileged material, even in nontestimonial settings.

B. *A Comparative Analysis of the Risk of Privilege Waiver*

1. Publicly Traded LFCs vs. Publicly Traded Non-LFCs

The publicly traded LFC presents an acute case of a broader, usually easy-to-solve, problem. Public companies are always involved in litigation, some of which is usually material for purposes of the securities disclosure regime and must be disclosed to investors.[170] They face competing demands for *more* disclosure concerning material litigation on the part of investors and for *less* disclosure (or outright confidentiality and silence) from their lawyers.

The lawyers desire confidential treatment for two basic reasons. First, they want to avoid waiver of the important evidentiary protections flowing from the attorney-client privilege and the work-product doctrine. Second, they want to avoid disclosing strategically important information to adversaries or factfinders in a manner that prejudices their likelihood of success on the merits or diminishes their settlement negotiating leverage. For a non-LFC public company, these competing priorities are activated and weighed against one another every time a company feels pressure to discuss material litigation with investors.

WORK PRODUCT DOCTRINE 105, 119 (2015), https://jenner.com/system/assets/publications/14637/original/2015Jenner_26BlockAttorney-ClientPrivilegeHandbook.pdf [https://perma.cc/TG76-2EHJ].

169. *See* Doe v. Baylor University, No. 6:16-CV-173-RP, 2019 U.S. Dist. LEXIS 99362, at *35 (W.D. Tex. Jun. 7, 2019).

170. *See* 17 C.F.R. § 229.103 (2020) (setting forth Item 103 of Regulation S-K, which requires disclosure of "material pending legal proceedings, other than ordinary routine litigation incidental to the business"); Cynthia A. Williams, *The Securities Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1208–09 (1999) (describing how Item 103 works). For purposes of U.S. securities law, a matter is "material" if "there is a substantial likelihood that a reasonable investor would consider it important" in deciding how and whether to take actions in connection with the security—whether to transact in it and on what terms, how to vote it, etc. TSC Indus. v. Northway, 426 U.S. 438, 449 (1976); *see also id.* (adding that the touchstone of materiality is whether the matter "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information" available for investor review).

With an LFC, by contrast, litigation is all the company does! Virtually everything that is operationally relevant to an LFC revolves around active litigation. Nearly every cash flow originates from a lawsuit, and *ceteris paribus* investors would like to understand the LFC's assessments of its cases—a matter which is informed directly or indirectly by discussions, decisions, and consultations between the funded litigant and its attorneys, occasionally with involvement of the LFC itself. The relevance of these communications can be appreciated by considering the LFC's use of the information; they also frequently serve as the basic inputs for a publicly traded LFC's Level 3 valuation models.[171] As a result, when compared with the concerns facing public companies outside the LFC sector, the concerns over privilege waiver in the LFC context apply to a much wider range of material disclosures that reasonable investors might otherwise want to see.

2. Publicly Traded LFCs vs. Private LFCs

Whether publicly traded or not, every LFC will expect to review some information bearing on the lawyer-litigant relationship during due diligence and post-investment monitoring of assets. Most of the literature examining the issue of privilege waiver in the LFC context has focused on the issue of inadvertent waiver traceable to these communications.[172] The focus here is instead on the information transfer *to investors in the LFCs themselves*—a group that Maya Steinitz and Abigail Field helpfully describe as "secondary funders."[173] The secondary funders are those that fund the LFCs, and where the LFC is publicly traded, that group includes LFC stockholders, who bring to the secondary funding relationships legitimate and heightened expectations of information disclosure.[174]

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171. *See supra* text accompanying note 155 (reporting how Manolete adjusts reported asset values based on "positive or negative legal advice").

172. *See* Sebok, *Inauthentic Claim*, *supra* note 29, at 135 (noting the salience of the issue and recommending that "bar associations and other concerned parties develop solutions that preserve the right of litigants to communicate with third-party funders without necessarily destroying privileges they would otherwise enjoy").

173. *See* Steinitz & Field, *supra* note 19, at 730 (also analogizing secondary funders to reinsurers).

174. *See* Viral Acharya, Conor Kehoe & Michael Reyner, *The Voice of Experience: Public Versus Private Equity*, THE MCKINSEY QUARTERLY, Dec. 2008, at 1 ("Clearly, public boards cannot (and should not) seek to replicate all elements of the [private equity] model: the public-company one offers superior access to capital and liquidity but in return requires a more extensive and transparent approach to governance and a more explicit balancing of stakeholder interests.").

The risk of waiver arising out of communications from litigants and their lawyers to LFCs (the "primary" funders), while still significant, is lower than it is with secondary funders owing to the potential applicability of the "common interest" exception to the privilege waiver rules.[175] The common interest exception has historically facilitated communications between co-defendants[176] and even defendants and their insurers.[177] The risk of waiver of work-product protections is more remote because waiver only occurs where a litigant effectively provides an adverse party with access to the work product, which would almost never occur in the context of discussions between litigants, law firms, and LFCs.[178] Even in this more liberal disclosure context, litigation funding agreements typically require the LFC to maintain confidentiality of information learned in the course of funding and management of the case.[179]

C. *The Concrete Effects of Privilege Waiver Concerns on Disclosure Practices*

This waiver risk is particularly problematic where an LFC has a highly concentrated portfolio—a not uncommon situation in the sector

175. *See* Steinitz, *Incorporating Legal Claims*, *supra* note 2, at 1203 n.220 ("[I]f the parties are contractually agreeing to co-manage a litigation for a common purpose as defined in the litigation management agreement—[their] agreement, e.g., lays out how settlement offers are to be evaluated—then their relationship seems much closer than simply that of codefendants agreeing to cooperate in their defense, which is the situation the common interest doctrine arose from."); Steinitz & Field, *supra* note 19, at 734 (recommending acknowledgement in funding agreement that funder and litigant share a "common interest"); Langhoff, *supra* note 52 ("Recent court rulings in a number of different jurisdictions (federal and state) have strongly recognized that funders and those assisting the funding process are—in essence—part of your litigation team, and should be treated with the same protection of confidentiality as expert witnesses and others who are not acting in a purely legal capacity."); Michele M. DeStefano, *Claim Funders and Commercial Claim Holders: A Common Interest or a Common Problem?*, 63 DEPAUL L. REV. 305, 342–52 (2014) (arguing in favor of the applicability of the common interest exception to communications between litigation funders and litigants and their lawyers). *But see* Grace M. Giesel, *Alternative Litigation Finance and the Attorney-Client Privilege*, 92 DENV. U. L. REV. 95, 124–26 (2014) (expressing skepticism about applicability of common interest exception in this context, and registering that some case law "certainly cast[s] doubt on whether the privilege protects materials shared with an [LFC].").

176. *See* RESTATEMENT, *supra* note 163, § 75.

177. *See* De Stefano, *supra* note 175, at 349–52; Michael Keeley, *The Attorney-Client Privilege and Work Product Doctrines: The Boundaries of Protected Communications Between Insureds and Insurers*, 33 TORT & INS. L.J. 1169, 1182 (1998) ("[I]n the context of third-party insurance, communications between the insured and his lawyer in connection with the underlying lawsuit against the insured may be shared with the insurer without waiving the privilege where the insurer has a common interest in the subject matter of the communications.") (emphasis omitted).

178. *See* Jonathan T. Molot, *The Feasibility of Litigation Markets*, 89 IND. L.J. 171, 186–87 (2014).

179. *See* Steinitz & Field, *supra* note 19, at 763.

today.[180] Ideally, investors in a publicly traded LFC could read lawyers' assessments of strengths and weaknesses of the company's material litigation assets, or at least those (like Burford's YPF-related portfolio)[181] that constitute an outsize proportion of the company's balance sheet. To be sure, an investor in a well-diversified—or even a well-enough-diversified—publicly traded LFC would tend to rely more on the company's track record of producing profits and cash flows over the long haul. In other words, the investor would not expect to conduct its own underwriting analysis of the LFC's funded lawsuits; after all, that is why the investor is *investing in* an LFC rather than *running* one.

But this point should not be drawn too sharply. Each of the publicly traded LFCs is a corporate adolescent, having at most a decade-long history of managing a portfolio of assets that take several years to mature.[182] In theory, over time, a publicly traded LFC will develop a historical track record of actual realizations on which investors will be able to rely. But until that track record materializes, investors would prioritize the shape of the actual portfolio, and even some of the individual assets, during the pre-realization stage. And yet, the specter of waiver of these important privileges is a decisive factor in determining how much—or, really, how little—portfolio information can be disclosed to investors.

The critical point for present purposes is that these evidentiary protections prevent adverse parties and factfinders from learning of significant, relevant information concerning the cases underlying the litigation assets. A detailed study of these privileges—what they are, how they may be waived, and the exceptions to the waiver rules—is well outside the scope of this Article. However, it should be apparent that much of the protected information flows directly or indirectly into the valuation models that LFCs use when deciding whether to invest in lawsuits or considering how to assess the fair value of their litigation assets for financial accounting purposes. And the reason the information is relevant to the lawyers, litigants, and the LFCs themselves is the same reason why reasonable investors would like to see some of it.

In its annual report, Burford insists that concerns over waiver preclude it from disclosing individual asset valuations publicly:

> In order to make our underwriting decisions and conduct our ongoing asset monitoring, we receive from our clients confidential and legally privileged information . . . . That sensitive

180. *See infra* text accompanying notes 222–223 (discussing portfolio concentration at Juridica); *see also supra* text accompanying notes 146–148 (discussing portfolio concentration at Burford).

181. *See supra* text accompanying notes 146–148.

182. *See* Healey et al., *supra* note 16, at 3.

> information can lose its protection and become accessible to a litigation opponent if it is disclosed (a concept called "waiver"), which could have catastrophic consequences for the litigant. We are entitled to receive such information but are under a strict obligation to protect it to minimize the risk of waiver. . . . [T]his obligation requires us to tightly restrict access to the information itself and conclusions drawn from it. As an example, the release of individual valuations of ongoing legal finance assets may create a risk of waiver over sensitive information since a court order or other event that might give rise to an asset valuation can only be put in context with the use of privileged information. We thus do not release asset valuations of ongoing matters . . . and are similarly unable to provide other asset-specific information about our portfolio . . . .[183]

As a result of this privilege-imposed risk aversion, publicly traded LFCs provide only high-level, aggregate descriptions of their accounting practices. And they do not provide any meaningful information related to particular assets, even significant ones that comprise an outsized share of their total assets. Moreover, there is virtually no disclosure of middle-level information concerning, for instance, how management generally estimates the likelihood of success on the merits for types of cases, evaluates counterparties' willingness to settle and ability to pay, and assesses the commercial reasonableness of the litigant and the professional expertise of the counsel involved in the case.[184] The net effect is a chilled communicative environment pertaining to a publicly traded LFC's core assets.

D. *Privilege Waiver in the LFC Context as an Acute Case of a Familiar Securities Disclosure Problem*

This tension between legitimate investor expectations to understand the business and company demands to preserve the confidentiality of sensitive corporate information is ubiquitous in the mandatory securities law disclosure regime. Historically, the SEC formally struck a balance between these competing principles through a specific carve-out from the disclosure rules for "otherwise nonpublic corporate information the disclosure of which would affect adversely the registrant's competitive posi-

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183. Burford 2020 Annual Report, *supra* note 34, at 9; *see also id.* at 126.

