ECONOMIC CONUNDRUMS IN SEARCH OF A SOLUTION: The Functions of Third-Party Litigation Finance

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ABSTRACT

Despite a rapid increase in economic significance and substantial increase in international use, third-party litigation financing remains poorly understood. No academic consensus takes account of the multiple economic conundrums that third-party litigation financing arises to solve, nor do legal scholars adequately consider obvious public and private substitutes for litigation financing that society rightfully recognizes as innocuous or outright beneficial. In this Article, we explore the economic challenges driving both business plaintiffs and sophisticated law firms to seek external litigation financing. We examine closely the key elements of the litigation financing arrangement itself, focusing on eligible cases and clients, devices financiers employ to ensure repayment without meaningful control over the litigation, and theorize conditions under which third-party litigation financing will be attractive to companies and firms. We then address several concerns regarding third-party litigation financing, ultimately finding them either unpersuasive in theory or undemonstrated in fact. We conclude by noting the variety of similar arrangements already safely beyond the scope of these concerns. Ultimately, litigation financing encourages both businesses and firms to make more efficient uses of capital. Any attempt to regulate or dissuade litigation financing must begin with an economically and legally sound appreciation for how the industry actually functions.

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I. INTRODUCTION

An international proliferation in third-party litigation financing—a nominally novel but economically familiar arrangement—has attracted relatively little academic attention. Despite modest journalistic coverage and regulatory interest, no scholarly consensus has emerged describing how, or theorizing why, litigation financing occurs.[1] The full economic origins and implications undergirding third-party litigation financing remain equally unclear. But where legal academia has largely overlooked litigation financing, businessmen have not: third-party litigation financing has rapidly blossomed both domestically and internationally as several new litigation-finance corporations have emerged.[2] Juridica Investments, the first publicly traded litigation firm, was founded in just 2007; now multiple public and private corporations, investment banks, hedge funds, and even individuals have billions invested in commercial lawsuits.[3] And by at least several accounts, litigation financing remains in its inchoate stages in the United States; these figures understate—possibly drastically—the practice's full economic impact.[4] Rarely in the academy can such a momentous development escape scrutiny for long.

This Article explores why commercial third-party litigation finance arises in the United States, focusing on multiple separate economic incentives leading business plaintiffs and sophisticated law firms to seek out external litigation financing. Businesses generally shy away from expensive litigation with questionable future returns in favor of more efficient uses of capital, and large law firms are hesitant to carry expenses from protracted business

[1] For one earlier treatment of the topic, see Joanna M. Shepherd, *Ideal Versus Reality in Third-Party Litigation Financing*, 8 J.L. ECON. & POL'Y 593 (2012); *see also* Elizabeth Chamblee Burch, *Financiers as Monitors in Aggregate Litigation*, 87 N.Y.U. L. REV. 1273 (2012); Jonathan T. Molot, *The Feasibility of Litigation Markets*, 89 IND. L.J. 171 (2014).

[2] William Alden, *Litigation Finance Firm Raises $260 Million for New Fund*, N.Y. TIMES DEALBOOK (Jan. 12, 2014, 10:33 PM), http://dealbook.nytimes.com/2014/01/12/litigation-finance-firm-raises-260-million-for-new-fund/; *Investing in Litigation: Second-hand Suits*, THE ECONOMIST (Apr. 4, 2013, 3:09 PM), http://www.economist.com/news/finance-and-economics/21575805-fat-returns-those-who-help-companies-take-legal-action-second-hand-suits.

[3] Binyamin Appelbaum, *Investors Put Money on Lawsuits to Get Payouts*, N.Y. TIMES, Nov. 15, 2010, at A1. Other litigation finance corporations include Burford Capital, Gerchen Keller Capital, Parabellum Capital, ARCA Capital, Calunius Capital, Juris Capital, IMF Ltd., and recenlty closed BlackRobe Capital Partners. *See also* Alden, *supra* note 2; STEVEN GARBER, ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWNS, AND UNKNOWNS, 14–16 (2010), http://www.rand.org/pubs/occasional_papers/OP306.html.

[4] *Investing in Litigation: Second-hand Suits*, *supra* note 2; *see also* Interview with Richard A. Fields, CEO, Juridica Investments Ltd., in N.Y.C., N.Y. (Jan. 9, 2014) (notes on file with authors) [hereinafter Richard Fields Interview].

suits—even when profitable. Third-party litigation financing arises to resolve an otherwise adverse economic relationship between capital-constrained attorneys and litigation-cost-averse clients. Any critique or regulation of commercial third-party litigation financing must begin by understanding the economic forces that make these funding arrangements desirable to both law firms and business clients.

The dearth in understanding of third-party litigation financing is surprising considering the field's ancestry. Notions of champerty, third-party lawsuit support contingent on shared recovery with the outsider, and maintenance, simple external support of another's lawsuit,[5] date back centuries and across countries rooted in English law.[6] Champerty and maintenance were each both crimes and torts.[7] Both criminal and tort prohibitions against each practice have long been virtually abolished in the United States;[8] instead, various forms of litigation financing have crept into practice since at least the 1980s.[9] Cash-advance lenders offer small loans to personal injury victims to fund pending lawsuits.[10] Some larger-claim plaintiffs directly solicit individual lenders, syndicating costs and allocating potential recovery accordingly.[11] Federal courts have considered a potential class representative's financial ability to prosecute a class action as integral to whether that proposed party can adequately represent the class;[12] courts have gone so far as to even consider whether the class attorney was willing to partially or fully fund the class litigation.[13] While each of these arrangements could be fairly described generically as "third-party litigation financing," this Article instead explores the new breed of litigation financing that has emerged in the past decade: the investment of millions of dollars by outside financiers in large commercial cases.

[5] *See generally* 14 AM. JUR. 2D *Champerty and Maintenance, Etc.* §§ 1–18 (2015).

[6] Sarah Northway, *Non-Traditional Class Action Financing and Traditional Rules of Ethics: Time for a Compromise*, 14 GEO. J. LEGAL ETHICS 241, 243 (2000).

[7] *Id.*

[8] *See, e.g.*, *Facts About ALFA*, AM. LEGAL FIN. ASS'N, http://www.americanlegalfin.com/FactsAboutALFA.asp (last visited Nov. 16, 2015) (discussing successful efforts to overturn Ohio champerty law).

[9] *See generally* Jason Lyon, Comment, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 574 (2010).

[10] GARBER, *supra* note 3, at 12 ("two industry leaders estimate the average sizes of their cash advances to be $1,750 and $4,500").

[11] Daniel C. Cox, *Lawsuit Syndication: An Investment Opportunity in Legal Grievances*, 35 ST. LOUIS U. L.J. 153, 154–59 (1990); Susan Lorde Martin, *Syndicated Lawsuits: Illegal Champerty or New Business Opportunity?*, 30 AM. BUS. L.J. 485, 498 (1992).

[12] *See* 7A CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE & PROCEDURE § 1767 (3d. ed. 2015).

[13] *See generally id.*

This Article proceeds in five parts. In Part II, we argue that third-party commercial litigation has arisen to solve several interrelated economic problems arising between lawyers, law firms, and business plaintiffs. Business plaintiffs retain both institutional prejudices against acting as plaintiffs as well as a justifiable age-old mistrust of lawyers, whose services are notoriously opaque, difficult to value, and billed on a metric necessarily rivalrous against the company's interests. Large law firms, by contrast, may prove willing to partially align incentives with business plaintiffs through contingent-fee and similar arrangements, but ethical rules rooted in history and tradition effectively prohibit firms from raising capital through some of the most obvious channels.[14] Further, competently prosecuting many commercial cases requires a substantial capital commitment, potentially exceeding millions of dollars. This amount is often difficult to predict *ex ante*, adding an unwelcome uncertainty dimension to a risky financial proposition.[15] Rather than a novel—or dangerous!—practice, third-party litigation is a simple financial solution to an old and familiar incentives problem between business plaintiffs and law firms, between clients and lawyers. In fact, third-party litigation financing is so common—in both the legal and economic senses—that obvious substitutes inexplicably escape notice. Third-party litigation financing is far from new.

In Part III, we analyze the concerns and constraints confronting the litigation financier. The financier's need to ensure a safe return on investment without a direct method for compelling litigation settlement (or non-settlement) puts him in an economically vulnerable position. Sophisticated financiers therefore include various *ex ante* and *ex post* devices in the third-party litigation financing agreement itself to mitigate this risk. The financier's choice of clients, and the collateral or conditions the financier may require, protect the financier from this risk in light of his fundamental and nearly irreconcilable alienation from the attorney/client relationship.

Part IV addresses the potential benefits and concerns regarding this burgeoning industry. Litigation financiers provide the initial or ongoing investment necessary to operate a lawsuit, obviating the need for the business plaintiff to divert capital from business lines and reducing various agency problems. Litigation financiers also align law firms' incentives by requiring law firms to take on some portion of risk in the form of future, contingent payment. Financiers also monitor firm billing against the financier's guaranteed funding, reducing the business plaintiff's monitoring costs. Yet as with many poorly understood practices, third-party litigation financing

[14] *See generally infra* Section II.B.

[15] *See generally infra* Section II.A. and accompanying notes.

inspires a variety of criticisms. Of greatest concern among these is that third-party litigation financing either directly encourages additional litigation, frivolous litigation, or ethical compromises in the attorney-client relationship. As we explain, these concerns are unfounded: the frivolous-litigation complaints fail in theory, the ethical questions in practice. This is especially true when one considers that the billions of dollars in what we now call third-party litigation financing represent a mere fraction of the larger swath of economically and legally similar litigation-financing arrangements.

Part V concludes. Ultimately, we argue that third party investment in commercial cases allows both business plaintiffs and law firms to make more efficient use of their limited capital. In the process, litigation finance solves a host of other agency and information problems. Any regulation of this burgeoning industry must fully appreciate the benefits of third-party litigation financing to both law firms and business plaintiffs: illiquid lawyers and cost-averse businesses will seek a solution to their economic problems.

II. TWO ECONOMIC PROBLEMS IN SEARCH OF A SOLUTION

Most third-party litigation financing arrangements rely on a familiar cast of characters: an operating company, a law firm, lawyers, and a financier. Each has an equally familiar incentive; these incentives provide both the opportunity for and the contours of the third-party financing relationship. The prototypical operating company has limited and scarce liquid capital and wants to maximize profits across a line of businesses, typically sensitive to insider and shareholder perceptions of company decisions. Business plaintiffs are skeptical to invest scarce capital in unfamiliar ways, especially in lawsuits. The prototypical law firm carries substantial overhead, is broadly illiquid for its size, and is risk-averse vis-à-vis future income streams. The prototypical litigation financier wants a competitive return on his investment and, accordingly, to hedge various losses as much as possible: in bad cases, stubborn clients, unnecessarily sanguine clients, ineffective attorneys, and so on. In this section, we discuss the cast of characters in a third-party litigation financing agreement, focusing on each party's unmet economic needs giving rise to need for the financing.

