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By Thomas D. Sykes

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In this article, Sykes explains how litigation finance, which has become a common arrangement outside tax litigation, could be extended to benefit taxpayers and tax professionals in potentially meritorious cases when large amounts are at stake.

The landscape for funding large nontax cases in court has shifted in the last few years with the development of a new resource: nonrecourse litigation finance. Although litigation finance for large commercial cases has been available since at least the mid-2000s, it seems that hardly a week has gone by in 2016 without an article about the subject appearing in a prominent business publication. Tax practitioners may have wondered how this financing development might apply to tax cases.

Litigation Finance in Nontax Cases

Litigation finance firms invest in cases in exchange for a substantial portion of any recovery. The investment is nonrecourse: The party receiving the financing owes nothing unless there is a recovery in the suit. The investment in the case is designed to cover most or all of the anticipated attorney fees and expert witness expenses. If there is a recovery, the litigation finance firm is paid a multiple of its original investment in exchange for undertaking the risks of funding the litigation. Litigation finance has become a very attractive resource for cash- and earnings-conscious corporate legal officers.

Accredited investors, including large pension funds, view meritorious lawsuits as attractive investments, especially in a pervasively low-rate environment in which the equity markets are said to be "long in the tooth." Some very high returns on investment have been reported, along with some notable losses. Investments of this nature are known as "alternative assets." Their returns, positive or negative, are not correlated with the returns seen on conventional assets.

Large corporate law firms representing clients with claims requiring litigation are fully justified in seeking out win-win situations. Corporate general counsel increasingly demand alternatives to hourly billing. But large corporate law firms generally do not have financial and compensation structures that are conducive to meeting the demand for contingent fee arrangements (despite lip service to the contrary), which involve long-term investments in cases.

Large law firms and corporate general counsel are increasingly at a stalemate — which does not work in favor of either. Litigation finance resolves the conundrum. It allows general counsel to proceed with contingent fee arrangements and allows a law firm to receive the hourly fees that it prefers. The result is a win for both the litigant and the law firm.

On a policy level, litigation finance is also a win for the proper, systematic resolution of cases that appear meritorious because it allows those cases to get their day in court.

The courts have steadily been issuing opinions that respect and protect the confidentiality of information exchanged between litigation funding firms and litigants. All but a few states allow litigation funding arrangements. States increasingly regulate those arrangements involving consumers but not large commercial arrangements. Lawyers' ethics rules do not preclude litigation finance arrangements, although the arrangements can and must be structured in ways that respect those rules.

For a case to qualify for litigation finance, it must present a very good chance of success in court. (Naturally, investors are not interested in funding cases that lack powerful arguments.) The amount at stake will have to be large relative to the amount of funding sought and thus allow plenty of room for a settlement to leave the litigant with a substantial net recovery. The litigant will have to be represented by impressive counsel, in whom the litigation finance firm expects to have full confidence, because the litigant and its counsel retain control of all decisions during the litigation process.

The Need for Litigation Finance in Tax Cases

Historically, corporate finance and tax officials have been discouraged from taking disputes with the IRS to court, even when the amounts at stake were large and the merits of the taxpayers' cases were powerful. Spending current cash on the attorney and expert witness fees was not attractive: There was no guarantee of a recovery, and the recovery possibility that existed was, at best, a few years down the road. Perhaps more important, under accounting rules, the profit and loss statement took an earnings hit for amounts spent. Corporate tax officials were effectively instructed to "settle with the IRS and get what you can." Sometimes corporate officials, facing an intransigent IRS, wholly abandoned large and meritorious issues.

IRS personnel involved with firms under continuous audit presumably have been well aware of firms' litigation-averse tendencies. It is bad enough that issues are given away, but what happens later may be worse: The overly generous concessions in the earlier audit cycle set the IRS's expectations for negotiations in future cycles.

Tax litigation partners in large corporate law firms have faced the same conundrum as their partners conducting other types of litigation: Corporate clients demand contingent fee arrangements, but the financial structures of law firms are not designed to facilitate long-term investments in cases.