184. *See* Langhoff, *supra* note 52 (discussing the key underwriting criteria for LFCs).

tion."[185] The SEC eliminated the carveout in 2020 as part of a broader "modernization" reform, insisting that the new emphasis on "principles-based" disclosure would still offer companies flexibility to protect sensitive and proprietary nonpublic information.[186]

The carve-out and the subsequent principles-based assurances provided comfort to public companies engaged in businesses like pharmaceutical production. Indeed, an analogy might be drawn between LFCs and pharmaceutical companies engaging in research and development of new drugs. At first blush, the analogy makes a good deal of sense. In both cases, there is a trade-off between investor demand for disclosure and corporate demand for confidentiality. In both cases, the companies regularly make long-term investments, the profitability of which is subject to significant uncertainty.

Nevertheless, the analogy must be qualified in two important ways. First, the LFCs have an added thumb on the scale in favor of confidentiality owing to the privilege waiver rules—that is, it is not just that they want to protect their proprietary valuation models, they also must avoid discussing any litigation altogether. Even more importantly, the fair-value accounting issues require a further qualification to the analogy. The accounting rules for pharmaceutical companies—and, for that matter, technology companies more generally—do not require companies to estimate their projects at fair value. Instead, they recognize intangible assets (if at all) by capitalizing them at the cost of development.[187] The net result is that the securities and accounting rules instruct pharmaceutical and technology companies to "build your balance sheet and income statement conservatively" and "you have flexibility when it comes to disclosing sensitive details of your product pipeline." By contrast, with LFCs the securities, accounting, and privilege rules combine to say "directly link your balance sheet and income statement to your internal valuations of your investment pipeline" and "by the way, you can't talk about your pipeline at all." For this reason, pharmaceutical and technology company financial statements are more conservative and less susceptible to the fraud and manipulation risks highlighted in this Article.

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185. 17 C.F.R. § 229.101(c)(ii) (2020) (setting forth quoted text); *see* Modernization of Regulation S-K Items 101, 103, and 105, 85 Fed. Reg. 63,726, 63,760 (Oct. 8, 2020) (amending Item 101(c) of Regulation S-K to eliminate quoted text).

186. *See* 85 Fed. Reg. at 63,732.

187. *See* IAS 38, *supra* note 130, ¶¶ 54–67 (describing how IFRS allows capitalization for some development, but not research, expenses as intangible assets); FIN. ACCT. STANDARDS BD. ACCT. STANDARDS CODIFICATION 730.10.05-2, https://asc.fasb.org/section&trid=2127268 (describing how GAAP disallows any capitalization of research and development expenses as intangible assets).

VI. TWO CASE STUDIES ILLUSTRATING THE TWO THREATS TO THE OBJECTIVES OF SECURITIES LAW

This Part will describe two recent episodes that illustrate how highly opaque fair value accounting practices at publicly traded LFCs threaten the foundational securities law objectives of investor protection and market integrity. The first case study will recount the failure of Juridica Investments, using it to demonstrate how LFCs can potentially compromise the investor protection objective. The second case study will recount the hedge fund Muddy Waters's short attack on Burford in August 2019, explaining how the episode alerts us to the special risk of market manipulation when LFCs go public. In each case, the roots of the problems can be found in the opaque fair value marks of litigation finance assets.

A. *Undermining the Investor Protection Objective: The Case of the Juridica Investments Implosion*

The rise and fall of Juridica Investments, the first LFC to list its shares publicly, provides an illustrative case study of the potential for confusion and investor losses resulting from opaque marks. To be sure, as will be explained below, the proximate causes of Juridica's failure were excessive portfolio concentration and bad investment decisions, not misleading fair value marks. Indeed, Juridica's fair value accounting seems to have depicted economic realities just as well as a cash accounting system would have. Its only shortcoming appears to have been a delayed downward mark on one of its key assets. Still, Juridica's failure and the resultant significant investor losses provide a useful case study of how LFCs operate, and how they sometimes fail. It also serves as a vehicle through which we can imagine how different applications of the company's fair value accounting policies could have quite easily deepened the investor losses.

In December 2007, Juridica listed on the AIM, the LSE's market for smaller issuers.[188] Less than eight years later, stockholders would force the company to cease operations and eventually liquidate after announcing a total write-off of a litigation asset that the company had previously marked up to $30 million.

188. *See* Miles Costello, *Lawsuit Financier Set to Make AIM Debut*, THE TIMES (Dec. 21, 2007) https://www.thetimes.co.uk/article/lawsuit-financier-set-to-make-aim-debut-gxln2hn3v5j [https://perma.cc/DDA4-GPJN]; *see also supra* text accompanying note 54 (describing the AIM and its affiliation with the LSE).

Juridica, like most LFCs today, underwrote exclusively business-to-business litigation. It developed a special focus on financing antitrust /competition and patent infringement lawsuits. Like Burford and Manolete, Juridica recognized its assets as "financial assets" and implemented fair value accounting consistent with IFRS 9 and IFRS 13.[189] Its description of its fair value process is familiar:

> [W]e develop a fair value of a case or investment by discounting its expected terminal value from its expected completion date. We determine our initial expectations on quantum and timing of case results by assigning a probability of various scenarios coming to fruition and applying risk factors that: i) are intrinsic to the specific case; and ii) reflect general risks within and outside of the legal process. Our assumptions behind an investment's fair value are revisited on a semi-annual basis . . . .[190]

In developing the scenarios, Juridica noted that it:

> consider[s] the current legal merits of each underlying case, the legal history of the case, the current legal environment, and any other factors we feel are relevant as of the date of our valuation. Working with the lawyers assigned to each case, we develop scenarios of potential outcomes, including the various situations that can generate outsized returns, moderate returns, or a complete loss, and assign each scenario a probability.[191]

After the company developed the scenarios and assigned them probabilities, it would run a Monte Carlo simulation[192] resulting in a single point estimate of the asset's fair value.[193]

In late 2008, less than a year after its IPO, Juridica acquired an interest in an antitrust case (which it labeled "8008-L") brought by several U.S. Fortune 500 companies against a group of non-U.S. liquid crystal display suppliers for an anticipated commitment of $26 million, touting

189. Juridica Investments, Ltd., Annual Report & Accounts 2015, at 22, 29 (2016) [hereinafter Juridica 2015 Annual Report].

190. *Id.* at 7.

191. *Id.* at 7.

192. Monte Carlo methods model a system or structure mathematically, but randomly generate values of a large number of connected but stochastic elements, aggregating the results of a large number of possible outcomes. *See* DOUGLAS W. HUBBARD, THE FAILURE OF RISK MANAGEMENT: WHY IT'S BROKEN AND HOW TO FIX IT 60–63 (2007); Kenneth A. Bamberger, *Technologies of Compliance: Risk and Regulation in a Digital Age*, 88 TEX. L. REV. 669, 718-19 (2010).

193. *See* Juridica 2015 Annual Report, *supra* note 189, at 7.

the possibility of a billion-dollar recovery.[194] This particular case was one of six assets comprising an antitrust portfolio that was, at all relevant times, by far Juridica's largest collection of assets.

The specific form the investment took was a debt facility provided to Fields Law, a law firm established by the founders of the Juridica enterprise.[195] Under the term of the facility and a related swap agreement, Juridica stood to profit from favorable outcomes of the antitrust lawsuits pursued by plaintiffs represented by Fields Law.[196] Several of the defendants in 8008-L had already been convicted criminally under the Sherman Act for their roles in maintaining a price-fixing cartel in the displays market.[197] From 2011 to 2013, Juridica reported a net positive fair value markup of its antitrust portfolio of $93 million, most of which was attributable to 8008-L, resulting in an unrealized gain of the same amount that flowed directly to the income statement as profit.[198]

In 2011, the company marked up its antitrust portfolio[199] by $49.7 million[200] and reported comprehensive income of $37.8 million.[201] The following year, it booked another upward adjustment of $40.3 million,[202] and reported comprehensive income of $35.6 million.[203] We can assume that Juridica was marking the assets up on account of what they perceived to be positive developments in the litigation. These two years were by far Juridica's most profitable years over the company's history, more than doubling the next most profitable year ($16.5 million in 2009). The upshot is apparent: in terms of income, Juridica's only good

194. *See* Juridica Investments, Ltd., Annual Report 2009, at 8 (2010) [hereinafter Juridica 2009 Annual Report]; Press Release, Juridica Investments, Ltd., Further Loan to Fields Scrantom Sullivan PLLC (Jul 16, 2009), http://www.juridicainvestments.com/~/media/Files/J/Juridica/pdfs/New_investment_16_Jul_09.pdf [perma.cc/8LEY-Z4KK] (mentioning possibility of $1.0 billion damage entitlement).

195. *See* Juridica 2015 Annual Report, *supra* note 189, at 28–29.

196. *See id.* at 25.

197. *See* Juridica 2009 Annual Report, *supra* note 194, at 5; Julie Triedman, *Litigation Funder Juridica Pulls Back After Bad Bets*, THE AM. LAW. (ONLINE) (Nov. 19, 2015, 2:28 PM), https://www.law.com/almID/1202742910720/ [perma.cc/H767-C87F].

198. *See supra* note 100 and accompanying text (describing how adjustments to fair carrying values of financial assets flow to the income statement).

199. The size of the antitrust portfolio is taken from the "available for sale debt securities" (A4SDS) entries from Juridica's financial statements. The A4SDS entry consists exclusively of the loan to Fields Law, which went to fund the antitrust litigation. *See* Juridica 2015 Annual Report, *supra* note 189, at 5–6 (referring to the company's "single antitrust and competition investment" and noting that the downward fair value adjustment for that year "consist[ed] exclusively of our antitrust and competition portfolio").

200. *See* Juridica Investments, Ltd., Annual Report & Accounts 2011, at 22 (2012).

201. *Id.* at 10.

202. *See* Juridica Investments, Ltd., Annual Report & Accounts 2012, at 13 (2013).

203. *Id.* at 13.

years as a public company were attributable entirely to upward fair value marks on its antitrust portfolio.

Presumably, to prevent privilege waiver, Juridica meticulously avoided disclosing which precise assets were responsible for what proportions of its aggregate fair-value adjustments. Nevertheless, we can obtain a rough idea of the role that Case 8008-L and the antitrust portfolio played in the upward marks during the 2011-2012 period. For instance, we know that the upward marks related to the antitrust portfolio were handled by Fields Law.[204] We also know that Case 8008-L comprised an outsize share of the economic value of that portfolio. It was responsible for $26.0 million[205] of the initial $62.0 million that Juridica invested in the portfolio.[206] It also resulted in an outsize share of the total realized gains associated with that portfolio.[207]

For perspective, that means the investment had been quite successful for Juridica: an initial investment of $26 million in late 2008 had, by 2015, resulted in nearly $90 million of actual proceeds, representing a nearly 350 percent return on invested capital. The financial statements reflected this favorable asset performance chiefly in a series of upward fair value marks in 2011 and 2012.[208] Those upward marks would flow initially to the income statement as *recognized*, but *unrealized*, income. Shortly thereafter, as defendants settled (presumably motivated by the same favorable claim developments justifying the upward marks), the unrealized income would result in *realized* gains when the settlements were agreed. As an accounting matter, the settlements were simply balance sheet phenomena unlinked to the income statement; when Juridica received cash proceeds from settlements, it would simply debit the asset's carrying value and credit its cash or receivables account. The net impression an investor would receive from this is an emerging and increasingly reliable process of anticipatory revenue recognition followed by a corresponding economic realization in cash terms. That is, until it stopped working like that.