A. Business Plaintiffs

Every third-party litigation arrangement begins with a business with both a valuable commercial claim and a host of reasons not to prosecute that claim through judgment and appeals. These clients, typically sophisticated business entities, share four salient features. We may group these into two general categories: business plaintiffs are both *institutionally limited* in terms of relevant litigation experience, and they are *risk sensitive* to a lost investment in litigation. By institutionally limited, we mean that most corporations with sufficiently large unprosecuted claims to require financing—generally multiple millions of dollars in potential recovery—are typically inexperienced in relevant ways in the potential litigation.[16] This inexperience extends to both the company's posture as a plaintiff in business litigation as well as its comparatively narrow substantive legal expertise.[17] By risk sensitive, we mean that multiple predictable economic forces both inside and outside the operating company render the company sensitive to value or investment metrics as well as to manipulation by agents with divergent incentives from shareholders or other relevant stakeholders.[18] These two traits—institutional limitation and risk sensitivity—define the typical business plaintiff's resistance to bringing litigation.

Businesses beyond a minimal size typically accrue some institutional knowledge as litigants, but much of this knowledge, typically concentrated in the business's legal department, is in defending cases, not prosecuting them. Moreover, in-house corporate legal departments typically comprise attorneys whose background prior to their corporate experience focused on

[16] *See, e.g.*, Steven L. Schwarcz, *To Make or to Buy: In-House Lawyering and Value Creation*, 33 J. CORP. L. 497, 506–07 (2008) (noting how in-house counsel can perform even complex tasks as long as they are familiar or repetitive to the firm, but that companies typically turn to outside counsel in part due to economies of scale and specialization, and that outside counsel can offer experience and expertise to the business).

[17] *See generally* Elizabeth Chambliss, *New Sources of Managerial Authority in Large Law Firms*, 22 GEO. J. LEGAL ETHICS 63, 72–74 (2009) (describing distinct skill set of general counsel as different from large law firm partners, and trend towards intra-firm specialization through use of assistant general counsel); Janet Stidman Eveleth, *Life as Corporate Counsel*, 37 MD. B.J. 16, 20 (Jan.–Feb. 2004) ("Whether large or small, all corporate legal departments draw on the expertise of outside counsel. . . . most companies go outside for technical expertise, litigation, issues that are not routine[,] and big projects."); David Engstrom, *Harnessing the Private Attorney General: Evidence From Qui Tam Litigation*, 112 COLUM. L. REV. 1244, 1288–98 (2012) (describing specialization within law firms and greater recovery rates and discovering larger False Claims Act frauds by *qui tam* specialists); Richard S. Gruner, *General Counsel in an Era of Compliance Programs and Corporate Self-Policing*, 46 EMORY L.J. 1113, 1146–51 (1997) (describing specialization of general counsel for businesses and how in-house attorneys have to develop various kinds of specialization on industry that outside counsel likely will not possess, but that often in-house counsel lack expertise in specific areas, requiring outside counsel for assistance).

[18] This is not, by contrast, to discuss—or even evaluate in this context—the general assumption that firms are risk-neutral. In this sense, our observations regarding third-party litigation financing in part reflect that risk-neutral corporations may opt to partially finance litigation in lieu of accepting risk above a given threshold. We leave further implications regarding risk tolerance and risk neutrality in the litigation-finance context to another paper.

defending corporate litigation.[19] Companies' in-house legal experience, risk tolerance in litigation outcomes, settlement expectations, and litigation budgets all derive at least in part from this institutional bias towards defending, rather than prosecuting, lawsuits.[20] Prosecuting a lawsuit requires different expertise from defending one, however, and sometimes even different skill sets; certainly often different outside counsel.[21] Readily accessible insurance further reduces these incentives; to the extent businesses are often insured for the claims in which they are defendants, the insurers' lawyers, and not the company's lawyers, generally accrue substantive knowledge.[22] Companies used to defending lawsuits (or negotiating compliance with regulators)—but not prosecuting cases—therefore face comparatively higher information, agency, and monitoring costs as they must make sometimes substantial initial investments in the art of bringing a lawsuit as a plaintiff.[23]

A business's litigation expertise, already narrowed by disproportionate experience as defendants, must also be limited in substantive scope. Most businesses develop related product lines, or at least related portfolios of substantive legal expertise. Businesses in regulated industries may develop knowledge of administrative law and their applicable regulations.[24] Many

[19] *See* Tanina Rostain, *General Counsel in the Age of Compliance: Preliminary Findings And New Research Questions*, 21 GEO. J. LEGAL ETHICS 465, 465 (2008) (noting that corporations generally attract "well-known partners from elite corporate firms" to general counsel and high-ranking positions in-house).

[20] *Id.* at 474 (describing a large firm's business departments as the company's "offense" with the legal department as the company's "defense").

[21] *See generally* Rostain, *supra* note 19, at 472 (citing Robert L. Nelson & Laura Beth Nielsen, *Cops, Counsel, & Entrepreneurs: Constructing the Role of Inside Counsel in Large Corporations*, 34 LAW & SOC'Y REV. 457, 470–73 (2000) (listing three major roles for in-house counsel: (1) "cops" that police clients' conduct; (2) "counselors" who combine legal and business expertise; and (3) "entrepreneurs" who functioned as "gate-keepers" on proposed risks for various courses of action for primarily business advice); Mitchell J. Frank & Osvaldo F. Morera, *Professionalism & Advocacy at Trial—Real Jurors Speak in Detail About the Performance of Their Advocates*, 64 BAYLOR L. REV. 1, 23–25 (2012) (discussing similarities and differences in juror perceptions of prosecutors/plaintiffs' attorneys and defense attorneys and how jurors perceive similar qualities between plaintiffs' and defense bars differently, or to different degrees).

[22] Insurance's inherent uncertainty-mitigation functions may also encourage the prophylactic purchase of insurance and the general aversion to litigation. For many companies, and especially those that can effectively self-insure but choose not to, insurance is a partial substitute for litigation expertise (and for litigation more generally), and we discuss in greater detail below the economic similarity between insurance subrogation and third-party litigation financing arrangements. *See generally infra* Part IV.

[23] Rostain, *supra* note 19, at 474, 469 n.27, 472 n.43.

[24] *See, e.g.*, Schwarcz, *supra* note 16, at 499 ("[C]ompanies have legal departments numbering in the hundreds," a result of "the shift from outside to in-house 'transactional

businesses will be familiar with labor and employment law; those in unionized industries even more than others.[25] High-technology firms will grow familiar with intellectual property law, especially patent law.[26] But these firms have little to no reason to develop cross-topical specialization. When companies with comparatively small patent portfolios find themselves enmeshed in patent lawsuits, or companies with no reason to fear international competition law suddenly discover they are the efficient enforcers for viable antitrust claims, these companies likely will not know how to proceed.[27] This institutional limitation in substantive legal knowledge, like the limitation in experience with prosecuting claims, raises the costs of: detecting and evaluating viable claims, valuing potential cases, and analyzing collateral consequences; thus increasing the uncertainty to business plaintiffs in prosecuting viable claims. Businesses, like most people and organizations, shy away from the unfamiliar.[28]

lawyering,'" where the repetitive legal activities related to the regular business duties of the company, such as "the structuring, negotiating, contract drafting, advisory and opinion-giving process leading to 'closing' a commercial, financing, or other business transaction" are performed).

[25] *See generally* Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1061–62 (1998) (describing, in part, several differences demonstrated through experiences interacting with unions that unionized firms, or firms in unionized industries).

[26] *See, e.g.*, Mark A. Lemley & A. Douglas Melamed, *Missing the Forest for the Trolls*, 113 COLUM. L. REV. 2117, 2161–62 (2013); Craig Allen Nard & John F. Duffy, *Rethinking Patent Law's Uniformity Principle*, 101 NW. U. L. REV. 1619, 1648 n.101 (2007).

[27] *See* Peter J. Gardner, *A Role for the Business Attorney in the Twenty-First Century: Adding Value to the Client's Enterprise in the Knowledge Economy*, 7 MARQ. INTELL. PROP. L. REV. 17, 20–21 (2003) ("The rise of in-house counsel . . . will force outside firms to provide still further 'specialized services on a . . . transaction-by-transaction basis' in areas such as 'litigation and quick, intense transactions,' 'rapidly changing and complex areas of law,' and areas where specific expertise is required to accomplish a particular task.") (citing Nelson & Nielsen, *supra* note 21, at 458); Abram Chayes & Antonia H. Chayes, *Corporate Counsel and the Elite Law Firm*, 37 STAN. L. REV. 277, 293 (1985) (observing that outside lawyers are chosen for a particular job, case, or role); S.S. Samuelson & L. Fahey, *Strategic Planning for Law Firms: The Application of Management Theory*, 52 U. PITT. L. REV. 435, 453 (1991); MICHAEL S. HARRIS ET AL., *Local and Specialized Outside Counsel, in* SUCCESSFUL PARTNERING BETWEEN INSIDE AND OUTSIDE COUNSEL 20:1 (Robert L. Haig ed., 2000).

[28] *See generally* JEFFREY PFEFFER & GERALD R. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE (1978) (finding resource dependency theory to suggest organizations base their external relationships on the uncertainty resulting from their environment); OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES, ANALYSIS AND ANTITRUST IMPLICATIONS: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION (Free Press 1975) (discussing how transaction cost theory focuses on how uncertainty influences decisions of the firm, specifically when deciding to vertically integrate).

Essentially all prospective litigation as a plaintiff firm implicates business plaintiffs' *risk sensitivity*. Prosecuting litigation necessarily requires an immediate substantial capital investment for a remote future reward.[29] This entails another predictable problem: plaintiff-side litigation requires an immediate substantial investment for a future reward. Most companies with sufficient business ventures to engender valuable business litigation have lucrative substitutes for the capital required to prosecute a complex commercial case, including developing new product lines, recruiting scarce or expensive talent, or expanding current manufacturing or distribution channels.[30] Companies with outside investors are also hesitant to incur voluntary expenses with uncertain prospective payoffs because they must justify these expenses both directly to investors and through publicly available reports and metrics.[31] Even a comparatively small additional expense may be received unfavorably in market reports, mandatory corporate disclosures, or in share prices.[32] Even sophisticated managers with incentives aligned with the company understandably hesitate to assume these costs for temporally distant and financially varying future payoffs.

And where these incentives diverge, principal-agent problems within the firm further exacerbate a company's justified aversion to financing litigation. Myriad plausible self-interested alternatives abound. Agents may prefer to divert company resources to themselves through higher salaries or perquisites.[33] More covertly, agents may instead prefer to divert resources to

[29] *See* Marco de Morpurgo, *A Comparative Legal and Economic Approach to Third-Party Litigation Funding*, 19 CARDOZO J. INT'L & COMP. L. 343, 347 (2011) ("Among the most innovative systems for financing civil litigation is the after-the-event third-party investment in litigation, a practice that contemplates third parties . . . investing in claimholder's litigation, covering all his litigation costs in exchange for a share of any proceeds if the suit is successful, or, in the alternative, nothing if the case is lost."). We discuss contingency-fee arrangements generally *infra* Section II.B, Part IV.

[30] *See, e.g.*, Binyamin Appelbaum, *Investors Put Money on Lawsuits to Get Payouts*, N.Y. TIMES, (Nov. 14, 2010), http://www.nytimes.com/2010/11/15/business/15lawsuit.html?pagewanted=all.