Thus, for both taxpayers and their law firms, there is a need for outside capital to be invested in large, meritorious tax disputes that should go to court.

There is no reason to deny litigation finance in tax cases. There is no ethical prohibition, as long as investment arrangements are structured to respect the ethical obligations that govern lawyer conduct.

Accordingly, tax practitioners and potential investors should become familiar with litigation finance. It has not been addressed in publications, as far as I am aware.

One reason for the lack of tax practitioner attention is that tax and tax litigation are rightly viewed, by both tax practitioners and lawyers in general, as a complex specialty. With an abundance of large nontax cases available for investment, the well-established litigation finance firms have not focused on the tax case segment of the marketplace. No litigation finance firm that I have seen advertises an interest in tax cases or is staffed by personnel with a background in tax litigation. This may lead to an assumption that litigation finance is unavailable for tax cases. Further, many tax practitioners are not lawyers and thus may be unaware of what is happening in nontax litigation.

Factors Affecting Suitability for Investment

Tax litigation expertise would seem to be necessary for litigation finance firms to evaluate proposed investments in tax cases competently, efficiently, and confidently. Tax *is* special.

A few observations are in order from a longtime tax litigator who is familiar with how litigation finance could apply to tax cases.

First, at least $7 million in tax and interest must be at stake for an investment to make sense. The more money that is at stake, the easier it is to structure an investment so that the taxpayer gets a solid net recovery after the litigation finance firm receives its share. Because the litigation finance firm's recovery is typically determined as a multiple of its investment, the size of the recovery in the event of success must go up as the amount invested goes up. The size of the recovery might include the value of continuing issues found in periods not in suit.

Cases involving a pure issue of law will be of more interest to litigation finance firms than highly fact-bound cases, although valuation cases involving opposing experts (including cases under section 482) would likely be of interest, assuming that the tax and interest at stake are high. Cases in which economic substance is dubious (or missing) will not be of interest. Cases involving excise or employment taxes may be of interest, especially because the tax has already been paid. Cases involving estate and gift taxes may also be of interest. With the courts more carefully scrutinizing regulations (both nontax and tax) under *Chevron* step zero and under the requirements of the Administrative Procedure Act, cases in which the validity of Treasury regulations is at issue will be of interest as well. Cases that can be concluded within three or four years will be of more interest than cases that require more time. Litigants, especially in tax refund suits, must address possible offsets or counterclaims. If the case is to be brought in Tax Court, the litigant will have to have a strong balance sheet.

Cases that have been well developed during the administrative process will be of more interest. In fact, as a practical matter, that attribute may be a prerequisite for funding. Cases in which litigants were guided at the administrative level by highly regarded tax practitioners will be of more interest, as will cases in which highly regarded tax litigators will be representing the taxpayer in court. Cases with possible jurisdictional infirmities would not likely be of interest.

Cases that are already in court and that face a few more years of litigation may be apt candidates. They are more attractive investments to the extent that the government has clearly set out its legal and factual positions. Cases on appeal in which funding is sought for the appellate representation may also be apt candidates.

The described factors are meant to be illustrative, not exhaustive. I hope to stimulate vice presidents of tax, CFOs, treasurers, tax accountants, tax lawyers, and tax litigators to think in concrete terms about how this resource, which has been so well received in the nontax realm, might apply to tax disputes.

Conclusion

Litigation finance is a resource to corporate taxpayers and outside tax litigators. It creates the possibility of a win-win for taxpayers and outside counsel, not to mention a win for a judicial system that posits as a goal the successful resolution of meritorious claims. This relatively new resource may help firms under continuous audit avoid settlements that do not reflect the proper valuation of their claims and avoid setting damaging expectations for future audit cycles. Taxpayers and tax professionals involved in large, meritorious tax disputes may be well-advised to contact litigation finance firms possessing an expertise and interest in tax litigation. ■

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