Asset Purchase or Consumer Loan: One State High Court Weighs In

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In a case closely watched by players in the asset purchase space, the Colorado Supreme Court ruled that the purchase of a future interest in the litigation proceeds of a tort lawsuit - usually automobile accidents, slip and falls, construction site injuries and medical malpractice - constituted a loan subject to that state's consumer credit laws. Selling an interest in the potential proceeds of personal injury cases is not new. The Purchaser pays the Seller, who is a plaintiff in a tort lawsuit, money in exchange for the right to receive a portion of the proceeds of litigation. Although the Colorado case touches on the form of the transaction in the merchant cash advance space, the applicability of the decision to such transactions seems limited to consumer transactions.

In *Oasis Legal Fin. Grp. v. Coffman*, decided in mid-November, the Colorado Supreme Court concluded that a "litigation finance" transaction constituted a loan even though the tort plaintiff selling its interest in litigation proceeds did not have an obligation to repay any deficiency if the litigation proceeds were ultimately less than the amount purchased. The court further held that the transactions created a debt - an obligation to repay - that grows over time, thus strengthening the characterization of the transaction as a loan.

The case arose in response to a 2010 opinion of Colorado's Administrator of the Uniform Consumer Credit Code ("UCCC") classifying these transactions as loans. The Office of the Attorney General, Department of Law, which serves as counsel for the Administrator, issued an opinion letter concluding that litigation finance transactions are subject to the UCCC, and that the transactions are loans. The opinion letter analogized the transactions to refund anticipation loans, citing another Colorado Supreme Court case, *State ex rel. Salazar v. Cash Now Store Inc*. The opinion letter failed to note that in the *Salazar* litigation, the advances were repayable with full recourse, regardless of whether the ultimate amount of the refund from the government was less than the amount advanced. The opinion letter also noted that personal recourse was not a requirement for a transaction to be a loan under the UCCC and concluded that nonrecourse transactions, secured with a consumer's lawsuit or its proceeds, constituted loans under the UCCC. After the administrator learned that several litigation finance companies had operated in Colorado without the license required under the UCCC, the Administrator invited those companies to settle with the Administrator. Instead, the litigation finance companies, which left Colorado after the 2010 opinion letter, sued, arguing that the litigation finance transaction did not constitute a loan.

The form of a litigation finance agreement is a purchase and sale; essentially, the litigation finance company purchases the tort plaintiff's right to proceeds of pending litigation. The tort plaintiffs receive a purchase price - typically less than $1,500 - while the case is pending. The tort plaintiff is generally prohibited from using the money to prosecute the legal claim, but retains complete control over how the lawsuit is to be prosecuted. The tort plaintiff further represents that the purchase price will be used for consumer, personal, family and household purposes, pre-settlement or trial. In exchange, the tort plaintiff agrees to pay the litigation finance company the purchased amount, which equals the purchase price, plus an additional amount based on a multiplier that increased with the length of time taken to resolve the claims and application and administrative fees. The litigation finance agreement further provides that if the tort plaintiff complies with the litigation finance agreement and recovers nothing, the litigation finance company would receive nothing. If the seller does recover, the litigation finance agreement provides that the tort plaintiff would receive nothing until the litigation finance company receives its purchased amount. If the litigation proceeds are ultimately less than the purchased amount, the tort plaintiff does not have to repay the shortfall.

In the Colorado case, the litigation finance companies argued that because the transaction was without recourse to the tort plaintiff, it was not a loan. The Colorado Supreme Court disagreed, and noted that it would "liberally construe the UCCC to promote consumer protection." It further noted that *Salazar* rejected a "narrow interpretation" of the term "debt" in favor of a "broad reading" of the UCCC's definition of loan, which does not require an unconditional obligation to repay. Because "debt" includes "contingent debt," which is essentially what the litigation finance agreement is, it is also a loan. The court was unmoved by the litigation finance companies' assertions that they take the risk of complete loss on the money advanced.

The court explained that under the UCCC, debt is a necessary, if not completely sufficient, characteristic of a consumer loan, and that litigation finance agreements create debt because they create an obligation to repay. Interestingly, the court viewed the industry as a whole rather than the form of the agreement. It noted that "most of the time," the litigation finance companies obtain the purchased amount. According to data provided by the litigation finance companies, they recover the purchase amount in 85% of transactions. The fact that all tort plaintiffs had no obligation to forward the purchased amount if the litigation failed did not matter to the court, as it concluded that there is no requirement under the UCCC that the loan be "with recourse." The UCCC and *Salazar* demonstrate that a repayment obligation need not be unconditional, "the debt created by a UCCC loan need not be recourse."

The court also found it "significant" that the purchased amount increased with the passage of time, which it viewed as a "finance charge." The court observed that the longer the money is outstanding, the more the tort plaintiffs pay as a purchased amount. Whether it is called a multiplier or a "monthly use fee," the court concluded that the charges function as a finance charge, "a hallmark of a consumer loan under the UCCC."

The court also took great pain to note that there was no transfer of ownership rights, because the tort plaintiffs still controlled the pending litigation. The court simply dismissed the argument that a tort plaintiff has a right to sell the future proceeds from litigation.

So what does this decision mean for the merchant cash advance industry? As an initial matter, the UCCC - which has been adopted by about 12 states - generally does not apply to business-purpose transactions. There are a few UCCC states where this general rule may vary, so merchant cash advance companies would do well to touch base with counsel to ensure they are aware of states that may be susceptible to the kind of argument that prevailed in Colorado for consumer-purpose purchase and sale agreements. Additionally, merchant cash advance agreements generally do not have a "multiplier" found in the litigation finance agreement that causes the purchase amount to increase the longer the litigation proceeds are unpaid. Thus, although this decision certainly hits close to home for the merchant cash advance industry, most merchant cash advance companies should be able to avoid the negative outcomes that flow from this decision.

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