[31] *See* Steven T. Taylor, *CEO of a New Company Embraces a New Concept: Outside Investing in B2B Litigation*, 27 OF COUNSEL 24, Nov. 2008, at 16, 18; *see also* GARBER, *supra* note 3, at 15.

[32] *See generally* Nicholas Bloom, *The Impact of Uncertainty Shocks*, THE NAT'L BUREAU OF ECON. RES. (Sept. 2007), http://www.nber.org/papers/w13385.pdf (suggesting "that *changes* in stock-price volatility are . . . linked with real and financial shocks" and that firm-level shocks affect stock prices in general).

[33] *See* Chris Giles, *Curbs on Covetousness: Envy Can Make Capitalism More Efficient and Help to Restrain Executive Pay*, FINANCIAL TIMES (Feb. 2002), http://www.law.harvard.edu/faculty/bebchuk/pdfs/FT.Curbs.on.Covetousness.pdf ("[T]he pay and perks pacakges of CEOs better resemble 'rent extraction' than optimal contracting," and these compensation packages are the manifestation of the principal-agent problem between

preferred departments and subordinates rather than to an abstract legal conflict.[34] Agents may avoid prosecuting lawsuits fully because business cases involve extensive investigations of past firm and managerial conduct, and individually risk-averse agents may assume this investigation poses some risk to their positions.[35] And, of course, agents prefer not to incur present-tense costs on their charge in order to secure large gains for some future agent. For example, a company's general counsel typically holds significant reputational capital with other firms in the industry, with upstream vendors, and with downstream clients. Though it may be in the firm's best interest to sue one of these entities, prosecuting lawsuits against these entities may dissipate some of his portable and personal reputational capital. This aversion sharpens under many circumstances where traditional principal/agent problems increase, including an agent possessing desirable outside options or the credible possibility the agent will be fired.[36]

Even the rare business with substantial plaintiffs' experience, a legal department with substantial plaintiffs' experience, broad litigation knowledge (or a diverse set of business lines/models to defend), sufficient market capitalization, and broadly faithful agents sometimes abjures litigation simply due to mistrusting lawyers' incentives. Businesses want contentious litigation concluded quickly, efficiently, and at low cost. Businesses realize that law firms billing by the hour ordinarily want none of these. This risk would be sufficient if a business plaintiff bringing a suit had to contend with merely one law firm's adverse incentives; however, any substantial commercial litigation requires at least two firms—one for each

shareholders and managers). *See generally* Lucian Ayre Bebchuk, Jesse M. Fried & David I. Walker, *Executive Compensation in America: Optimal Contracting or Extraction of Rents?*, THE NAT'L BUREAU OF ECON. RES. (Dec. 2001), http://www.nber.org/papers/w8661.pdf.

[34] This is an expansion of the general principal-agent problem. *See* Sean Gailmard, *Accountability and Principal-Agent Models*, *in* OXFORD HANDBOOK OF PUBLIC ACCOUNTABILITY 90, 91–93 (Mark Bovens, Robert E. Goodin & Thomas Schillemans eds., 2014), http://www.law.berkeley.edu/files/csls/Gailmard_-_Accountability_and_Principal-Agent_Models(2).pdf (explaining that where the agent and principal have different preferences over the agent's possible actions, but the principal cannot directly control the agent's decision and there is no incentive for the agent to act in the principal's preferred manner, the agent will act per his own preferences).

[35] *See, e.g.*, Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 361, 413 (2008) (stating that a principal, i.e., a shareholder, may file suit against an agent, i.e., a CEO, who may be found guilty of securities fraud if he should have known—or was in a position to have known—of prior corporate fraud, even if the individual did not himself commit the fraud).

[36] *See generally* Robert Flannigan, *The Economics of Fiduciary Accountability*, 32 DEL. J. CORP. L. 393, 408–27 (2007) (surveying economics and law & economics literature on principal/agent problems and factors aggravating and mitigating this classic problem).

side—and, quite commonly, many more.[37] A business plaintiff therefore faces an unusual and difficult-to-monitor problem: hourly billing firms individually hesitate to hasten cases along, and it takes only one party's or firm's intransigence to increase costs on *all* parties.[38] This necessarily leads to substantial uncertainty in the ultimate costs in bringing even valuable and meritorious commercial litigation, and this uncertainty deters many potential plaintiffs.

Businesses would prefer something closer to a free option with partial recovery, even with a lower expected value, than to front litigation costs. Such an option would avoid both the risk and uncertainty of expensive litigation costs and the corresponding aversion to accounting for those costs to stakeholders. It would alleviate faithful agents' need to justify litigation expenses vis-à-vis immediately productive alternative investments, and discourage faithless agents' diverting litigation resources elsewhere. It would prevent the single most significant asymmetry in the lawyer/client relationship: the business's justified expectation that hourly billing discourages hasty dispute resolution. In exchange, the business could enjoy a partial future recovery of an already-sunk cost—the harm suffered from the underlying business tort—which it might have foregone altogether for fear of litigation expenses. A contingency-fee arrangement could obviously solve many of these problems; however, as we explain next, this incomplete solution is undesirable to most law firms.

B. Law Firms

Though contingency-fee billing broadly accommodates business plaintiffs' concerns, law firms sufficiently sophisticated to handle major business litigation rarely will, or even can, accept contingency-fee cases. Law firms are notoriously illiquid and leveraged business entities.[39] Major law firm principals draw their income proportionally from the firm's yearly

[37] Robert Rubinson, *A Theory of Access to Justice*, 29 J. LEGAL PROF. 89, 107 (2004–2005) (finding that the resulting legal team of cases involving large business organizations are generally made up of numerous lawyers from multiple firms and their personnel support); *see also* Richard H. Sander & E. Douglass Williams, *Why Are There So Many Lawyers? Perspectives on a Turbulent Market*, 14 LAW & SOC. INQUIRY 431, 471 (1989).

[38] Rubinson, *supra* note 37, at 113 (juxtaposing the hourly billing practice of lawyers at elite firms in the arguably slowly advancing commercial disputes to the lucrative, quick settlements that occur in personal injury cases where lawyers must take on numerous cases in order to generate significant returns).

[39] Jeremy Kidd, *To Fund or Not to Fund: The Need for Second-Best Solutions to the Litigation Finance Dilemma*, 8 J.L. ECON. & POL'Y 613, 617 n.21 (2012).

profits; law firm partners are therefore more attuned to a firm's income—and income stream—than almost any other business's officers.[40] Large law firm associates also represent substantial, consistent overhead for which firms must either earn predictable income streams or absorb costs.[41] A law firm solvent by an expected valuation of a contingency-fee case may find itself insolvent overnight if the case suffers an unexpected setback or adverse ruling.[42] Hourly-fee arrangements, by contrast, provide highly leveraged firms with predictability and smooth out income relative to contingency-fee arrangements.[43] In short, contingency-fee cases simply require leveraged and illiquid law firms to forego tantalizing income streams in favor of risky future payoffs.

Law firms' illiquidity and leverage derive from legal ethics rules strictly constraining firms' ownership, operation, and capitalization. The American Bar Association's Model Rules of Professional Conduct exemplify these constraints. First, the Rules essentially forbid law firms from hedging risk by diversifying business lines. Model Rule 5.4(a) forbids lawyers and firms from sharing fees with non-lawyers except in very limited circumstances.[44] Rule 5.4(b) backstops this prohibition by forbidding lawyers from forming partnerships that practice law with non-lawyers.[45] These restrictions segregate the for-profit practice of law from other professional services and other businesses; this restriction leaves law firms more vulnerable to market downturns.[46] The Rules then confine law firms to debt, rather than equity, to raise capital. Rule 5.4(d) prohibits lawyers from the for-profit practice of law within a corporation that conveys *any* interest—including any equity interest, down to common stock—on non-lawyers.[47] And Rule 5.4(d) then prohibits lawyers from practicing for corporations which contain non-lawyers as

[40] *See* Larry E. Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749, 755–56 (2010).

[41] *See id.* at 761–63.

[42] *See* Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 105 (2010).

[43] *See id.*

[44] For example, the Rules permit fee-sharing for the benefit of nonprofit entities in response to court-awarded legal fees when the entity referred the fee-generating lawyer. MODEL RULES OF PROF'L CONDUCT r. 5.4(a)(4) (AM. BAR ASS'N 2013) [hereinafter MODEL RULES]. Another exception permits fee-sharing as part of a profit-sharing or retirement plan with non-lawyers. *Id.* r. 5.4(a)(3). It suffices to say that none of the limited exceptions permit fee-sharing with a for-profit non-lawyer/non-law-firm corporate entity. *See id.* r. 5.4(a).

[45] *Id.* r. 5.4(b).

[46] *See* Thomas Markle, Comment, *A Call to Partner with Outside Capital: The Non-Lawyer Investment Approach Must Be Updated*, 45 ARIZ. ST. L.J. 1251, 1252–54 (2013); Ribstein, *supra* note 40, at 751–52.

[47] MODEL RULES, *supra* note 44, r. 5.4(d)(1).

corporate board members or officers, or which enable non-lawyers to direct lawyers' professional judgment.[48] Collectively, Rule 5.4's restrictions lock sophisticated law firms into the partner/associate model, its inherent illiquidity, its current undercapitalization, and its reliance on billing structures which avoid, rather than accept, economic risks. Contingency-fee cases simply prove too expensive and too risky for many of these firms.

This undercapitalization fundamentally aggravates the underlying misalignment between lawyers' and clients' incentives. A client matter extending in length guarantees future revenues but necessarily delays resolving or settling a dispute or consummating a transaction. Speedy and effective representations may guarantee future business, but a need for future legal services is highly unpredictable in the specific and broadly avoided in general. Lawyers and clients alike know that it is difficult for clients to monitor their attorneys' performance, and the Model Rules bar most of the time-honored and familiar methods for resolving this law firm undercapitalization problem in a way that also solves the attorney/client incentives problem.[49]

Law firms and clients develop novel business arrangements to circumvent Model Rule 5.4's antiquated and comprehensive business restrictions. Law firms understand the precarious economic position the Model Rules place the traditional law firm in; they also recognize their clients' view of the underlying adverse incentives between lawyer and client. Multiple arrangements have evolved to satisfy these problems. Some law firms adopt a contingency fee business model, operating with a larger capital cushion than rivals to absorb the periodic shocks from waiting on payoffs.[50] Large law firms' hiring practices post-crash is another response to this

[48] *Id.* r. 5.4(d)(2)–(3).

[49] Indeed, in-house legal departments are one of the only methods Model Rule 5.4 allows for companies to align generally a legal team's incentives with the firm's through long-term compensation arrangements and similar contracts.