By early 2014, adverse developments in case 8008-L started to belie Juridica's rosy expectations for the case and the continued reliability of

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204. *See* Juridica 2015 Annual Report, *supra* note 189, at 6.

205. Press Release, Juridica Investments, Ltd., Significant New Investment and Trading Update (Nov. 14, 2008) (on file with author).

206. Juridica Investments, Ltd., Half Yearly Report and Unaudited Condensed Financial Statements for the period from 1 January 2015 to 30 June 2015, at 5 (2015) [hereinafter Juridica 2015 Half Yearly Report].

207. *Id.* at 3; Juridica 2015 Annual Report, *supra* note 189, at 5 (reporting that Case 8008-L had delivered $89.7 million in gross settlement returns prior to its write-off). From 2010 to 2015, Juridica realized just over $100 million in *total* proceeds attributable to its antitrust portfolio.

208. *See supra* text accompanying notes 199–203.

its marks. In April 2014, the company noted that the trial court issued an unfavorable ruling concerning damages but reassured investors that the lawyers working the case had "advised that the adverse ruling is expected to be partially or wholly overturned in [favor] of the Plaintiff . . . ."[209] However, to preserve privilege, it provided no disclosure about the lawyers' rationale. Accordingly, Juridica did not mark the asset down; in fact, its net fair value adjustment for its antitrust portfolio was positive for 2013, checking in at $3.7 million. The following year, the company revealed the case prospects had deteriorated further, with the appellate court affirming the adverse trial court ruling.[210] The case finally fizzled out in June 2015 when the Supreme Court declined to review the case.[211]

When Juridica filed its 2015 semi-annual report in August, it announced that it was writing off the entire remaining 8008-L asset, resulting in a $29.7 million downward fair value adjustment for this asset alone.[212] This downward mark flowed directly to the income statement as an operating loss. That amount represented 20 percent of the company's *entire balance sheet* ($150.1 million at the end of 2014) and 36 percent of its main segment—antitrust, at $82.6 million at the end of the previous year.[213] Juridica swung from a loss of $5 million in 2014 to a $49.2 million loss in 2015.[214] Following a sixty percent decline in its share price during 2015 and pressure from shareholders, the board of directors opted to cease new investments and the business entered runoff,[215] finally liquidating in 2018.[216]

Table 2 below shows the net fair value marks to Juridica's antitrust portfolio in relation to various other metrics for the 2010-2015 years.

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209. Juridica Investments, Ltd., Annual Report 2013, at 10 (2014) [hereinafter Juridica 2013 Annual Report].

210. Juridica Investments, Ltd., Annual Report 2014, at 10 (2015) [hereinafter Juridica 2014 Annual Report].

211. *See* Juridica 2015 Half Yearly Report, *supra* note 206, at 5.

212. *See id.* at 3.

213. *See* Juridica 2014 Annual Report, *supra* note 210, at 7 ("The fair value of the Company's investments at 31 December 2014 was US$150.1 million."); *see* Juridica 2015 Half Yearly Report, *supra* note 206, at 34 (registering $82.6 million of "debt securities"); *see supra* note 199 (explaining that Juridica's "debt securities" consisted exclusively of their antitrust assets).

214. *See* Juridica 2014 Annual Report, *supra* note 210, at 18 ($5 million loss in FY 2014); Juridica 2015 Annual Report, *supra* note 189, at 14 (loss of $49.2 loss in FY 2015).

215. *See* Triedman, *supra* note 197; Michelle McGagh, *Struggling Establishment and Juridica Reach End of the Road*, CITYWIRE AMERICAS (Nov. 23, 2018), https://citywire.com/investment-trust-insider/news/struggling-establishment-and-juridica-reach-end-of-the-road/a1178650 [https://perma.cc/S3X3-GHR9].

216. *See* Regulatory News Service, *Juridica Investments, Ltd.: Winding up, Delisting & Notice of General Meeting*, FIN. TIMES (Nov. 22, 2018), https://markets.ft.com/data/announce/detail?dockey=1323-13876314-1UIRELOSQSKO8S67GJSFPOSTS0 [https://perma.cc/3B32-BH76].

Specifically, the table also shows, for each period, (1) the net fair value adjustment to the antitrust portfolio, (2) the total carrying value for the antitrust portfolio, (3) total assets, and (4) comprehensive income. The fair-value adjustments to the antitrust portfolio do not affect the portfolio's carrying value on a one-to-one basis. This is chiefly because the carrying value is also impacted by the resolution of cases by settlements or legal judgments (which *reduce* the carrying values as assets are transformed to receivables and cash) and additional investments in the portfolio (which *increase* carrying values as cash is invested in the assets). Nevertheless, these data demonstrate a pronounced correlation between the company's fair value marks on the one hand and its assets and, even more importantly, its income on the other.

TABLE 2: SELECT JURIDICA FINANCIALS 2010-2015

Year	Net FV Adjustment to Antitrust Assets	Total Carrying Value of Antitrust Assets	Total Invested Assets	Comprehensive Income
2010	(2.0)	95.1	198.8	(9.0)
2011	49.7	145.4	235.7	37.8
2012	40.0	153.6	255.8	35.6
2013	3.7	129.3	249.5	5.1
2014	(1.4)	82.5	235.3	(5.0)
2015	(35.2)	55.4	126.4	(49.2)

In its first public report disclosing the total write-off of Case 8008-L, the company wistfully recalled its halcyon hopes from just a few years earlier: "Had the case survived the challenges it faced, we believed the case would have generated cash proceeds to the Company far in excess of its US$29.7 million contribution to the Company's year-end 2014 [balance sheet]."[217] "If the case had actually gone to trial and prevailed," the report continued, "damages could have exceeded US$500 million and would have automatically been trebled."[218]

Until the end, Juridica management clung to hopes for that potential billion-dollar recovery that had tantalized them from the time they issued the press release announcing the initial investment.[219]

217. Juridica 2015 Half Yearly Report, *supra* note 206, at 5.

218. *Id.* at 5.

219. *See supra* text accompanying note 194.

The brute facts of Juridica's abrupt cessation of business and liquidation testify to the reality of investor losses. But, of course, losses are inevitable in the capital markets. The legacy of the Juridica failure and the legal-regulatory lessons to be drawn from it are more ambiguous.

Three preliminary points should be made to clarify matters. First, the use of Juridica here as a case study does not mean that company management or the auditors were engaged in fraud or even negligence.[220] Fair value marks of Level 3 assets are only as good as the models and predictions of the reporting entities, and problems can present even absent misconduct. Hence, the Juridica episode sheds light on the potential for misleading fair value accounting in the litigation finance context *in general*, whether on account of strategic manipulation and fraud, or as a result of a good faith effort to assess the fair value of these opaque assets accurately.

Second, one of the proximate causes of Juridica's failure was excessive portfolio concentration. To its credit, Juridica consistently warned of the significant concentration risk it posed. Each of its annual reports included some version of the following warning: "The main concentration to which the Company is exposed arises from the Company's loan to Fields Law"—that is, the law firm debtor litigating the antitrust portfolio.[221] In the five years leading up to the 2015 write-off of Case 8008-L, the antitrust portfolio's carrying value, which was already highly concentrated,[222] ranged from 54 percent to 76 percent of Juridica's total investments.[223] Following the write-off, Juridica disclosed that a *single* case in the portfolio comprised a whopping 43 percent of its total invested assets.[224]

Third, Juridica failed because its investments did not pan out, not on account of the way they were reported. In other words, alongside portfolio concentration, the second proximate cause of the failure was unfavorable investment selection. The starkest illustration of this is

220. Upon a shareholder's request, the Institute of Chartered Accountants in England and Wales (ICAEW), the chartering trade association for British accountants, opened an investigation into Juridica's accounts. *See* Peter Evans, *PwC Probed over Failed Funder of Court Claims*, THE SUNDAY TIMES, Oct. 7, 2018 (Business and Money), at 1. However, that investigation appears to have run its course without any finding of wrongdoing.

221. Juridica 2015 Annual Report, *supra* note 189, at 31; *see also supra* text accompanying notes 195–196 (explaining the role of Fields Law).

222. Throughout this relevant period, the antitrust portfolio consisted of the same six cases.

223. These figures are derived by comparing the "available for sale debt securities" entry in the notes to the financial statements (representing the antitrust portfolio) to the total non-current assets (representing the aggregate carrying value of *all* litigation finance investments) for each of the five years.

224. *See* Juridica 2015 Annual Report, *supra* note 189, at 7 (reporting the case at a carrying value of over $40.0 million relative to a total carrying value of all investments of $92.8 million).

Case 8008-L itself: if the courts had accepted the plaintiffs' damage theory that Juridica had invested in, Juridica's hopes of a billion-dollar recovery would have been in the realm of possibility. In combination with the portfolio concentration, the denial of certiorari on the damages issue was a sufficient cause of the investors' losses.

Nevertheless, even if we assume the lack of any fraudulent activity on the part of Juridica's management and leave aside the special issues attending concentrated portfolios, the Juridica failure should be seen a cautionary tale to investors about fair value accounting by publicly traded LFCs. By adopting fair value accounting treatment, Juridica assumed the burden of periodically valuing its assets based on its own predictions concerning the behavior of judges, juries, and adversaries, as well as other factors that impact asset valuation models, such as interest rates and risk premiums.

It must be acknowledged that Juridica's internal valuation models performed reasonably well at reflecting the emerging economic realities of its business. Indeed, the Juridica episode seems like an example of fair value accounting done roughly right. The company failed when the largest asset on its highly concentrated balance sheet had to be unexpectedly written off. More than anything else, it is a story about the dangers of portfolio concentration, as well as some combination of bad investment selection and bad luck. However, the episode does provide a window into potential fair value accounting problems in the LFC context.

Juridica initially touted Case 8008-L as a potential billion-dollar asset. It had already produced $90 million in realized settlements and was being carried on the balance sheet at $29.7 million, even after the adverse trial court ruling was upheld on appeal. Recall that following the initial adverse damage ruling, Juridica assured investors that "the adverse ruling is expected to be partially or wholly overturned in [favor] of the Plaintiff."[225] After the plaintiff lost its appeal and filed its writ of certiorari, Juridica changed its tone: "Uncertainty remains as to whether the requested review by the United States Supreme Court will be accepted."[226] However, it still did not materially change the carrying value of the asset.[227]

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225. *See* Juridica 2013 Annual Report, *supra* note 209, at 10; *see supra* text accompanying note 209.