[50] *See, e.g.*, Saucier v. Hayes Dairy Prods., Inc., 373 So. 2d 102, 105 (La. 1978) ("Such contracts promote the distribution of needed legal services by reducing the risk of financial loss to clients and making legal services available to those without means."); Alexander v. Inman, 903 S.W.2d 686, 696 (Tenn. Ct. App. 1995) ("Contingent fee arrangements serve a two-fold purpose. First, they enable clients who are unable to pay a reasonable fixed fee to obtain competent representation. Second, they provide a risk-shifting mechanism not present with traditional hourly billing that requires the attorney to bear all or part of the risk that the client's claim will be unsuccessful."); Neil F.X. Kelly & Fidelma L. Fitzpatrick, *Access to Justice: The Use of Contingent Fee Arrangements by Public Officials to Vindicate Public Rights*, 13 CARDOZO J.L. & GENDER 759, 768 (2008) (citing Landis v. Grange Mut. Ins. Co., 82 Ohio St. 3d 339, 342 (1998) (stating contingency fee agreements "permit persons of ordinary means access to a legal system which can sometimes demand extraordinary expense."); Markle, *supra* note 46, at 1263–64.

undercapitalization problem, decreasing reliance on expensive partner-track associates in favor of contract and staff attorneys with lower salaries and fewer expectations of job security.[51] These lower-paid attorneys may correspondingly be hired and fired to match expected work levels without firms suffering reputational costs.[52] And law firms operating outside the United States are not confined to American Bar Association restrictions—these firms may operate American offices or affiliates and nonetheless take advantage of many of the traditional benefits inherent in the corporate form, including capital-raising benefits.[53]

Third-party litigation finance offers law firms one more method to raise capital and smooth revenue streams despite an ethical framework apparently designed to inhibit both needs. But third-party litigation finance requires third-party litigation financiers; financiers with distinct motivations and concerns, separate from either lawyer or client. We next discuss where litigation financiers fit between litigation-cost-averse businesses and undercapitalized law firms.

C. Third-Party Financiers

Third-party litigation financiers are, first and foremost, investors. In general, investors all share a common want: the maximum possible risk-adjusted return on investment. Investors trade the time value of money and risk of loss in the underlying asset—the risk of an adverse decision in a case

[51] *See, e.g.*, Bernard A. Burk & David McGowan, *Big but Brittle: Economic Perspectives on the Future of the Law Firm in the New Economy*, 2011 COLUM. BUS. L. REV. 1, 95–97 (2011); Vanessa O'Connell, *The Rise of the Temp Lawyer*, WALL ST. J. (Jun. 15, 2011, 12:18 PM), http://blogs.wsj.com/law/2011/06/15/the-rise-of-the-temp-lawyer/; Anna Stolley Persky, *Under Contract: Temporary Attorneys Encounter No-Frills Assignments, Workspaces*, WASHINGTON LAW. (Jan. 2014), http://www.dcbar.org/bar-resources/publications/washington-lawyer/articles/january-2014-contract-lawyers.cfm.

[52] *See* Burk & McGowan, *supra* note 51, at 95–97.

[53] *See generally* Ashish Prasad & Ajay Mago, *Legal Process Outsourcing: A Guide to Important Considerations, Risk Mitigations & Achieving Success*, *in* DOING BUSINESS IN INDIA 2008: CRITICAL LEGAL ISSUES FOR U.S. COMPANIES (Practicing Law Institute, 2008); Kath Hall, *Educating Global Lawyers*, 5 DREXEL L. REV. 391, 393 (2013) ("[F]rom 2011 to 2012, the largest global law firms employed at least half of their lawyers in countries around the world. These firms also increased both the percentage of their lawyers working overseas and the countries in which they have operations. For example, . . . DLA Piper increased the number of lawyers working in thirty-two countries (expanding to three more countries) to 66%.") (citations omitted); *Offshoring Your Lawyer*, ECONOMIST (Dec. 16, 2010, 11:04 AM), http://www.economist.com/node/17733545.

for litigation financiers—for a return.[54] Third-party litigation financiers employ relationships within the legal sector, knowledge of specific law firms (and even specific lawyers), and knowledge of legal positions to evaluate cases.[55] This evaluation allows financiers to identify undervalued assets—namely meritorious cases which business plaintiffs hesitate to prosecute or to continue prosecuting—and to offer both business clients and law firms a partial solution to their respective problems.

Third-party litigation financiers are therefore simply an additional type of investor in a specialized two-sided market. Financiers understand businesses' hesitation to divert scarce company resources away from primary business lines to pursue even an obviously meritorious claim, and offer to assume these costs from companies (partially or wholly). Financiers also know that many sophisticated law firms cannot afford to carry protracted litigation costs, and that these dual economic issues aggravate an underlying incentives misalignment between law firms and clients. Substitutes to bringing or maintaining a case exist for business plaintiffs, including investing in other product lines, settling at a deep discount, insuring valuable interests (and thereafter subrogating claims), or reluctantly licensing or selling infringed or converted property. Likewise, law firms have several substitutes for carrying debt associated with covering the costs of a lawsuit, including contingency-fee agreements, alternative foreign business structures, and hiring fewer partnership-track associates. Third-party litigation financiers offer a service familiar to each side of the lawyer/client relationship, for which adequate substitutes exist on both sides, but for which no single device adequately resolves *both* parties' problems.

As we discuss next, third-party litigation financiers approach this conundrum familiar with the capitalization problems and incentives problems large law firms face, as well as the reasons for business plaintiffs' hesitation

[54] *See generally* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and The Theory of Investment*, AM. ECON. REV. 261, 262 (Jun. 1958) http://www.aeaweb.org/aer/top20/48.3.261-297.pdf ("According to the first criterion [profit maximization], a physical asset is worth acquiring if it will increase the net profit of the owners of the firm. But net profit will increase only if the expected rate of return, or yield, of the asset exceeds the rate of interest. . . . Investment decisions are then supposed to be based on a comparison of this 'risk adjusted' or 'certainty equivalent' yield with the market rate of interest.").

[55] AM. BAR ASS'N COMMISSION ON ETHICS 20/20: INFORMATIONAL REPORT TO THE HOUSE OF DELEGATES 22 (2011), http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111212_ethics_20_20_alf_white_paper_final_hod_informational_report.authcheckdam.pdf ("In order to protect their investments and to maximize the expected value of claims, suppliers may seek to exercise some measure of control over the litigation, including the identity of lawyers pursuing the claims, litigation strategy to be employed, and whether to accept a settlement offer or refuse it and continue to trial.").

to maintain expensive lawsuits. Financiers possess the sophistication to find and value appropriate business litigation cases and to manage and monitor law firms. They are not cost-sensitive—at least not in the same way—that business plaintiffs are. Nor are they illiquid or leveraged like law firms, and they, like any investor, come to any case willing to invest much-needed capital. But financiers come to the attorney/client relationship as a stranger, albeit an interested stranger; they lack the authority to settle the case, or even the standing to intercede in the attorney/client relationship.

This fundamental asymmetry—that financiers depend on the outcome of cases for their returns, but ultimately possess no formal controls over those cases' prosecution or settlement—shapes the entire third-party litigation finance contract. As we discuss next, third-party litigation financiers select clients, cases, law firms, and contractual terms to ensure repayment without violating the attorney/client relationship's boundaries. Overcoming this challenge while still addressing business plaintiffs' and law firms' unique economic needs defines the litigation financier's role.

III. A THIRD-PARTY LITIGATION FINANCE AGREEMENT

Litigation financiers approach potential cases with the above-discussed economic problems in mind. The case requires both a cost-averse business plaintiff and a law firm equally unwilling or unable to shoulder the risks and costs of business litigation going forward. Further, litigation financiers must structure agreements to ensure recovery despite a lack of formal controls over settlement and litigation. We next discuss how these elements shape what cases litigation financiers approach for investment, how litigation financiers structure relationships and contracts, and how various mechanisms protect financiers' interests without impermissibly intermeddling in the attorney/client relationship.

Business plaintiffs' incentives partially shape which cases third-party litigation financiers find attractive. For a case to have any surplus for a litigation financier to share, it must be prohibitively expensive for the business company to pursue, yet valuable for an outside party. If litigation financiers bring external expertise and capital to litigation, the most valuable cases will be ones in which business plaintiffs most suffer from a lack of expertise in the relevant area and for which defendants enjoy the greatest potential premiums in settlement terms for having disproportionate litigation resources. "Non-core" business cases—cases in which business plaintiffs have no reason to be familiar with the substantive area of law at hand—provide the best opportunities for litigation financiers to add value by adding expertise.[56] Business plaintiffs are, in turn, less likely to view these non-core cases as essential to their business, either retrospectively or prospectively. In retrospect, non-core business cases are less likely to involve long-term business relationships, repeat occurrences or transactions, or incidents which arose from the firm's long-term strategic decisions. They therefore implicate fewer prospective concerns about the ongoing relationships and business decisions which drive the business plaintiff's central business lines and ongoing enterprises.

Cases in areas of law with exceedingly favorable remedial schemes, such as antitrust and patent claims, also present desirable investment opportunities.[57] These areas commonly feature defendants that are highly averse to actually trying a case to judgment, but that are prepared to use an advantageous asymmetrical financial position to bargain down settlement prices.[58] In these regimes, the defendant's knowledge that the plaintiff has obtained additional capital to litigate drives up a given case's settlement value.[59] Conversely, legal areas with favorable remedial schemes typically create costs and risk imbalances that favor plaintiffs, especially sophisticated or experienced plaintiffs.[60] Patent, antitrust, and similar cases offer potent tools for enthusiastic plaintiffs: preliminary injunctions, permanent injunctions, attorneys' fees, treble damages, and highly variable punitive damages awards.[61] Where business plaintiffs may have a natural aversion to engaging in these cases due to their complexity and expense—at least when they can reasonably avoid it as a business decision—these substantive legal areas present ripe opportunities for the basic trade for any litigation financier:

[56] Anthony J. Sebok & W. Bradley Wendel, *Duty in the Litigation-Investment Agreement: The Choice Between Tort & Contract Norms When the Deal Breaks Down*, 66 VAND. L. REV. 1831, 1833 (2013), http://scholarship.law.cornell.edu/facpub/670 (noting that "litigation investment is a way to manage the risk associated with litigation while bringing to bear the particular subject matter expertise of a risk-neutral institutional actor").

[57] As a previous paper noted, these investment opportunities are desirable precisely in part because the remedial opportunities for these business wrongs often largely outstrip any economic harms they present. *See generally* Shepherd, *supra* note 1.

[58] *Id.* at 594 (stating that third-party financing can reduce any barriers to justice may result from financially constrained plaintiffs bringing suit against well-financed defendants).

[59] *Id.* at 595. Note, again, that this additional settlement value need not correlate to any additional social welfare presented by the potential case.

[60] *Id.*

[61] *See, e.g.*, 2008 ANNUAL REPORT & ACCOUNTS, JURIDICA INVS. LTD. 9 (2008), http://www.juridicainvestments.com/~/media/Files/J/Juridica/pdfs/2008_Annual_Report.pdf (noting that antitrust litigation under the Sherman Act or Clayton Aact allow for the possibility of statutory treble damages); Shepherd, *supra* note 1, at 595 (noting patent infringement cases allow for the possibility of preliminary injunctions & treble damages, attorneys' fees, and permanent injunctions).

litigation risk for profit. A third-party litigation financier therefore prefers cases in these potent legal regimes precisely because a risk-accepting plaintiff enjoys a wider and more indulgent panoply of remedies that can be traded for better settlement terms or a larger judgment.[62]

Sophisticated law firms' undercapitalization also contributes another narrowing criterion for litigation financiers: cases must typically be prohibitively *expensive* or have a payoff too temporally remote for law firms to carry these potentially profitable suits themselves. Business plaintiffs can, and likely will, bear relatively inexpensive cases with sufficiently certain and temporally proximate payoffs. Law firms may assume some of the litigation risk through a contingency-fee arrangement where a favorable settlement is both likely and proximate, assuming the firm has some information advantage over the business plaintiff on the outcome of the litigation and the costs are sufficiently low. But law firms cannot or will not carry the risk of many commercial cases, at least not without making contingency fee litigation their primary business model.[63] Investment-grade cases are therefore typically expensive either through expected or already realized litigation costs. These cases are lengthy, or at least potentially lengthy—in the most threatening remedial regimes, dilatory tactics are common—and with distant or variant future payoffs.[64]

[62] *See The Fund*, JURIDICA INVS. LTD., http://www.juridicainvestments.com/about-juridica/the-fund.aspx (last visited Oct. 10, 2015); Jason Douglas, *UPDATE: Burford Capital Raises GBP80 Million In 5th AIM Float of '09*, DOW JONES NEWSWIRES (Oct. 16, 2009, 6:23 AM), http://www.advfn.com/news_UPDATE-Burford-Capital-Raises-GBP80-Million-In-5th-AIM-Float-OF-09_39926053.html (reporting that Burford's CEO has stated their focus is on cases with big rewards such as "patent thefts, antitrust proceedings or corporate torts"). In this sense, third-party litigation financing, strictly speaking, encourages *some* additional litigation: it reduces risk to business plaintiffs to bring highly technical cases in non-core businesses for meritorious claims in remedy-rich legal areas. This is, of course, a far cry from the comparatively unsophisticated claim that third-party litigation financing encourages "frivolous litigation," a claim that, as we demonstrate below, necessarily contradicts the essence of the litigation financier's business model. But this somewhat subtler claim presents a different question of social benefits and social costs, and we discuss this below. *See infra* Part IV; *see also* Shepherd, *supra* note 1, at 610 ("[A]n increase in litigation among the types of cases where cost and risk imbalances lead to inefficient case outcomes will magnify [some] inefficiencies.").

[63] *See, e.g.*, John S. Dzienkowski & Robert J. Peroni, *The Decline in Lawyer Independence: Lawyer Equity Investments in Clients*, 81 TEX. L. REV. 405, 546 (2002); *see generally* A. Barry Cappello, *A Contingency Fee Business Litigation Practice*, 23 AM. J. TRIAL ADVOC. 189 (1999).

[64] *See generally* John H. Beisner, *Discovering a Better Way: The Need for Effective Civil Litigation Reform*, 60 DUKE L.J. 547, 549 (2010) (describing how "[d]iscovery abuse . . . represents one of the principal causes of delay and congestion in the judicial system"); Jeanne L. Schroeder, *The Midas Touch: The Lethal Effect of Wealth Maximization*, 1999 WIS. L. REV. 687,

The fundamental trade in a third-party litigation financing arrangement is, like virtually all investments, immediate capital for future returns: the financier provides immediate capital to prosecute the case in exchange for a percentage of the future recovery. Of course, the most direct way to guarantee some return in a litigation investment is to settle a case, preferably after a favorable ruling on a potentially dispositive motion.[65] This introduces a new economic problem: the financier is not the client.[66] The client—the business plaintiff—retains the essential tools to direct the course of the litigation, and therefore, to choose between the essential paths at the various decision nodes that every case may encounter.[67] Whether to settle a case is the most substantial tool in directing a case's potential payout.[68] But the business plaintiff also retains the powers any client retains over counsel: to hire local or outside counsel, to pursue (or waive) various procedural or forum-selection tactics, such as changes of venue, arbitration, or administrative adjudication, to pursue various theories of the case, to retain one or more experts, to fire counsel, or to dismiss the case altogether (in this circumstance, to file another time).[69] These decisions, each deriving from the power to direct

689 (1999) (describing how wealth—or value—is made up of money and time, and generally individuals and corporations are wealth maximizers).

[65] *See generally* BRUCE A. ERICSON, BUSINESS & COMMMERCIAL LITIATION IN FEDERAL COURTS § 33:24 (2013) (describing that, for cases with an uncertain legal theory, a motion testing legal theory of case can reduce uncertainty and encourage settlement); Michael Greenberg, *The Forum Non Conveniens Motion & the Death of the Moth: A Defense Perspective in the Post-Sinochem Era*, 72 ALB. L. REV. 319, 331–42, 332 n.65 (2009) (describing the "death knell" effect of a successful forum non conveniens motion on a potential case and potential settlement effects).

[66] *See generally* U.S. CHAMBER INST. FOR LEGAL REFORM, SELLING LAWSUITS, BUYING TROUBLE THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES 1 (2009), http://legaltimes.typepad.com/files/thirdpartylitigationfinancing.pdf.

[67] *See generally* Andrew F. Daughety & Jennifer F. Reinganum, *The Effect of Third-Party Funding of Plaintiffs on Settlement* 5 (Vand. U. Cent. for the Study of Democratic Insts., Working paper No. 01-2013, 2013), http://www.vanderbilt.edu/csdi/research/CSDI_WP_01-2013.pdf (finding under game-theoretic model that plaintiff necessarily maintains control over the suit due to her private information as to the suit, and that she makes the decisions about settlement bargaining and trial).

[68] *See* Sebok & Wendel, *supra* note 56, at 1839 (suggesting that a plaintiff might have accepted a settlement in the absence of a third-party funder, however may re-think that decision as it is disadvantageous to the investor); Daughety & Reinganum, *supra* note 67, at 1 (emphasizing that "*optimal* loans" from third parties "induces *full* settlement" of a case) (emphasis added).

[69] Symposium, *Third-Party Litigation Financing,* 8 J.L. ECON & POL'Y 257, 262 (2011) [hereinafter *Third-Party Litigation*] (quoting Paul Sullivan, a Senior Vice President at Juridica Capital Management, a firm that provides a form of litigation financing, stating that his company does "not have control over litigation strategy or settlement decisions. Because litigation strategy and settlement decisions remain in the control of the plaintiff or defendant, Juridica needs to make

the litigation, can, and probably will, affect a case's expected value. The financier controls—*may* ethically control—exactly none of these.[70]

Instead, financiers exert all the influence they can, and, indeed, all the influence they will ever have in the contract-formation stage of the investment. Financiers typically enter cases in one of two postures: at the outset, when contractual incentives will apply to the most future decisions, or in the shadow of a case's insolvency, when more investment-adverse decisions have been made, but the client, firm, or both strongly desire the financier's intervention and will consent to more stringent terms.[71] But the financier must secure his investment in the formation of the contract as much as he can, because he can never formally affect the litigation's outcome, and can, at most, informally affect the client's decisions only lightly, and at the client's request. Depending on the posture, the case, and individual negotiations, financiers design the investment contract including *ex ante* and *ex post* incentives—relative to the investment contract—to ensure both business clients and law firms secure the financier's returns.

Ex ante protections broadly include all screening choices the financier can make prior to the contract's formation. These predominantly include choosing parties in the relationship: there are many more avenues seeking investment money, even litigation investments, than financier dollars.[72] Litigation financiers thoroughly screen clients for business sophistication, solvency, and realistic expectations. Financiers will occasionally outright purchase a claim from an undesirable client when the case seems especially

sure that the plaintiff or defendant is incentivized to make decisions that, although they are self-interested, benefit us as well because of our alignment").

[70] *See* Burch, *supra* note 1, at 1320 (citing MODEL RULES OF PROF'L CONDUCT r. 1.2(a) (AM. BAR ASS'N 2011) (requiring a lawyer to "abide by a client's decisions concerning the objectives of representation" and to "consult with the client as to the means [for pursuing those objectives]")) (stating that funders are currently prohibited "from interfering with or controlling litigation"). This is not to say that a litigation financier does not assert some influence over these decisions through the litigation contract; of course he does. But litigation finance contracts do not disturb formal mechanisms of control over any of these decisions; at most, litigation financiers insist on retention of or termination of, for example, a given law firm *prior* to executing a finance agreement. This is one of multiple *ex ante* screens, discussed above, that helps align an financier's and a business plaintiff's incentives in maximizing recovery in light of litigation risk and time preferences.

[71] *See* Shepherd, *supra* note 1, at 598–99 (stating that in situations where contingency fee arrangements don't provide justice for risk-averse individuals facing large financial barriers, financiers can provide the financing for meritorious suits that would otherwise not be filed).

[72] According to Richard Fields, an article in a major national newspaper in which Juridica Investments indicated it sought cases in which to invest yielded over 12,000 responses soliciting an investment, a consultation, or further investigation. *See generally* Richard Fields Interview, *supra* note 4. Of these, Juridica made four investments. *Id.*

meritorious and the law firm especially competent; in this sense, the amount of the financier's investment (as a fraction of the expected recovery) may be viewed as an *ex ante* protection. Financiers may also condition investment in the case on retaining preferred counsel, local counsel, or terminating current counsel.[73] While this could present serious ethical problems from within the attorney-client relationship, it seems both wholly defensible and similar to other business arrangements surrounding the attorney-client relationship as a condition for extrinsic funding.[74] Financiers will also examine the solvency and history of the law firm to ensure the lawyers on the case are prepared to partially assume the risk of the case—a necessary incentives-aligning function of any finance arrangement.[75]

Financiers also stringently investigate cases' expected value aside from the plaintiff and firm prosecuting the case. This involves two dimensions: investigating the merits of the case and examining the profitability of the attendant legal regime.[76] Financiers independently review a case's legal theories and evidence, retaining or examining experts when necessary to externally evaluate the business plaintiff's probability of success on the merits.[77] Financiers also adjust these expectations where necessary by taking account of the judge and venue. Some forums systematically skew towards

[73] *See Third-Party Litigation*, *supra* note 69, at 261 (Paul Sullivan stating that his company, Juridica, is "unlikely to invest in cases with a misalignment of interests between the client and counsel . . . . Actually, we spent a lot of time vetting the lawyers and evaluating the lawyers as a part of our due diligence process.").

[74] *See id*. Contrast this perspective with Model Rule of Professional Conduct 1.16's official comments, which provide that a lawyer has an option to withdraw only for misuse of services (or similar, for-cause grounds), if withdrawal will not impose a "material adverse effect on the client's interests," or if the client fails to adhere to an already-made agreement regarding the representation, such as regarding fees. MODEL RULES OF PROF'L CONDUCT r. 1.16 (AM. BAR ASS'N 2011). By implication, the necessity of a failure to abide an agreement presupposes an agreement to be broken; in other words, that an attorney may not withdraw simply because a client has failed to agree with the attorney regarding outside counsel to employ or methods to use in prosecuting the case. In fact, Model Rule 1.2(a) assigns these responsibilities expressly to the client. *Id.* r. 1.2(a); *see* MODEL RULES, *supra* note 44, r. 1.16(b)(1), cmt. 7, r. 1.2. But these duties attach, by definition, to lawyers, and not to outside investors.

[75] *See generally Third-Party Litigation*, *supra* note 69, at 261; *see also* Richard Fields Interview, *supra* note 4.

[76] *See generally Third-Party Litigation*, *supra* note 69, at 260.