226. Juridica 2014 Annual Report, *supra* note 210, at 10.

227. Only Juridica and its auditors know the precise marks of specific assets, but given the size of 8008-L, the de minimis aggregate 2014 portfolio mark (a decline of $1.4 million), and the lack of any narrative disclosure of significant development in other portfolio assets, this seems to be a safe assumption.

This failure to adjust the carrying value downward significantly is the most contestable discretionary decision concerning 8008-L on Juridica's part. Following the 2014 appellate court ruling, it is difficult to imagine that some partial or total write-down was not appropriate. Such a write-down would have smoothed the otherwise abrupt deterioration from the 2014 loss of $5 million to the 2015 loss of $49 million (as reflected in Table 2). This discretionary call can serve as an entry point to explore the potential dangers with discretionary Level 3 fair value marks. We can imagine how Juridica, by adopting even more aggressive marks, could have delayed the recognition of the emergent problems or increased investor losses.

It is important to note that investors remained credulous of Juridica's marks of the antitrust portfolio throughout the relevant events. In fact, the stock exhibited very little volatility at all during 2013 and 2014, the period during which the relevant case developments took place. This invites us to consider whether investors would also have been credulous of marks that were inflated through more aggressive modeling, whether done fraudulently or simply foolishly. Lacking access to relevant case-specific information, an investor would have no principled way to maintain an objective basis from which to exercise skepticism concerning the marks.

Imagine that instead of carrying the 8008-L asset at $29.7 million during early 2015, Juridica had maintained a more optimistic mark, consistent with its initial hopes for the billion-dollar recovery. Consistent with its valuation process detailed in its public disclosure, Juridica could have developed (relatively more optimistic) scenarios and/or assigned them (relatively more optimistic) probabilities before churning them through their confidential simulation model.[228] It is easy to imagine the company landing on a valuation of, say, $129.7 million instead of $29.7 million. Given the restrictions on disclosure imposed by the privilege and work product rules, investors would have little reason to question the inflated fair value marks. In the process, investors could have easily lost another $100 million. Crucially, acknowledging as much requires us to confront this possible loss not only as a narrowly avoided hypothetical, but also as a plausible possibility that casts a shadow over LFC capital markets today.

228. *See supra* text accompanying notes 189–193 (describing Juridica's valuation model).

B. *Undermining the Market Integrity Objective: The Case of the Muddy Waters Case Short Attack*

The Muddy Waters short attack on Burford demonstrates how market perceptions of opaque accounts can incentivize manipulative strategies that create costly firm-specific and market-wide effects. Muddy Waters, helmed by its founder Carson Block, is a short-only hedge fund. Its business model is to identify overvalued publicly traded securities and to sell them short. Since its founding in 2016, it has achieved an impressive record of success, yielding a 19 percent annualized return for its investors after fees.[229] Its returns are all the more impressive in light of the record bull run among global equity markets during which one might expect that it would be difficult to build a business betting that stock prices will go down.[230]

The hedge fund capitalizes on the fit between its organizational principles and the prevailing internet-skeptical zeitgeist.[231] Muddy Waters is, if nothing else, skeptical of authority and received wisdom; Block claims his experience working in China taught him to "see the matrix" at play in official-sounding explanatory-speak, and to "question everything."[232] Block also positions himself as a free speech maverick, a truth-teller in a profession where inertia and sycophancy usually prevail.[233]

In August of 2019, Block and Muddy Waters declared war on Burford.[234] "We are short BUR," began the fund's 25-page missive against

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229. *See* Michelle Celarier, *In Tough Year for Short Sellers, Muddy Waters Pulls Off Big Gains*, INST'L INV. (Jan. 7, 2021), https://www.institutionalinvestor.com/article/b1q0svr5gm2kl3/In-Tough-Year-for-Short-Sellers-Muddy-Waters-Pulls-Off-Big-Gains [https://perma.cc/2WXE-2EHB].

230. *See* David Brenchley, *The Cautious Bets That May Be Riskier Than You Think*, THE SUNDAY TIMES, July 25, 2021, at 11 (describing the "record-breaking 12-year bull market").

231. *See, e.g.*, Nathan Ballantyne & David Dunning, *Skeptics Say, 'Do Your Own Research.' It's Not That Simple*, N.Y. TIMES (Jan. 3, 2022), https://www.nytimes.com/2022/01/03/opinion/dyor-do-your-own-research.html (discussing proliferation of "do your own research" meme).

232. Laurence Fletcher, *Carson Block, the Short-Seller Taking Aim in the UK Market*, FIN. TIMES (Aug. 9, 2019), https://www.ft.com/content/06d43352-bab3-11e9-8a88-aa6628ac896c (quoting Block).

233. *See* Trista Kelly, *The Inside Story of How Short Seller Carson Block Made a Killing This Year, Even as the Market Made Life Miserable for Many Investors*, BUS. INSIDER: INDIA (Dec. 14, 2018, 14:48 IST), https://www.businessinsider.in/the-inside-story-of-how-short-seller-carson-block-made-a-killing-this-year-even-as-the-market-made-life-miserable-for-many-investors/articleshow/67090846.cms [https://perma.cc/6X2Y-4FDA] (quoting Block as observing that "in Europe there just isn't the protection of free speech that we have here in the US, [which] presents issues when your business model is speaking truth to power").

234. The opening salvo took the form of a tweet on August 6. Muddy Waters followed the tweet with its fulsome report the following day. *See Burford Alleges Manipulation of Shares Around Muddy Waters Attack*, REUTERS (Aug. 12, 2019, 2:23 AM), https://www.reuters.com/article/burford-muddy waters/burford-alleges-manipulation-of-shares-ahead-of-muddy-waters-attack-idUKFWN2580BB [https://perma.cc/2YVA-PZLC]; Burford Cap. Ltd. v. London Stock Exch. plc [2020] EWHC 1183 (Comm) [9]-[13] (Eng.).

the litigation finance pioneer.[235] The thesis of the report, acerbic even for salty-tongued short-seller literature, is that Burford's "Enron-esque mark-to-model accounting" has turned the company into "the biggest stock promotion on the AIM."[236] While the report sets forth a scattershot list of purported corporate governance failures, Block's argument is simple: Burford management has elected to mark its Level 3 assets to model, and it has done so in order to strategically profit by exercising its discretion to adopt overly optimistic marks that inflate earnings—and the value of their stock.[237]

The report continues to describe Burford's accounts in the following terms:

> [Burford] is a perfect storm for an accounting fiasco. It is a fund that invests in an illiquid and esoteric asset class, which few investors can understand well. By remaining listed on AIM despite being a midcap company, the company's disclosure requirements are lighter than they would be for the main board—and far lighter than they should be. By choosing to account for its litigation investments as financial assets, [Burford] utilizes fair value accounting for a balance sheet largely comprised of Level 3 fair value assets (i.e., "mark to model" accounting of Enron fame). [Burford] disingenuously blames IFRS for needing to take (outsized) fair value gains when in fact, it was BUR's choice to adopt this accounting.

The publication of the Muddy Waters report on its own erased *half* of Burford's market capitalization (roughly $2 billion) in a single day.[238] The following day saw further bloodletting, with the stock dipping 72 percent below its pre-report levels.[239] On the day of the report, Burford's bonds also cratered, losing 29 pence to a record-low of 61 pence—i.e., at 61 percent of their principal value.[240] The panic and uncertainty gripped both retail and institutional investors; GAM, the Swiss asset manager

235. Muddy Waters Burford Report, *supra* note 9, at 2.

236. *Id.* For a description of the "AIM" market, see *supra* note 54 and accompanying text.

237. *See* Muddy Waters Burford Report, *supra* note 9, at 2–5.

238. *See supra* note 10.

239. *See* Fletcher, *supra* note 232; Burford Cap. Ltd. v. London Stock Exch. plc [2020] EWHC 1183 (Comm) [1]-[7] (Eng.).

240. *See* Lisa Pham, *Muddy Waters Short Wipes $2 Billion Off Burford Market Value*, BLOOMBERG NEWS (Aug. 7, 2019), https://news.bloomberglaw.com/us-law-week/muddy-waters-short-wipes-2-billion-off-burford-market-value-3 [https://perma.cc/7HCZ-APWQ].

and then Burford's largest bondholder, *liquidated its entire position* in response to the report.[241]

When Moody's assigned the first-ever credit rating to Burford a few months after the short attack, it rated the company at Ba3, the lowest rating classification in Moody's category for "non-investment grade" and "speculative" credit investments, just a step above the "highly speculative" category.[242] When explaining its rationale, Moody's cited the familiar fair value accounting opacity that Muddy Waters highlighted:

> Burford's Ba3 ratings also consider the credit challenges associated with the esoteric and illiquid nature of the company's litigation investments, which have indeterminate realization in terms of both timing and amount, contributing to high expected asset and earnings volatility. About half of the company's income consists of unrealized gains, which also contributes to volatility and weakens earnings quality.[243]

While there is, of course, no way to directly link Moody's rating decisions to the Muddy Waters short attack, these two roughly contemporaneous developments should be seen as joint evidence of an increasingly skeptical mood settling in among capital markets participants regarding fair value accounting at Burford.

In response, Burford defended the integrity of its accounts and impugned Muddy Waters's motives.[244] On this latter point, it claimed that Muddy Waters had already closed out its short position within a few days of publishing the report, booking a healthy gain flowing directly from the stock's precipitous—and, in Burford's estimation, artificially induced—decline.[245] It also scrambled to make various corporate gov-

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241. *See* Robert Smith, *Retail Investors Aren't Alone in Struggling to Value Burford's Assets*, FIN. TIMES, Aug. 13, 2019 (noting that prior to its sale, GAM held £80 million of a total of £365 million in Burford's U.K. Sterling-denominated debt).

242. *See* Press Release, Moody's Invs. Serv., Moody's Assigns First-Time Ba3 Corporate Family Rating to Burford Capital Limited; Outlook Is Positive (Oct. 30, 2019), https://www.moodys.com/research/Moodys-assigns-first-time-Ba3-corporate-family-rating-to-Burford—PR_412507 [https://perma.cc/J3QF-YFX7] [hereinafter Moody's 2019 Burford Rating Report]. In March of 2021, Moody's upgraded Burford from Ba3 to Ba2. *See* Press Release, Moody's Invs. Serv., Moody's upgrades Burford Capital's long-term senior unsecured rating to Ba2 from Ba3; outlook is stable (Mar. 25, 2021), https://www.moodys.com/research/Moodys-upgrades-Burford-Capitals-long-term-senior-unsecured-rating-to—PR_443204 [https://perma.cc/64W8-79T2].

243. Moody's 2019 Burford Rating Report, *supra* note 242.

244. Burford executives appeared in financial television programs, and the company published a lengthy rebuttal the day after the Muddy Water's report. *See* Press Release, Burford Capital, Ltd., Response to Short Attack (Aug. 8, 2019) (on file with author) [hereinafter Burford Response to Short Attack].