[77] *Id.* (Paul Sullivan states that "Third-party capital tries to identify good cases in which to make an investment—similar to a portfolio manager identifying a good stock, or a contingency fee lawyer deciding on which cases to invest his or her time. [Alternative litigation financing], therefore, looks for efficiency, predictability, transparency, and timely returns to drive results. We look for cases that can be completed efficiently and in a timely manner, and for cases where the lawyers and the clients are trying to drive cost out of the process and reduce risk because we are usually being asked to finance those costs.").

plaintiffs or towards defendants, of course. But some forums skew towards lengthier case durations where others are famously, even notoriously, efficient.[78] Still other forums famously prefer motion practice, while others resolve as many issues as possible in front of juries.[79] Finally, financiers evaluate the remedial scheme in the legal regime surrounding the case. Cases with more generous remedial systems, including punitive damages and attorneys' fees, enjoy several positive effects for a financier. Generous remedial regimes encourage defendant settlement, drive up the price of settlement, and increase the probable recovery in a jury trial.[80] These factors each inform a financier's evaluation of a case's investment quality; financiers prefer speedy, predictable case resolution, with forums favoring plaintiffs, under generous remedial regimes.

The financier's *ex ante* filters rely on information advantages and generate positive externalities by signaling this information to other players in the case and surrounding legal world. Financiers act as legal arbitrageurs in one sense, purchasing or investing in undervalued cases that business plaintiffs might otherwise abandon, and thereby transmitting signals to other participants about what makes a case valuable.[81] Financiers send signals to defendants as to the strength of plaintiffs' cases, and to judges and legislatures as to which venues and legal regimes offer comparatively promising payoffs.[82] Fair

[78] *See, e.g.*, Mark A. Lemley, *Where to File Your Patent Case*, 38 AIPLA Q.J. 401, 415–18 tbl.5 (finding that there are "rocket docket" districts, such as the Western District of Wisconsin and Eastern District of Virginia that resolve the average patent case in just over six months, and that some of the slowest jurisdictions include the Eastern District of Texas, Northern District of California and the Eastern District of Pennsylvania, where the average time to disposition is about 15-16 months).

[79] *See, e.g.*, Timothy C. Meecee, *Litigation in East Texas After the Federal Circuit's Decision in* TS Tech, BANNER & WITCOFF: INTELL. PROP. UPDATE, Spring 2009, at 1, http://www.bannerwitcoff.com/_docs/library/articles/05.09%20Meece%20Client%20Newsletter.pdf (stating that 93% of East Texas jurors favor protecting inventions with patents).

[80] *See* Shepherd, *supra* note 1, at 594 (describing how in patent and price-fixing cases defendants face numerous potential losses at trial, including treble damages and large attorneys' fee awards, and discussing how these costs weaken defendants' bargaining positions and lead to systematically larger than expected trial outcomes and settlements).

[81] Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1305 (2011) [hereinafter Steinitz, *Whose Claim Is This Anyway?*] (citing Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 972–73 (1979) (explaining the ways in which information is transferred in litigation and negotiation)) (describing how "an institutional commercial funder's willingness to fund a law suit, if known to the opposing party, may itself function as a signal to the opposing party regarding the strength of the claim").

[82] *Id.*; *Third-Party Litigation Financing*, *supra* note 69, at 277 (Professor Michelle Boardman stating that in insurance cases, an "insurance defense payment for the defendant creates an imbalance for the plaintiff" and that this related claim that is made, "which is that the insurer

arguments can be made against a system where information signals on any of these points are possible: after all, the value of a signal regarding the desirability of a given court takes as an assumption that courts are not all alike, which is to say that legal outcomes result from more inputs than simply the law.[83] These arguments are lost on the litigation financier; and, considered carefully, should never have been directed to him in the first place. Litigation financiers do not create a system where navigating different forums can affect the potential payout of a case—they merely acknowledge and overtly monetize it.

The financier's *ex post* filters rely on contractual terms that align the client's and law firm's potential decisions with the financier's payment. The financier is one part of a triangular relationship: he must influence both the business plaintiff and the law firm, and in somewhat different ways. The financier must ensure the business plaintiff pursues the highest time-justified payout possible from the litigation. Reasonable trade-offs may exist between a quick settlement for 50% of a claim's value, a slow settlement for 80% of a claim's value, and going to verdict for potentially more than a claim's expected value, but the financier must ensure the business plaintiff neither dithers to accept a reasonable settlement nor hastens to accept a mediocre one. The financier must also ensure the law firm efficiently and effectively prosecutes the litigation to the maximum cost-justified payout: neither allowing a case to develop slowly as a long-run revenue stream to the law firm nor over-staffing it to justify expensive and new associates. Devices familiar to both finance and the principal-agent literature abound for each of these problems.

The financier influences the business plaintiff's behavior going forward principally by structuring the investment contract to mandate the financier's repayment first. The simplest device is the most common: financiers require repayment of at least their initial investment, usually with a minimum acceptable return, before any other constituency is paid.[84] This "first money out" policy disproportionately front-loads the financier's expected fraction of

providing the defense is like an imperator, it is like a signal to the other party and to the court that the defendant has a good case. And, if you allow a third-party funder to come in, that is a counter-billing signal, and the funder thinks that the plaintiff has a good case.").

[83] *See, e.g.*, LEE EPSTEIN ET AL., THE BEHAVIOR OF FEDERAL JUDGES: A THEORETICAL AND EMPIRICAL STUDY OF RATIONAL CHOICE (2013); Joanna M. Shepherd, *Money, Politics, and Impartial Justice*, 58 DUKE L.J. 623, 670–72, tbls. 7, 8 (2009).

[84] *See, e.g.*, Maya Steinitz, *The Litigation Finance Contract,* 54 WM. & MARY L. REV. 455, 467–71 (2012) [hereinafter Steinitz, *Finance Contracts*] (describing Burford Capital's payment arrangements in *Chevron/Ecuador*); Steinitz, *Whose Claim Is This Anyway?*, *supra* note 81, at 1276–78; *see also* Richard Fields Interview, *supra* note 4.

payment in the case both to discourage the business client from settling for too little as well as to ensure the business plaintiff retains some incentive to maximize the total recovery. This first money out policy sometimes accompanies a "waterfall" payment structure, where the financier receives a decreasing marginal rate of money across tranches of payments.[85] For example, the financier might receive 100% of the first $2M in any settlement or verdict, but 75% of the next $2M, 50% of the next $2M, and a quarter of everything beyond $6M the case yields. This decreasing marginal return again encourages the business plaintiff to maximize total recovery. As a backstop to both of these tactics, and a partial substitute to the former, the financier may take collateral in a tangible asset, contingent on recovery: this turns the investment into effectively a secured loan, and is a tolerable substitute—but better complement—for guaranteeing repayment.[86]

The financier controls the law firm principally by converting an hourly-fee arrangement into a hybrid billing structure. Rather than requiring the law firm assume the risk of the case completely, as in a contingency fee arrangement, the financier provides a fixed amount of money for going-forward litigation costs, to be earned hourly, combined with a contingency fee. This contingency fee may be a percentage of the total recovery or a fixed sum, but is always paid after the financier receives his initial investment and base return—and either on equal step with, or before, the business plaintiff, depending on the agreement.[87] The financier advances an amount of money significantly *less* than the expected litigation costs, including any arrears the business plaintiff may owe the law firm. This deficit ensures the law firm retains a meaningful incentive to recover *more* than the financier's initial investment; the first money out policy means that the law firm must ensure the financier is paid in full before it receives essentially the balance of its

[85] *See generally* Maya Steinitz & Abigail C. Field, *A Model Litigation Finance Contract*, 99 IOWA L. REV. 711, 713, 745–48 (2014); Steinitz, *Finance Contracts*, *supra* note 84, at 467–68; Steinitz, *Whose Claim Is This Anyway?*, *supra* note 81, at 1276–78; Richard Fields Interview, *supra* note 4; Roger Parloff, *Have You Got a Piece of This Lawsuit?*, FORTUNE (June 28, 2011, 6:06 PM), http://features.blogs.fortune.cnn.com/2011/06/28/have-you-got-a-piece-of-this-lawsuit-2.

[86] Our discussions suggest this is comparatively rare, and some of the scholarship in this area discusses third-party litigation finance arrangements as nonrecourse debt, whereby the financier's *only* security for his loan is the underlying case. *See, e.g.*, Steinitz & Field, *supra* note 85, at 720 (describing traditional structure as nonrecourse). We believe this is not true, though we acknowledge that litigation finance agreements are notoriously confidential, and that the industry is notoriously "opaque." *See id.* at 719 (noting opacity of industry).

[87] *See, e.g.*, GARBER, *supra* note 3, at 25–28; Steinitz, *Finance Contracts*, *supra* note 84, at 467–71 (describing Burford Capital's payment arrangements in *Chevron/Ecuador*); Steinitz, *Whose Claim Is This Anyway?*, *supra* note 81, at 1276–78; *see also* Richard Fields Interview, *supra* note 4.

expected fees. More aggressive firms may prefer a percentage recovery past the financier's recoup amount to a fixed dollar recovery; this depends entirely on the individual contract. The financier also monitors the hours earned and accrued, essentially allowing or disallowing billed hours akin to a sophisticated client—and by default pushing law firms to generally more productive and cost-effective litigation strategies.

Ex post screens broadly generate welfare and positive externalities by reducing agency costs. Business plaintiffs no longer suffer adverse incentives between internal principals and the firm or between the firm and shareholders by resisting profitable litigation out of concern for justifying litigation expenditures. Potentially faithless agents no longer struggle to divert litigation expenditures back to themselves or preferred firm constituencies. Law firms' adverse incentives to extend cases into the future are quelled two ways. First, law firms know with certainty the fixed pool of hourly fees they can generate from the case, and second, law firms enjoy some incentive to bring a case to its conclusion to receive the contingent portion of their fee. This new fee structure, combined with the financier's monitoring of billed hours, reduces the business plaintiff's agency costs vis-à-vis the law firm.

Note that each of these *ex post* screens responds to business plaintiffs' and law firms' core economic concerns. The *ex post* screens financiers apply to business plaintiffs guarantee that the business plaintiff need spend little to no additional future money on the litigation, and retains a large portion of a substantial future return. Yet the financier structures both his finance arrangement and his prospective return to ensure that the business plaintiff, effectively a stranger, makes litigation and settlement decisions which will maximize the time- and risk-adjusted payoff for both the financier and the business. The *ex post* screens to law firms guarantee a known and fixed revenue stream for a known future and require only a manageable amount of risk exposure to an otherwise financially exposed firm. Yet the financier monitors the law firm's activities and billed hours more stringently than most business plaintiffs could, and only *partially* finances future litigation expenses, requiring law firms to earn their keep in the ultimate settlement or verdict.

Litigation financiers reinforce these *ex ante* and *ex post* screens by hedging risk outside of individual cases as well. Like any investor, litigation financiers first hedge against risk by buying stakes in large pools of litigation, purchasing portions of many cases rather than a few cases in entirety. This partially explains most litigation financiers' ideal case value—from several million to $25M in expected payout—as the major litigation finance firms currently can afford a tranche of diverse cases at this rate, but only a handful of much larger cases.[88] Litigation financiers may also insure their judgments: for example, through appeal gap insurance, which protects against a favorable judgment being overturned on appeal.[89] Multiple similar forms of insurance against the disturbance of a favorable judgment are available.

Viewed broadly, third-party litigation financiers occupy an economically and legally familiar position. To the extent that financiers purchase stakes in cases that they fundamentally do not own, they merely take a position familiar to finance and corporate law: that of a claimant not entitled to control over an asset.[90] To the extent that financiers assume a business plaintiff's downside risk and cost from potential litigation, they merely take the place of any common insurer or risk-sharer. To the extent that financiers provide a capital cushion and liquidity while monitoring law firms' expenditures, they resemble and have similar interests to a general creditor.[91] Unfortunately, because of the relative obscurity and comparative novelty third-party litigation financiers hold in each of these three functions, litigation finance as a practice has drawn several meritless (and a few understandable) criticisms. We next evaluate several common criticisms of third-party litigation financing, explaining the practice's benefits and costs and displaying how remarkably *unremarkable* the practice really proves.

IV. ARGUMENTS FOR AND AGAINST THIRD-PARTY LITIGATION FINANCING

We next address both the benefits and criticisms of third-party litigation financing. To appreciate both these benefits and potential drawbacks, it is

[88] Richard Fields Interview, *supra* note 4; *see also* BURFORD CAPITAL, LITIGATION FINANCE: AN INTRODUCTION 4 (2013), http://www.burfordcapital.com/wp-content/uploads/2013/08/Booklet-Intro-to-Litigation-Finance-FINAL-Web-2013-08-16.pdf (describing financier's investments in cases as "sometimes up to $15 million and beyond" while maintaining approximately $300 million under management).

[89] Note: in some sense, this is insurance on insurance on insurance. To the extent we view litigation as a substitute for insuring non-core business assets, and that third-party litigation financing acts as a substitute for insurance, this insurance is the third vertical level in risk spreading. Doubtless one could investigate these appeal gap insurance policies' underwriters further to discover further levels, but that is beyond the scope of this paper.

[90] *See, e.g.*, Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. 897, 908 (2010) ("A corporation . . . does not allow the co-owners to act independently (unless they agree otherwise). Instead, shareholders act together to elect directors who are given control over the assets.").

[91] *See generally* Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 WASH. U. L.Q. 1005, 1008–13 (1994) (discussing uses of credit for firms in financial stress and also corresponding influence creditors have over these firms as a consequence, including restrictive covenants, management changes, and influence over similar business decisions).

important to emphasize that many concerns critics raise to new financial devices do not apply to commercial litigation financing. First and foremost, litigation finance is a voluntary arrangement between almost exclusively sophisticated parties with recourse to multiple other options, both business plaintiffs and law firms alike. The possibility that litigation finance will somehow deprive business plaintiffs or law firms of free agency in either the attorney-client relationship or at the investment contract formation stage is deeply implausible. Note the wide distinctions between commercial third-party litigation finance and, for example, personal injury third-party litigation finance: commercial litigation parties are almost uniformly sophisticated and can deal with financiers and law firms at arm's length. To the extent we contrast business plaintiffs with individuals unable to meet basic needs due to an injury, business plaintiffs are undoubtedly more elastic regarding the cost of money than individuals, and are therefore less susceptible to coercion, overreaching, or even simple unfairness. In a civil justice system predicated on private ownership of private claims, this independence and arm's-length bargaining is worth substantial deference.

But most benefits to third-party litigation financing are private, easily overlooked, and internal to parties within the system. Criticisms ignore these benefits, fail to perceive these benefits, or presume the litigation financing agreement imposes external costs on the general public. We therefore first summarize the benefits of third-party litigation financing, as we've discussed above, before turning to the most common criticisms of litigation financing. We then compare litigation financing to several more familiar business and political arrangements to illustrate that current criticisms of litigation finance are broadly misplaced.

A. Benefits of Third-Party Litigation Financing

The benefits to business plaintiffs are obvious: third-party litigation financing transforms an expensive and burdensome lawsuit into essentially a free option. Business plaintiffs pursuing third-party litigation financing worry about the potential downside risk to litigation: lengthy proceedings and variant expenses. As outlined above, initiating litigation unexpectedly diverts resources from within a business, introducing principal-agent problems and increasing agency costs to the business plaintiff.[92] The business plaintiff's

[92] *See supra* Section II.A. and accompanying notes; *cf.* Burch, *supra* note 1, at 1291, 1316 (discussing the agency costs that arise in aggregate litigation because of the contingent-fee attorney's dual roles as agent and investor, and suggesting third-party litigation financing as the solution to this conflict of interest).

directors and officers must justify litigation expenses to shareholders or other investors; its employees and principals will resist even profitable litigation to preserve resources for favored departments or to reduce perceived individual responsibility for any blameworthy conduct underlying the case.[93] Litigation also inflicts information, monitoring, transaction, and decision costs on the business plaintiff: the business plaintiff must select and retain a law firm, monitor the law firm's litigation decisions and billing, and so on. In short, litigation is deeply disruptive to all but the largest or most litigation-experienced businesses.[94] These costs and risks drive many business plaintiffs away from litigation; these business plaintiffs would otherwise settle immediately at a substantial discount,[95] forego bringing a case altogether, or drop a case that has already been filed.[96]

Litigation financiers ameliorate these problems partially or completely. Litigation financiers provide the initial or ongoing investment necessary to operate a lawsuit, obviating the need for the business firm to divert capital from business lines. This in turn eliminates or reduces these myriad agency problems. Litigation financiers also align law firms' incentives by requiring law firms to take on some portion of risk in the form of future, contingent payment, and monitor firm billing against the guaranteed funding by the financier, reducing the business plaintiff's monitoring costs.[97] Third-party investment presents an enticing trade to business plaintiffs: business plaintiffs

[93] *See* GARBER, *supra* note 3, at 15 ("[I]n some instances, corporate legal departments may prefer using outside capital to requesting additional funds from corporate management to pursue litigation opportunities that were not identified in time to be considered in budgeting processes.").

[94] *See id.* at 15–16.

[95] As we discuss below, objections that litigation financing increases settlement prices raises distributional concerns between tortfeasor defendants and external litigation financiers. These concerns, while valid, have ambiguous social utility consequences at best. *See generally* Part IV.

[96] This of course reflects the anodyne and well-accepted fact that to increase a good's cost is to reduce the amount a rational actor will consume of that good—including litigation. *See generally* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 529–31, 575–77 (1991) (discussing costliness of litigation in securities context, transaction costs imposed on defendants and resultant unwillingness to litigate, and effects of contingency-fee arrangements on plaintiffs in securities cases); Claire A. Hill, *Bargaining in the Shadow of the Lawsuit: A Social Norms Theory of Incomplete Contracts*, 34 DEL. J. CORP. L. 191, 208–10 (2009) (discussing the complex transacting community's strong norm against litigation and noting that "[o]nce the norms for negotiating and contracting are established, seeking additional increments of precision may signal one's propensity to litigate, which in turn may signal that one is a less desirable transacting partner"); Richard L. Schmalbeck & Gary Myers, *A Policy Analysis of Fee-Shifting Rules Under the Internal Revenue Code*, 1986 DUKE L.J. 970, 975–76 (1986) (referencing fee-shifting statutes in tax context and discussing how potential attorneys' fees and related litigation expenses deter even potentially meritorious claims).

[97] *See* GARBER, *supra* note 3, at 15–16.

give up a large fraction of the potential gains from litigation, but almost *all* of the underlying risks and costs.[98] The resulting deal is a free, positive-value option, which even very conservative business plaintiffs find irresistible.

Litigation financiers also reduce present and future information costs to business plaintiffs through their *ex ante* screening functions. Litigation financiers act as independent checks on the company's assessment of its case, its legal theories in that case, and its law firm.[99] Litigation financiers' conditions before the investment contract provide useful signals to companies. Some of these may be used regardless of whether the investment contract comes to fruition: a financier informing a business plaintiff that he will only invest in a case if the business plaintiff retains a specific firm—at the financier's cost—sends a valuable signal; a financier demanding the business plaintiff terminate current counsel sends an even *more* valuable signal.[100] These signals precede the investment contract's formation, and therefore come at little or no cost to the business plaintiff.[101] While some information signals are case-specific, such as various theories or claims to advance, others, including counsel to retain or dismiss, potentially reduce future costs in seeking out competent and effective counsel for business plaintiffs in other matters.[102]

Litigation financing also imparts to business plaintiffs another degree of sophistication that law firms often cannot (or will not): sophistication in dealing with *law firms themselves*. Litigation financiers will inform a

[98] *See id.* at 15.

[99] *See id.*

[100] *But see* AM. BAR ASS'N COMM'N ON ETHICS 20/20, *supra* note 56, at 16 ("An agreement between an ALF [alternative litigation finance] supplier and a client, permitting the ALF supplier to have veto power over the selection of counsel, may limit the client's right to terminate counsel in a manner that is inconsistent with Model Rule [of Professional Conduct] 1.16(a)."); Molot, *supra* note 1, at 178–79 (noting that litigation financier Burford Capital is a "passive provider of financing" and does not interfere with the traditional attorney–client relationship; instead the company's financing allows clients to retain the lawyers and firms of their choice).

[101] Litigation financiers might resort to "lock-up fees" or earnest money to counteract the potentially free transmission of information here, and might even be wise to do so. We have not, however, encountered this phenomenon in our research of third-party litigation contracts. Nor would we expect to: when business plaintiffs are already highly cost-sensitive, it stands to reason that these businesses might balk at even relatively small sums demanded in advance to secure a deal. In this sense, critiques that imply litigation financiers somehow take advantage of cost-sensitive plaintiffs ignore that litigation financiers must make the first investment in investigating a case—and confer valuable benefits on prospective clients—before receiving anything in return. *See* GARBER, *supra* note 3, at 24–26.

[102] *See* Molot, *supra* note 1, at 179–80 ("Although Burford's capital has been used by different businesses for different purposes, as a general matter Burford's financing has enabled those businesses to retain higher-quality counsel and/or mount a more vigorous prosecution of a case than would have been possible without Burford financing.").

business plaintiff about the business plaintiff's relative strength and realistic settlement options in a powerful signal that hourly billing attorneys do not have the correct incentives to provide.[103] Despite ethical obligations to the contrary, law firms billing by the hour have a critical incentive to vigorously prosecute even marginal cases; third-party litigation financiers must necessarily pass on even many infra-marginal cases, much less truly risky ventures.[104] Similarly, litigation financiers also sometimes condition investment agreements on working with certain firms (or not others). This signal indicates to business plaintiffs the relative trustworthiness and competence of a given law firm in a given area.

Litigation financiers also serve as the business plaintiff's agent in dealing with relevant law firms. Litigation financiers monitor strictly the billed hours retained firms claim against the money the financier invests, discounting or writing off altogether some charges.[105] The financier strictly acts as the business plaintiff's agent in this function, monitoring the law firm's progress and coordinating with the business plaintiff periodically.[106] The financier effectively negotiates a discount with the law firm based on disallowed expenses, controlling costs to the case.[107] Inexperienced business plaintiffs gain some sophistication simply by monitoring the litigation financier's monitoring of the law firm; as the principal in the litigation, the business plaintiff is entitled to know the litigation financier's methods and criteria for allowing or disallowing expenses in the case.[108] And though the financier may not control the business plaintiff's settlement options, the financier, along with the law firm, gladly provides advice on whether a defendant's settlement terms are comparatively favorable.[109] This advice provides an external check

[103] GARBER, *supra* note 3, at 32–33.