245. *See id.*

ernance changes. Burford replaced its Chief Financial Officer (who was married to the then- and current CEO Christopher Bogart),[246] doubled down on planned executive stock purchases,[247] and deepened the level of disclosure about its fair value accounting practices.[248]

In its lengthy press release published on August 8, Burford chastised Muddy Waters for engaging in market manipulation:

> Short attacks such as this are a fundamental menace to an orderly market and to the value inherent in long-term investing companies such as Burford that are revolutionising industries. Burford is well-equipped to investigate and pursue market manipulators, and as stewards of investor capital, we are exploring doing so here, cognisant of the substantial losses our investors have suffered. Our early investigation already shows the hallmarks of market manipulation.

Of course, even if we credit Burford's description of its revolutionary role, not all vanguard companies report earnings on a fair value basis, and therein lies the rub. Something about LFCs and their accounts makes them especially susceptible to short attacks.

A key weapon in Burford's defense was its argument that Muddy Waters had engaged in so-called "spoofing" and "layering"—that is, creating and canceling a large volume of limit orders that distorted the supply and demand for a security.[249] It asked the London Stock Exchange (LSE), which operates the AIM market on which Burford stock trades, to investigate the matter and provide confidential trading data that would identify the investors responsible for the order flow at the time of the Muddy Waters report.[250] After LSE ceased its investigation and refused to turn over the trading data, Burford sued LSE in the Commercial Court division of the High Court of Justice of England and Wales, seeking a court order compelling the disclosure.[251] It made a

246. *See* Kate Beioley & Robert Smith, *Burford Tries to Calm Storm by Replacing CEO's Wife as Finance Chief*, FIN. TIMES (Aug. 15, 2019), https://www.ft.com/content/ce24cee4-bf6d-11e9-89e2-41e555e96722 [https://perma.cc/8VU9-A82E].

247. *See* Burford Response to Short Attack, *supra* note 244, at 1.

248. Among other things, Burford began disclosing the percentage of its realized gains that had been previously recognized as fair value gains. *See supra* text accompanying note 145.

249. *See, e.g.*, 7 U.S.C. § 6c(a)(5) (2018) (defining spoofing as "bidding or offering with the intent to cancel the bid or offer before execution").

250. *See* Jonathan Browning, *FCA Found No Market Abuse in Burford Fight with Muddy Waters*, BLOOMBERG L. (Apr. 1, 2020), https://news.bloomberglaw.com/securities-law/fca-found-no-market-abuse-in-burford-fight-with-muddy-waters-1 [https://perma.cc/WG4E-Z23D].

251. *See* Ben Rigby, *Burford Capital Loses Fight to Force London Stock Exchange to Hand over Confidential Trading Data*, GLOBAL LEGAL POST (May 15, 2020), https://www.globallegalpost.com/news

similar inquiry with the Financial Conduct Authority (FCA), the primary U.K. capital markets regulator.[252] These efforts were ultimately unsuccessful, as the FCA informed the company it found no evidence of market manipulation.[253] The court denied the petition to compel LSE to disclose the trading data.[254]

In the end, whether to credit Block's accusations of accounting fraud or Burford's market manipulation story is a question that the company's future operating history will resolve. Over the next decade or so, as a half dozen or so of its asset vintages mature and it develops a more established track record, one of these opposing narratives will be vindicated.

However, it is not necessary to resolve this matter to appreciate the disclosure problems that a conflict like the one between Muddy Waters and Burford presents. Whether or not Muddy Waters is engaged in an opportunistic and manipulative scheme, a short attack of this sort is only possible because the target company is using fair value methods to account for opaque Level 3 assets. More fundamentally, it is not only possible, but it is an omnipresent threat for these companies, particularly when they lack an extensive operating history that ratifies their accounting policies. The crucial point is that the publicly traded LFC will face great difficulty explaining their fair value marks at any given time, given existing privilege waiver rules. As a result, it will have a hand tied behind its back when would-be market manipulators attack it. It should also be pointed out that the threat applies on the upside and the downside. While the Muddy Waters attack, involved a short-only fund talking down a stock, it is possible for manipulation to occur on the upside too, which can also disrupt the normal course of corporate governance, albeit in different ways.[255]

/burford-capital-loses-fight-to-force-london-stock-exchange-to-hand-over-confidential-trading-data-20041883 [https://perma.cc/ZUQ6-V59F].].

252. *See* Browning, *supra* note 250.

253. *See id*.

254. *See* Burford Capital v. London Stock Exch. plc [2020] EWHC 1183 (Comm) [1]-[7], [216]-[218] (Eng.).

255. The recent "meme stock" phenomenon has heightened attention to the possibility of market manipulation on the upside, even with companies whose accounts cannot be described as particularly opaque. *See* Dave Michaels, *GameStop Mania Is Focus of Federal Probes Into Possible Manipulation*, WALL ST. J. (Feb. 11, 2021), https://www.wsj.com/articles/gamestop-mania-is-focus-of-federal-probes-into-possible-manipulation-11613066950 [https://perma.cc/J5PM-57DF] (reporting that meteoric meme-fueled stock price rise in stocks such as GameStop Corp. was being investigated by federal prosecutors for evidence of market manipulation fraud); *see* Faith Stevelman & Sarah C. Haan, *Corporate Governance After GameStop*, PROJECT SYNDICATE (Feb. 1, 2021) https://www.project-syndicate.org/commentary/gamestop-effect-on-corporate-governance-by-faith-stevelman-and-sarah-c-haan-2021-02 [https://perma.cc/R634-QJT6] (discussing corporate governance implications of meme stock phenomenon).

For so long as it is possible to evaporate half of a company's market capitalization in a single day simply by running to the rumor mill, the LFC industry will face higher volatility, higher trading costs, higher capital costs, lower security prices, and even decreased capital investment.[256] Furthermore, this dynamic also undercuts the investor protection objective of securities regulation, since part of the resultant volatility—that relating directly to stock movements—creates a systematic set of winners (the manipulators) and a systematic set of losers (everyone else).

VII. POSSIBLE REFORMS

As more LFCs consider listing their shares to expand in this growing sector, the special problems that publicly traded LFCs pose will only acquire greater salience. This concluding Part will propose several reforms that might help redress these problems, drawing attention to their respective advantages and disadvantages. As securities regulators and accounting standard setters acknowledge the problem and consider reform proposals, the following materials can serve as a rough checklist for possible reforms. A checklist, but not a blueprint; it is unlikely that adopting all of these proposals is possible, or even desirable. Still, adopting a limited combination, or even an isolated single proposal, will go some way to remediate the problems examined here.

Four of these proposals are more promising than the others: (1) mandatory direct involvement of external claims valuers in the production and verification of fair value marks; (2) greater deployment of claims valuation expertise in the context of the audit (either external or in-house audit expertise); (3) mandatory disclosure of portfolio-wide sensitivity analysis of the fair valuation marks; and (4) mandatory disclosure of details concerning material litigation assets with accompanying changes to the privilege waiver rules. The first three of these are not only promising, they are also highly feasible; efforts to implement the fourth proposal should expect greater headwinds. Two other reform ideas—promoting markets for litigation assets and requiring independent valuation committees for publicly traded LFC boards—are less promising, but still worthwhile projects to consider. This Part will begin with these latter two proposals and then move to discuss the four more promising initiatives.

256. *See supra* text accompanying note 87.

A. *Promoting the Development of Markets for Litigation Assets*

The problems associated with valuing Level 3 assets result from what has repeatedly been referred to here as the *intrinsic, structural opacity* of the assets. This situation could also be described as a high degree of uncertainty clouding the fit between the reported value and the asset's intrinsic value. Resort to mark-to-model fair value accounting is, as the IASB has stressed, an imperfect but workable way to intelligibly bridge the gap between these two values. Indeed, under IFRS and GAAP "fair value hierarchies," recourse to internal models is only permissible if there are neither quoted prices for the asset nor direct or indirect observable data concerning the asset's price.[257]

One way to improve the accuracy and reliability of the reported asset values is to bump them up the fair value hierarchy by developing markets that generate quoted prices or other observable inputs. Others have argued in favor of developing markets for claims to pursue other goals, such as improving settlement outcomes,[258] increasing access to justice,[259] or legal risk management.[260] The goal here, however, would be to generate more reliable informational inputs to use in the fair value process. One of the main benefits of decentralized capital markets, in contrast to bank credit or state finance, is the phenomenon of price discovery. Price discovery refers to the "efficient and timely incorporation of the information implicit in investor trading into market prices."[261] Price discovery is the process by which market efficiency can be, such as it is present in any market, achieved. And efficient markets, in turn, facilitate efficient capital formation. Indeed, the suboptimal efficiency of the LFC capital market is half of the policy problem with which this Article is concerned.[262]

Burford's efforts to stimulate a market for its YPF-related assets are instructive. As noted earlier,[263] Burford has sold a portion of its YPF-related assets to third-party investors for a total of $144 million. For

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257. *See supra* text accompanying notes 102-106 (describing the fair value hierarchy).

258. *See* Molot, *supra* note 1, at 82–101.

259. *See* Steinitz, *Incorporating Legal Claims*, *supra* note 2, at 1161.

260. *See* Molot, *supra* note 43, at 367.

261. Bruce N. Lehmann, *Some Desiderata for the Measurement of Price Discovery Across Markets*, 5 J. FIN. MKTS. 259, 259 (2002); *see also* Stanislav Dolgopolov, *The Doctrinal Quandary of Manipulative Practices in Securities Markets: Artificial Pricing, Price Discovery, and Liquidity Provision*, 45 J. CORP. L. 1, 5 (2019).

262. *See* Lehmann, *supra* note 261, at 268; *supra* Part III (describing the importance of preventing market manipulation in terms of efficient capital formation).

263. *See supra* note 146-148 and accompanying text (introducing Burford's YPF portfolio).

these assets, the company takes those sales prices into consideration for valuation purposes:

> In a small number of instances, the Group has the benefit of a secondary sale of a portion of an asset. When that occurs, the market evidence is factored into the valuation process; results on portfolios with multiple fair value factors are presented based on whether the portfolios are in an overall positive or negative fair value position. The more robust the market testing of value is, the more weight that is accorded to the market price.[264]

Given these transactions' relative paucity and infrequency, Burford's characterization of these transactions as "market evidence" adopts a liberal sense of the term. Even with that "market evidence," however, Burford still treats the assets as Level 3 assets; in other words, the market evidence is taken into account not as observable inputs, much less quoted asset prices, but as unobservable inputs under IFRS rules.

Although, in principle, this is a constructive response to the disclosure problems, marketizing a sufficient portion of litigation finance assets to generate meaningful inputs to use in fair value calibrations is unlikely to prove effective, at least anytime soon. Before purchasing a litigation finance asset, capital markets investors will expect to review the relevant information. Concerns over confidentiality, and the possible waiver of privilege and work product protections, impose strict limits on the practical ability of this information to flow freely between the claim holder and the investor. Burford's YPF assets remain a special case because most of the details concerning the case are already public.[265]

Burford's use of market-like data in asset valuation models is only an initial step in commodifying and marketizing legal claims. More aspirational proposals advocate for the large-scale securitization of commercial legal claims.[266] That is, a claimant would form a special purpose entity, capitalize it by contributing one or more lawsuits, and arrange for the SPE to issue securities that derived their value from the underlying litigation.[267] These securitized lawsuits could then be publicly traded. The capital market for litigation finance would bifurcate, with pri-

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264. Burford 2020 Annual Report, *supra* note 34, at 118.

265. *See* HARDMAN & CO., BURFORD CAPITAL: STRONG EVIDENCE THAT VALUE IS FAIR 4 (2019), https://www.hardmanandco.com/wp-content/uploads/2019/10/Burford-Capital-Strong-evidence-that-fair-value-is-fair-17.10.19.pdf [https://perma.cc/HGU7-3NSP].

266. *See generally* Steinitz, *Incorporating Legal Claims*, *supra* note 2.

267. *See id.* at 1162.

mary and secondary markets for *direct* claims existing alongside the publicly traded LFC market in which investors could gain *indirect* exposure to the asset class. The direct market would possess several advantages as a coordinating and signaling mechanism—for instance, clearing of supply and demand based on the collective, inter-subjective information set of a decentralized group of agents. We might imagine publicly traded LFCs looking to this market to form reasonable expectations concerning the riskiness and future cash flows of their own assets and portfolios. This comparative inquiry would formally take place in the context of an improved Level 3 asset valuation process or even a step up the fair value hierarchy to a Level 2 process.[268]

However, this type of direct secondary market in securitized litigation assets would also be frustrated by the familiar privilege waiver and work product problems. As Professor Maya Steinitz explains as a matter of financial history and corporate law, there is nothing particularly exotic about securitizing a lawsuit.[269] However, whether maintaining a public market in that lawsuit communicates any meaningful information to the owners of similar lawsuits is another matter altogether. For instance, if Burford was seeking to value an asset deriving from Lawsuit A, how would it even know that Lawsuit B, which was securitized and publicly traded, was sufficiently similar to Lawsuit A to make it an acceptable proxy observable input under IFRS 13? The SPE could not disclose any relevant details concerning Lawsuit B to its security holders without waiving privilege.

Capital markets perform their signaling function by aggregating a multiplicity of opinions and expectations concerning the relevant inputs impacting an asset's valuation, and clearing at a single, individual price. The problem is that an aggregate of investors, lacking any relevant information concerning the underlying merits of the litigation asset on account of the confidentiality restrictions, would not have any intelligible basis on which to formulate such opinions and expectations concerning a particular asset. This epistemic gap (between what an investor would like to know and what an investor can practically expect to know) is particularly pronounced in the early stages of litigation, narrowing later on as information about the matter is made publicly available.[270]

268. *See supra* text accompanying note 105 (noting that Level 2 inputs consist of, among other things, quoted prices for similar assets in active markets).

269. *See* Steinitz, *Incorporating Legal Claims*, *supra* note 2, at 1171–91.

270. *See id.* at 1183 (chronicling the "wildly overstated" initial market valuation of a lawsuit that was partially securitized in order to value a claim in the context of negotiations concerning the appropriate pricing of a bank holding company acquisition).

Pooling individual assets into tradable portfolios would diversify away much of the idiosyncratic risk of particular assets, such that the market price might be thought to express aggregate expectations concerning the development of particular types of litigation assets (e.g., patent claims). However, even crediting this possibility, the market prices of the tradable portfolios would lack any clear advantage as a fair value input over the subjective internal models that LFCs currently use. While they might contribute an incremental informational input about market perceptions concerning the asset class, the internal models would still possess the important advantage of being able to incorporate information actually relevant to the claim.

In conclusion, marketization is unlikely to solve the disclosure problems on its own. Burford's efforts to develop secondary markets for specific assets is handicapped by the incompleteness of the "market," such as that term can even be credibly employed. Further, marketization through the development of publicly traded, securitized litigation assets face the same privilege waiver issues that any involvement of public investors in a capital market for litigation risk inevitably entails.

B. *Requiring an Independent Valuation Committee for Publicly Traded LFCs*

An independent committee of the board of directors with the primary responsibility for approving fair valuation practices and fair value marks might also contribute positively to the perception of reliability of LFC fair value marks. Such a strategy would focus *internally* on modifying the publicly traded LFC's corporate governance infrastructure. Securities regulators could require the establishment of such a committee as a precondition to listing on an exchange. The independence requirement would be met in the typical securities law fashion: that is, by restricting membership to the members of the board who are otherwise unaffiliated with the company.[271] In this way, the valuation committee would resemble the independent audit committee.[272] It would amount to an independent corporate organ with specialized oversight—in this

271. The independence requirement in the context of U.S. public company audit committees illustrates this approach. *See* 15 U.S.C. § 78j1(m)(3)(A)-(B) (requiring independence of members of audit committee, with independent status determined by the non-payment of "consulting, advisory, or other compensatory fees" and absence of any affiliation with issuer or its subsidiaries); Standards Relating to Listed Company Audit Committees, Release No. 34-47654, 68 Fed. Reg. 18,788, 18,790-96 (Apr. 9, 2003) (clarifying non-affiliation requirement).

272. *See supra* note 271; Directive No. 2014/56/EU, art. 1, para. 32, 2014 O.J. (L 158) 221 ("A majority of the members of the audit committee [of most public companies within the European Union] shall be independent of the audited entity.").

case, over the fair value accounting function.[273] If securities regulators also require some third-party valuation checks,[274] the valuation committee would also be responsible for overseeing how those reviews are taken into consideration by management and reflected in the financial statements.

Burford already has established a "valuation committee," although it differs in crucial aspects from the type of committee envisaged here. Burford's valuation committee is responsible for reviewing and approving any fair value marks, but it is a management committee, not a board committee.[275] Crucially, it is not an independent committee, but is instead composed of senior managers performing the vital task of monitoring the value of the assets in the firm's portfolio. The involvement of senior management in the fair valuation process makes sense; once the LFC adopts fair value accounting, it could hardly be otherwise. While Burford does stress that its independent, board-level *audit* committee oversees the fair value process, audit committee oversight necessarily entails a more general level of scrutiny of the fair value process rather than granular attention to the assumptions underlying valuations of specific assets.

While the valuation committee might initially seem a promising antagonistic agent, a closer look justifies some skepticism. The reasons for this skepticism emerge more clearly if we deconstruct the analogy between an independent valuation committee and an independent audit committee. The independent audit committee oversees the audit process, which is, by definition, operationally and logically distinct from a company's business. The auditor checks and reviews the financial reports that management compiles, as well as the adequacy of the internal processes and controls that produced those reports. The price of the audit committee's independence is some distance from the operational realities of the business. Here, however, the expertise to value the assets is highly specialized and the management team possesses it in overwhelming, if not exclusive, proportions. In other words, although independent directors likely possess the ability to oversee an auditor's work, it is unlikely that such independent directors possess adequate skills and expertise to assume authority for valuing the LFC's

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273. In the case of the U.S. audit committee, the specialized oversight responsibility concerns the audit itself, as well as mediating and resolving disputes between the auditor and company management. *See* 15 U.S.C. § 78j–1(m)(2).

274. *See infra* Part VII.C.

275. Burford's "valuation committee" consists of the Chief Executive Officer, Chief Investment Officer, Deputy Chief Investment Officer, Chief Financial Officer, Co-Chief Operating Officer, and the Managing Director responsible for portfolio oversight. Burford 2020 Annual Report, *supra* note 34, at 61.

assets. After all, that is management's core value proposition along the life cycle of the litigation funding transaction, from the underwriting decision to the settlement terms.[276]

C. *Requiring Use of External Claims Valuers*

Another possible incremental solution to the fair value disclosure problems is the use of external certified claims valuers. If the independent valuation committee would represent an internal validation strategy operating at the corporate governance level, outside claims valuation would represent an external validatory tool. A cadre of valuation advisory teams, both standalone firms and units within larger diversified advisory firms, have developed alongside the LFCs to provide valuation advice to improve underwriting and fair value accounting. In the United Kingdom, LFCs also retain some solicitors to provide claim valuation advice.[277] When considering whether to underwrite a litigation asset, an LFC reviews the valuation assessment of the selling litigant or law firm and conducts its own valuation process. Sometimes, it also involves a third party as a sort of "sanity check" on the process.[278] Manolete currently incorporates third-party claims valuation in its fair value accounting process. At the conclusion of each reporting period, it takes a sample of its cases and obtains written valuation assessments from external solicitors.[279] This type of independent third-party valuation certification is common with Level 3 fair value assets like illiquid securities and derivatives.[280] So far, the practice has yet to become standard in the publicly traded LFC context.

Securities regulators could require publicly traded LFCs to undertake an external review of a portion of their fair value marks. The regu-

276. Indeed, in the mutual fund industry, it is common for a board committee responsible for the fair valuation function to be comprised entirely of *affiliated* (i.e., not independent) members of the board. *See* MUTUAL FUND DIRECTORS FORUM, PRACTICAL GUIDANCE FOR FUND DIRECTORS ON VALUATION OVERSIGHT 9–10 (2012), https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/practical-guidance-for-fund-directors-on-valuation-oversight .pdf?sfvrsn=68e27dc6_2 [perma.cc/33ML-BZSL]; INVEST. CO. INST. ET AL., FAIR VALUATION SERIES: THE ROLE OF THE BOARD 8 (2006), http://www.ici.org/pdf/06_fair_valuation_board.pdf [https://perma.cc/YW5G-TAY4]. The valuation committee is then overseen by the full board of directors.

277. *See, e.g.*, Manolete 2020 Annual Report, *supra* note 60, at 48.

278. Litigation Finance & Litigation Funding: Due Diligence & Case Valuation Webinar - Elev8 June 2020, YOUTUBE (June 13, 2020), https://www.youtube.com/watch?v=SkUouGxazgA (comment of Justin Kuczmarski, founder of NAV Valuation & Advisory LLC).

279. *See* Manolete 2020 Annual Report, *supra* note 60, at 48.

280. *See* HOULIHAN LOKEY, INDEPENDENT THIRD-PARTY VALUATION INSIGHTS: PORTFOLIO VALUATION BEST PRACTICES 6–7 (2016), https://www.hl.com/uploadedFiles/50_Newsroom/43_Insights_and_Ideas /Valuation%20Best%20Practices_Houilhan%20Lokey.pdf [https://perma/cc/6LTN-DGAE].

lators could then require the external valuer either to certify the reasonableness of the marks to investors in the disclosure, or, more modestly, to prepare a report to LFC management to the same effect. External certification of investor disclosure is a common feature of securities disclosure, most obviously in the case of the independent audit requirement. Late last year, the SEC permitted the boards of directors of investment companies and small business development companies to appoint a "valuation designee" to make fair value determinations for the fund.[281]

A certification requirement would at once be more and less than an audit: less than an audit because the external certifier would only assess a portion (the fair value marks) of the accounts, but more than an audit because it would perform independent valuation of assets. A full-blown certification requirement would be costlier than a more modest report to management, but would further enhance the credibility of the accounts. The increased cost would correspond to the reputational and financial risks the external valuers would assume in consenting to the inclusion of their expert reports in securities disclosure materials.[282] On the other hand, if the external valuer simply provided a report to management and the auditor, no securities law liability would attach absent extenuating circumstances. The report would doubtless impact the audit too, providing the auditor with more data and information concerning the appropriateness of the fair value marks. How to weigh the burdens of preparing reports for management or for public disclosure to investors against the anticipated increase in account reliability is outside the scope of this Article. However, these certification requirements should be considered as part of any regulatory reform effort in this space.

281. *See* Good Faith Determinations of Fair Value, Release No. IC-34128, 86 Fed. Reg. 748, 749–50 (Dec. 3, 2020) (to be codified at 17 C.F.R. pts. 210, 270) (also clarifying that (i) the valuation designee must be the investment adviser for the fund and (ii) the valuation designee itself may utilize third-party "pricing services").

282. Section 11(a) of the Securities Act of 1933 creates a cause of action permitting investors to sue various persons associated with the preparation of the registration statement, the central disclosure document used to solicit interest in public distributions of securities. Included among the eligible defendants are any "person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement . . . ." 15 U.S.C. § 77k(a)(4) (2018). Such a defendant, known to securities lawyers as an "expert" (although that term is not used in the Act), is only liable "with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him." *Id.* A lower, but still meaningful, risk would attach to the certifications accompanying annual and quarterly financial reports under Rule 10b-5, which proscribes the making or dissemination of false or misleading statements with intent to defraud. *See* Lorenzo v. SEC, 139 S. Ct. 1094, 1099–1103 (2019).

D. *Leaning on the Audit Profession to Develop Heightened, Standardized Verification Practices Concerning the Accuracy of Fair-Value Marks*

Broadly speaking, the programmatic, normative function of a modern public company's independent audit is to produce increased confidence in the reliability of financial statements, improving the efficiency of capital markets in the process.[283] The public company audit is a process punctuated by the delivery of an audit letter expressing an opinion concerning the fairness of the presentation of the company's financial accounts. In the lead-up to the delivery of the audit letter, the audit process consists of samples, checklists, and analytical methods designed to provide assurance to the auditor, and eventually the investors, of the financial reports as prepared by company management.[284] This Article is hardly the place to summarize the operational, functional, and aspirational realities of public company audit practice. However, some brief recommendations can be made concerning how audit practice might meet the challenges posed by fair value accounting in the litigation finance sector.

The Public Company Accounting Oversight Board (PCAOB), the governing body for the U.S. public company audit function, publishes general guidance for public company audits. Its Audit Standard 2501, titled *Auditing Accounting Estimates, Including Fair Value Measurements*, sets forth the assurance expectations for public company auditors regarding a company's fair value marks.[285] When evaluating a company's fair value mark, that standard requires the auditor to "us[e] some or all of his or her own methods, data, and assumptions to develop an expectation of the estimate for comparison to the company's estimate."[286] In a subsequent note, the standard notes that:

> [i]n developing an independent expectation, the auditor should take into account the requirements of the applicable financial reporting framework and the auditor's understanding of the company's process, including the significant assumptions used

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283. *See* Michael K. Power, *Auditing and the Production of Legitimacy*, 28 ACCT., ORGS. & SOC'Y 379, 380 (2003).

284. *See* MICHAEL POWER, THE AUDIT SOCIETY: RITUALS OF VERIFICATION 4–7 (1997).

285. *See* PUB. CO. ACCT. STANDARDS OVERSIGHT BD., AUDITING STANDARD 2501: AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE MEASUREMENTS, https://pcaobus.org/oversight/standards/auditing-standards/details/AS2501 [https://perma.cc/5WG7-Y4X7] (last visited Apr. 15, 2023).

286. *Id.* § 2501.21.

> by the company, so that the auditor's expectation considers the factors relevant to the estimate.[287]

The standard also clarifies that auditors should assume that the risk of material misstatements of stated fair values are higher in the context of Level 3 assets.[288] And yet, the guidance is ambiguous precisely where it is most needed. When the auditor is reviewing Level 3 asset marks, it "should obtain an understanding of how unobservable inputs were determined and evaluate the reasonableness of the unobservable inputs[.]" In doing so, it should take into account (1) "[w]hether modifications made to observable information generally reflect the assumptions that market participants would use when pricing the financial instrument, including assumptions about risk"; and (2) "[h]ow the company determined its fair value measurement, including whether it appropriately considered the information available."[289] The first specification here basically copies-and-pastes the fair-value accounting rules, and the second amounts to a directive to use common sense; together, they do nothing to empower the auditor to scrutinize the substance of the fair value marks.

If an LFC auditor were to engage a valuation specialist to review some portion of the LFCs' fair value marks, it would obtain greater assurance over the reliability of the marks and the broader integrity of the company's accounts. The PCAOB has published a general standard governing the use of such specialists.[290] Such specialists might come from a separate team within the audit firm itself (frequently called the "valuation team") or a third-party provider. For instance, the "big four" accounting firms maintain specialist valuation teams that, among other engagements, assist their audit colleagues.[291]

Greater involvement of valuation expertise in the audits of publicly traded LFCs would be a welcome development. The impetus to mandate or encourage the involvement of a specialist in the audit could come

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287. *Id.*

288. *See id.* § 2501.A1.

289. *Id.* § 2501.A10.

290. *See* PUB. CO. ACCT. STANDARDS OVERSIGHT BD., AUDITING STANDARD 1210: USING THE WORK OF AN AUDITOR-ENGAGED SPECIALIST, https://pcaobus.org/oversight/standards/auditing-standards/details/AS1210 [https://perma.cc/5CV9-XRJF] (last visited Apr. 15, 2023).

291. *See, e.g.*, ERNST & YOUNG LLP, OUR COMMITMENT TO AUDIT QUALITY INFORMATION FOR AUDIT COMMITTEES, INVESTORS AND OTHER STAKEHOLDERS 8 (2020), https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/topics/assurance/ey-2020-commitment-to-aqr-brochure.pdf [https://perma.cc/9YJH-RDWJ]; DELOITTE PORTFOLIO VALUATION SERVICES, LEVERAGING VALUATIONS AS A STRATEGIC ENABLER: PORTFOLIO VALUATION SERVICES 25–26 (2017), https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-portfolio-valuation-services.pdf [https://permac/8NNN-AWU2].

from the applicable securities regulator, the PCAOB, or the American Institute of Certified Professional Accountants (AICPA). The AICPA publishes interpretive guides for auditors concerning particular industries and particular types of transactions, providing localized advice and guidance for audit professionals.[292] While the size of the litigation finance industry probably would not justify a standalone industry guide, special treatment for LFCs might be indicated in the AICPA's existing guidance for auditing derivative investments, hedging activities, and investments in securities.[293] The PCAOB could also expand on its guidance concerning Level 3 assets, perhaps by encouraging the use of internal or external valuers to assist the auditor in assessing the reliability of the fair value process.

E. *Requiring Sensitivity Analysis of Valuation Models*

Sensitivity analysis is an analytical tool that can enhance user understanding of financial models and accounting policies, demystifying the isolated point estimates that are usually the standalone end products. When conducting sensitivity analysis, the analyst moves isolated input parameters in valuation models or accounting policies by a unit amount to reveal how "sensitive" the relevant output metrics are to the changes. In the context of Level 3 litigation finance assets, the relevant output metrics are straightforward: the reported fair values, with the associated flowthroughs to profit and loss. The relevant inputs, as discussed below, are considerably messier.

The SEC has recently shown its willingness to make sensitivity analysis part of the standardized disclosure materials for public companies. In December 2020, as part of its significant suite of amendments to the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) disclosure requirements, the SEC mandated

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292. This guidance is recognized as an interpretive publication pursuant to Generally Accepted Auditing Standard 150. An interpretive publication, in turn, sets forth a recommended application of the fundamental Statements of Accounting Standards in specific circumstances, including audits of entities in specialized industries. *See* PUB. CO. ACCT. STANDARDS OVERSIGHT BD., AUDITING STANDARD 150.05: GENERALLY ACCEPTED AUDITING STANDARDS (categorizing AICPA guides for "specialized industries" as "interpretive publications" for purposes of auditing standards), https://pcaobus.org/oversight/standards/archived-standards/pre-reorganized-auditing-standards-interpretations/details/AU150#:~:text=The%20report%20shall%20state%20whether,relation%20to%20the%20preceding%20period [https://perma.cc/8XWG-DGGY] (last visited Apr. 15, 2023).

293. *See generally* AM. INST. OF CERTIFIED PROF. ACCTS., AU § 332: AUDITING DERIVATIVE INSTRUMENTS, HEDGING ACTIVITIES, AND INVESTMENTS IN SECURITIES, https://us.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/au-00332.pdf [https:/perma.cc/6TNR-SFUF].

that public companies conduct sensitivity analysis regarding certain "critical accounting estimates."[294] An accounting estimate is "critical" for these purposes if it "involve[s] a significant level of estimation uncertainty and ha[s] had or [is] reasonably likely to have a material impact on the [company's] financial condition or results of operations."[295]

The amended Item 303(b)(3) of Regulation S-K reworks the MD&A requirements concerning these critical accounting estimates. Among other disclosures, it requires an analysis of the "sensitivity of the reported amount to the methods, assumptions and estimates underlying its calculation."[296] By requiring this sort of sensitivity analysis, the SEC acknowledges the significant subjectivity and contestability underlying many accounting policy choices and their quantitative byproducts. For instance, revised Item 303(b)(3) would provide important information to investors regarding a swap contract that receives a $50 million fair value mark, but would be worth $10 million if the benchmark interest rate were to rise, say, fifty basis points. The utility of this information from the perspective of financial statement users is apparent.

The fair value accounting rules do mandate footnote disclosure of some basic sensitivity analysis for Level 3 assets. For instance, IFRS 13, paragraph 93(h) requires:

> a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, an entity shall also provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.[297]

In practice, however, the sensitivity analysis conducted by Manolete and Burford to date has been less than illuminating. Burford simply imagines a 10 percent increase or decrease in the aggregate value of its

294. *See* Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information, Release No. 33–10890, 86 Fed. Reg. 2,080, 2099–102 (Jan. 11, 2021).

295. 17 C.F.R. § 229.303(b)(3) (2021).

296. *Id.*

297. IFRS 13, *supra* note 101, ¶ 913(h)(i); GAAP Fair Value Rules: Topic 820, *supra* note 94, at 128 (also requiring a "narrative description of the sensitivity of the fair value measurement to changes in significant unobservable inputs and a description of any interrelationships between those unobservable inputs.").

Level 3 assets while holding all other inputs constant.[298] Investors could perform this back-of-the-envelope calculation on their own.

Not to be outdone, Manolete's sensitivity analysis is even less availing—indeed, it is nonexistent. The company appears to ignore paragraph 93(h) altogether: "Sensitivity analysis has not been included, due to the vast amount of inputs and number of variables which are inherently specific to each case, making it impossible to provide meaningful data."[299] The company is onto something, but not everything, here. The number of inputs involved in litigation finance asset valuation are not vaster than that of any other complicated financial asset.

However, Manolete is correct in its observation that the variables in litigation finance asset valuation models are especially asset-specific. It is undoubtedly more difficult to mechanistically toggle input variables to produce useful, even intelligible, sensitivity analysis of a litigation finance model than it is with a financial model for an interest rate swap or collateralized debt obligation. That is not to say that it is impossible.

We might imagine, for instance, an LFC that reports an aggregate fair value of its litigation assets of $100 million. That estimate derives from aggregating individual asset values, each of which is arrived at through a modeling analysis using case-specific assumptions concerning the likelihood of success on the merits, the expected future cost outlays to maintain the litigation, the likely case duration, the probable settlement amounts or judgment awards, and the likelihood of recovery. Such an LFC could report to investors how the $100 million figure would decrease if, for instance, its expected recoveries for all, or those for a portion of its high-value assets, were decreased by, say, 25 percent. Or if its assumed recovery rate decreased from, say, 90 percent to 75 percent. Or if the likelihood of success of its two largest assets were halved. Or all three of these input adjustments.

This sort of analysis permits some rough extrapolation of the valuation models and techniques without disclosing case information in a manner that would result in privilege waiver or revealing proprietary information that would erode the LFC's competitive position. Any reform effort to combat the disclosure problems incident to publicly traded LFC should consider including mandatory sensitivity analysis as a securities disclosure matter, building off the existing, but presently ineffectual, accounting rules.

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298. *See* Burford 2020 Annual Report, *supra* note 34, at 143.

299. Manolete 2020 Annual Report, *supra* note 60, at 47.

F. *Mandating Standardized Disclosure of Material Asset Valuations and Amending Privilege and Work-Product Waiver Rules*

The most straightforward way to remedy these problems would also be the most controversial: requiring publicly traded LFCs to disclose significantly more details about their asset portfolios, perhaps even case-specific financial and strategic information. Such a requirement would need some filtering mechanism to structure the disclosure. For instance, it could include a materiality threshold, such that disclosure would be provided only for significant matters likely to be of interest to reasonable investors.[300] It could instead be calibrated quantitatively according to percentage of total LFC assets (e.g., "any asset the reported value of which exceeds 5 percent of the registrant's total assets") or a specified number of the LFC's largest assets (e.g., "the 5 largest assets by reported value"). For U.S.-listed LFCs like Burford, the S.E.C. could even sensibly determine that no formal rule change is required and publish a release interpreting its existing Regulation S-K to require the disclosure.[301]

The controversy would arise because of the familiar attorney-client privilege and work-product concerns, which presently cast a shadow on publicly traded LFC disclosure that at present chills almost *all* case-specific information.[302] The privilege waiver issue is more pressing than setting the precise scope of the disclosure burden, or its precise location within the securities law compendium. If securities regulators wanted to maximally promote this sort of transparency, they would have to create litigation finance carve-outs from the privilege waiver rules. The challenge in crafting such a carve-out is in achieving two goals at once: allowing meaningful information flows to investors sufficient to com-

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300. *See supra* note 170 (summarizing materiality standard in U.S. securities law).

301. Regulation S-K sets forth the disclosure requirements applicable to periodic reports, registration statements, and prospectuses. Item 303(b)(2)(i) of Regulation S-K requires companies to "[d]escribe any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations and, in each case, indicate the extent to which income was so affected." 17 C.F.R. § 229.303(b)(2)(i) (2023). In addition, it requires companies to "describe any other significant components of revenues or expenses that, in the registrant's judgment, would be material to an understanding of the [company's] results of operations." *Id.* Material changes to assets marks, even for individual assets, would seem to be "significant economic changes" with material income effects, or, by analogy (because LFCs do not typically report "revenue" as such), "significant components of revenues" that are "material to an understanding of the [company's] operations." Furthermore, Item 1011(c) of Regulation S-K, in a syntax with which U.S. securities lawyers are well familiar, requires companies to "[f]urnish such additional material information, if any, as may be necessary to make the required statements [(including material disclosed in the financial statements)], in light of the circumstances under which they are made, not materially misleading." *Id.* § 229.1011(c).

302. *See supra* Part V.

bat the twofold securities disclosure problems discussed here while also protecting the confidentiality of privileged communications between funded litigants and their counsel.[303]

To implement any approach, the securities regulators should work collaboratively with professional bar associations, courts and, other judicial bodies responsible for evidentiary rules, and legislatures to craft the carve-out. Alternatively, in the United States at any rate, securities regulators could seek congressional approval to preempt state privilege laws with new federal securities rules.[304] Whatever political-institutional strategy for legal adoption is preferred, as a technical matter different approaches are feasible.

First, legal authorities could clarify that the general disclosures required by the securities laws would not open the door to broader "subject matter" waivers of the documents to which those general disclosures refer or from which they draw.[305] Such an approach would in ef-effect adopt a version of the "selective waiver" doctrine, under which disclosure to a government agency does not waive the privilege vis-à-vis other parties.[306] Here, the criterion for selectiveness would be scope of content, not the identity of party obtaining disclosure. Disclosure would only waive privilege with respect to the specific matters disclosed and nothing that underlies or contextualizes them.

Second, the carve-out could be designed as an exception for "disclosures required by securities law set forth in [the relevant statute or

303. A similar exercise in balancing occurred in the mid-to-late-aughts over increasing demands and expectations on the part of auditors for information pertaining to litigation contingencies. *See* AM. BAR ASS'N, COMMENTS OF THE A.B.A. ON THE FINANCIAL ACCOUNTING STANDARDS BOARD EXPOSURE DRAFT TITLED "DISCLOSURE OF CERTAIN LOSS CONTINGENCIES: AN AMENDMENT OF FASB STATEMENTS 5 AND 141(R)" (2008), https://www.americanbar.org/content/dam/aba/administrative/government_affairs_office/comments-priv-waiv-fasb.pdf?logActivity=true [https://perma.cc/J9UP-6VW8]; A.B.A. TASK FORCE REPORT ON THE ATTORNEY-CLIENT PRIVILEGE 302A (2006), https://www.americanbar.org/content/dam/aba/directories/policy/annual-2006/2006_am_302a.pdf [https://perma.cc/4AMX-4TZ9] (referring to "the tension between preservation of the fundamental protections of the attorney-client privilege and work product doctrine and the need for reliable financial reporting and effective audits"); David M. Brodsky & Michael D. Fricklas, *Under Fire—Again*, INSIDE LITIG. (Spring 2005), https://www.lw.com/upload/pubContent/_pdf/pub1315_1.pdf [https://perma.cc/8CCU-GY2Y] (making a similar point regarding disclosures to auditors).

304. This article takes no position on whether the SEC, if it considers going down this route, should adopt a collaborative approach or seek congressional approval for a preemptive approach. It should be noted that the latter approach will require sacrifices when it comes to the desiderata of agency accountability and federalism. *See* Mila Sohoni, *The Power to Privilege*, 163 U. PA. L. REV. 487, 524–42 (2015).

305. *See supra* text accompanying notes 168–169 (discussing subject-matter privilege waivers).

306. *See* Sohoni, *supra* note 304, at 511–16; Richter, *supra* note 163, at 132–33. Some courts prefer the term "limited waiver." *See* GREENWALD & SLACHETKA, *supra* note 168, at 139. In any event, the theory of selective waiver has not received a welcome reception from the judiciary. *See id.* at 175 ("The selective waiver doctrine has been rejected by all but a small minority of courts.").

regulation requiring the disclosures]." A broader carveout for "disclosures required by securities law" would be inadvisable because there might be cases where an issuer—even a non-LFR operating company—voluntarily discloses information in its securities disclosures that *should* amount to waiver.

Even assuming the privilege waiver issues are solvable, mandatory case-specific disclosure will still prejudice the LFC's funded litigation clients—and, for the same reason, the LFC itself—by disclosing otherwise confidential information that could be used strategically in settlement negotiations. For instance, if an LFC discloses that it values a financed plaintiff lawsuit at $22 million, then the defendant might sensibly view that as a ceiling above which it is unwilling to pay. Thus, there are benefits to confidentiality apart from the privilege issues that should be taken account of in any balancing of competing pros and cons. As a number of leading law firms put it in a joint memo concerning the privilege issue in the context of a similar regulatory setting (bank examiners divulging privileged information to Congress):

> [A]s a practical matter the value of privilege is diminished in correlation to the number of people who have access to the privileged information. The candor that the privilege is intended to promote is undermined when the communications are subject to public or even private view regardless of whether the communications are used directly or indirectly in a legal proceeding.[307]

In other words, privilege rules do not apply outside courtrooms. Strictly speaking, they, along with the other rules of evidence, delimit the information set that factfinders can consider when applying the law to facts.

If a litigant involved in settlement negotiations believes that its case on the merits is flimsy, but its settlement leverage rather substantial, it offers no comfort that a leak of memo in which it describes its view of the case cannot be introduced later as evidence in a courtroom. It will by that point already have foundered the settlement talks, not to mention affected the adversary's strategic posture to the conduct of the liti-

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307. Memorandum from The Clearing House Ass'n, Cleary Gottlieb Steen & Hamilton LLP, Covington & Burlington LLP, Davis Polk, Simpson Thacher & Bartlett LLP, Sullivan & Cromwell LLP, Wilmer Cutler Pickering Hale & Dorr LLP & Debevoise & Plimpton LLP on Bank Regulators' Legal Authority to Compel the Production of Material That Is Protected by Attorney-Client Privilege 21–22 (May 16, 2018), https://www.debevoise.com/insights/publications/2018/05/banking-regulators-examination-authority-does [https://perma.cc/F447-GA32].

gation. Even more importantly, this hypothetical example draws our attention to possible deeper ramifications for the future availability of litigation finance: if the securities regime pushes too far, the transactional logic of litigation finance itself will come under pressure, at least for those companies considering listing on a public stock exchange. In that scorched-earth circumstance, securities law would solve a problem by eliminating publicly traded LFCs from public markets altogether.

VIII. CONCLUSION

In concluding, I want to underscore a detail from the Muddy Waters short attack on Burford that was mentioned only in passing above. Within a week of Muddy Waters announcing its short, GAM, a Swiss asset manager with over $140 billion in total assets under management,[308] liquidated its entire £80 million position in Burford bonds.[309] A sophisticated institutional investor if there ever was one, GAM was sufficiently affrighted, virtually overnight, to abruptly unravel one of its largest positions. While steep declines in stock prices are par for the course following a short attack, such hair-trigger nervousness on the part of institutional *debt* investors is both remarkable and telling. One can almost imagine the GAM investment manager going around the table, inquiring if any colleagues knew anything about the real composition of Burford's case portfolio, and receiving only a few shoulder shrugs in response. If one hopes for the continued expansion of the industry through the deployment of funds from public capital markets, one should also hope for more confident responses to the manager's inquiry the next time around. The reform framework sketched here offers a place to start building that confidence.

308. GAM, Half-Year 2019 Report 3 (2019), https://www.gam.com/-/media/content/results/hy-2019/update2020/20190729_half-year-report-en_web_version_update.pdf [https://perma.cc/E2BQ-X2V3] (listing total assets under management at 136.1 billion Swiss francs at a time when the U.S. dollar to Swiss franc exchange rate was approximately 0.97:1).

309. *See supra* note 241 and accompanying text.