[104] *See id.* at 32–33; Burch, *supra* note 1, at 1317. It is easy to understate how risk-averse litigation financiers are in selecting cases. By one account, a litigation finance fund need only "lose"—in the sense of fail to recoup an investment—as few as a tenth to a quarter of invested cases for a fund to fail. *See* Richard Fields Interview, *supra* note 4.

[105] *See* Burch, *supra* note 1, at 1316, 1336 ("[A]s repeat players, financiers are likely to be more efficient than one-time clients at monitoring litigation costs and keeping attorneys' fees manageable.").

[106] *See id.* at 1315 (describing litigation financiers as intermediaries that have the expertise, sophistication, and substantial capital to monitor the attorneys involved in a case).

[107] *See id.* at 1316–17 (explaining that "a litigation-savvy financier [can] negotiate a better hourly rate and thereby prevent astronomical fees while ensuring that the case is adequately funded.").

[108] *See id.* at 1319–20.

[109] *See id.* at 1317.

on, and confirmation of, the law firm's advice on whether to prosecute litigation further or accept a settlement offer.[110]

Third-party litigation financing also benefits law firms. Financiers provide an additional option for law firms to capitalize themselves—and, by necessity, an additional business model for firms to take on additional cases. This additional model alleviates law firms' illiquidity and financial fragility. Litigation financing allows law firms to continue prosecuting expensive cases that the firms and clients would be mutually unwilling to pursue further absent the outside capital.[111] This reduces the amount of debt law firms would have to carry to successfully prosecute a case and guarantees the law firm some amount of guaranteed future income along with an incentive to vigorously prosecute the case vis-à-vis a contingency payment.[112]

Litigation financing expands the pool of potential matters and clients that a law firm may accept. This expansion necessarily enables firms to diversify revenue streams: all else equal, carrying additional cases gives firms some flexibility in taking on debt in one matter while pending a settlement, judgment, or payment in another.[113] The ability to take on additional matters also offers law firms the chance to diversify practice areas and internal expertise in various types of commercial litigation, potentially opening up new pools of clients for the firm in the long run.[114] Litigation financing also opens law firms to new business clients, and, by extension, allows law firms to foster relationships with these businesses for potential future cases or matters. Of course, this additional supply naturally provides some downward pricing pressure in the market for complex legal services and legal services at large, which benefits consumers of legal services and the general public as well.[115]

Finally, litigation financing also directly spreads risk across litigation constituencies, encouraging risk-neutral decision-making at key stages of the litigation. Like all economic actors, business plaintiffs and law firms have risk tolerances.[116] This level, the amount of money as an expected value of a litigation decision, that either a business plaintiff (as the owner of a claim) or law firm (on a contingency-fee contract) will tolerate losing at any given litigation decision node is finite, often shifting, and sometimes unknown *ex*

[110] *See id.*

[111] *See, e.g.*, Lyon, *supra* note 9, at 590.

[112] GARBER, *supra* note 3, at 15.

[113] *See* Shepherd, *supra* note 1, at 598–99.

[114] *See id.*

[115] *See* Geoffrey J. Lysaught & D. Scott Hazelgrove, *Economic Implications of Third-Party Litigation Financing on the U.S. Civil Justice System*, 8 J.L. ECON. & POL'Y 645, 658 n.37 (2012).

[116] *See* Molot, *supra* note 42, at 76.

ante.[117] Favorable rulings early on in litigation, or a relatively unfavorable initial fixed cost in starting a case, can cause business plaintiffs to forego profitable litigation and law firms to forego successful cases out of nothing more than risk aversion. Third-party litigation financiers by definition accept part of this litigation risk—and sometimes are willing to continue to accept *more* litigation risk in favorable circumstances.[118] This financier risk-acceptance encourages risk-neutral decision-making by both business plaintiffs and law firms by driving values of litigation decisions below sensitive business plaintiffs' risk tolerances.[119] Similarly, hybrid billing terms, where litigation financiers guarantee a finite sum earned hourly combined with a contingent-fee sum reduces law firms' risk exposure relative to a pure contingency fee contract. This diffusion of risk discourages either business clients from accepting, or contingency-fee law firms from encouraging, lower-valued or premature settlements in the wake of adverse business conditions or litigation setbacks.[120]

B. Arguments Against Third-Party Litigation Financing

Criticisms of third-party litigation financing do not deny the above-described private benefits; instead, they imply corresponding public costs, especially in the form of additional litigation. This is perhaps the most insistent and easily understandable criticism of litigation finance. It comes in two varieties: either that financing encourages *frivolous* litigation, or that it merely encourages *additional* litigation. The former claim is easy to dispatch: frivolous litigation makes for a worthless investment. Third-party litigation financiers invest only in cases with millions to tens of millions of dollars at stake and between incredibly sophisticated parties.[121] Litigation funds can afford few failed investments for an entire fund family to collapse.[122] It seems ludicrous at first blush that investment managers with a strong aversion to worthless assets would pursue an asset class—frivolous litigation—that is, by definition, worthless.

Proponents of the "frivolous litigation" theory of third-party litigation finance might respond that litigation financiers effectively intimidate

[117] *See* Shepherd, *supra* note 1, at 597–98.
[118] *See id.* at 599–600.
[119] *See id.* at 595, 599.
[120] *See id.* at 599.
[121] *See* Lyon, *supra* note 9, at 593.
[122] *See id.* at 593–94.

defendants into settlement by bankrolling otherwise frivolous claims.[123] This response overlooks the costs borne by the business plaintiff and law firm, however, as well as the implicit threat (such as it is) undergirding financial support of litigation. A substantial fraction of cases financed receive litigation funding after the case has begun: namely, after the business plaintiff has invested money in the case.[124] Litigation finance agreements also commonly require law firms to accept some risk through a partial contingency-fee arrangement.[125] These each strongly suggest that the business plaintiff and law firm alike invest expecting the case is valuable.[126] Defendants in litigation-financed cases are broadly sophisticated, able to resort to experts and attorneys that can discern worthwhile claims from worthless ones. To the extent defendants find litigation finance coercive vis-à-vis settlement, it is because financing litigation carries the threat not of a forcible settlement, which is naturally a contradiction in terms, but of a business plaintiff prepared to litigate a case *to judgment*.[127] This, of course, implies not only a meritorious claim, but a potentially strong claim, or at least a strong claim in light of available remedies.[128]

It is more difficult to evaluate the more sophisticated claim that third-party litigation financing encourages additional meritorious litigation. We are glad to concede that third-party litigation financing reduces the cost of litigation to business plaintiffs and the cost of carrying some cases to law firms, and accordingly almost certainly increases the total amount of litigation. Even if this litigation is particularly strong on the legal merits, we can envision sensible objections to enabling meritorious business tort cases. There is well-established literature on the comparative inefficiency of the tort system in

[123] *See id.*

[124] *See* Molot, *supra* note 1, at 178–80; *see also* Paul Barrett, *Hedge Fund Betting on Lawsuits is Spreading*, BLOOMBERG (Mar. 18, 2015), http://www.bloomberg.com/news/articles/2015-03-18/hedge-fund-betting-on-lawsuits-is-spreading.

[125] *See* Burch, *supra* note 1, at 1318–19.

[126] To the potential rejoinder that the law firm perceives value out of the litigation financier's potentially coercive settlement power, we would note that this assertion obviates the need for the financier entirely. Such a firm could simply take the case on contingency to begin with. But even if the financier served only a signaling function, one hesitates to conclude why this signaling function would work only perversely—to support meritless cases—rather than accurately, in suggesting a case's relative strength. We discuss the potential social benefits to third-party litigation finance encouraging *meritorious* cases immediately below.

[127] This, of course, implies that the role of a third-party litigation financier ends once a case has gone to judgment. Naturally, it does not. But litigation financiers' and business plaintiffs' slightly differing incentives following a favorable judgment but preceding collection of the judgment, as opposed to preceding judgment, are beyond the scope of this paper.

[128] *See generally* Shepherd, *supra* note 1, at 607–09.

transferring wealth in even the simplest of cases, and surely sophisticated business litigation is far from the simplest of cases. Several studies have found that tort plaintiffs receive between thirty-seven and fifty cents of every dollar spent by defendants.[129] And additional meritorious cases, even additional meritorious judgments, guarantee nothing in social value in and of themselves. It could be, for example, that current tort rules penalize some socially beneficial conduct that a combination of transaction costs, litigation costs, informal norms, and intra-firm constituencies prevent.[130] Third-party litigation financing under these conditions would enable business plaintiffs to vindicate legal rights at the cost of public welfare or economic efficiency.[131]

As a preliminary matter, it seems to us that these potential objections instead focus on either the social benefits of the underlying rules of decision or the inefficiency of the civil justice system. These are serious and substantial problems, but neither of these problems has anything to do with third-party litigation financing. Recourse for full vindication of legal rights under current legal regimes must at least primarily lie with lawmakers broadly, in legislatures, administrative agencies, or courts.[132] Private parties seem especially poorly positioned to effect a society-wide abrogation of legal rights through legal unilateral disarmament—e.g. foregoing a meritorious claim because of theoretical benefits to outside parties if all others similarly situated also forego similar claims.[133]

And any discussion of litigation financiers' impact on litigation costs must include all dimensions of financiers' involvement. It is certainly true that litigation financiers enable business plaintiffs to prosecute cases that these plaintiffs would otherwise conclude.[134] The amount of additional litigation costs incurred due to litigation finance must be offset by reductions in costs through financiers': (1) partial re-alignment between business plaintiffs' and law firms' incentives, discussed above; (2) downward cost pressure on

[129] STEPHEN J. CARROLL ET AL., RAND INST. FOR CIVIL JUSTICE, ASBESTOS LITIGATION 104 (2005) (concluding that plaintiffs receive forty-two cents of every dollar paid by defendants in asbestos cases); PETER W. HUBER, LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES 151 (1988) (concluding that plaintiffs receive forty cents of every dollar paid by defendants in medical practice cases and forty cents of every dollar paid by defendants in products liability cases); Patricia M. Danzon, *Liability for Medical Malpractice*, *in* 1B HANDBOOK OF HEALTH ECONOMICS 1339, 1369 (Anthony J. Culyer & Joseph P. Newhouse eds., 2000) (concluding that plaintiffs receive forty cents of every dollar paid by defendants in medical practice cases).

[130] *See* HUBER, *supra* note 129, at 287.

[131] *See* GARBER, *supra* note 3, at 34–36.

[132] *See* Lyon, *supra* note 9, at 608–09.

[133] *See* Burch, *supra* note 1, at 1306–11.

[134] *See* GARBER, *supra* note 3, at 23.

litigation generally; (3) signals regarding case quality to defendants, encouraging settlement; and (4) general deterrence to other potential tortfeasor businesses, discussed below. The ultimate effect of third-party litigation financing on total litigation costs is quite complex and an empirical question that we do not endeavor to resolve. We merely note that it is anything but clear that litigation finance net *increases* litigation costs.

But even with these responses, potential objections to third-party litigation as increasing litigation seem to overlook the theoretical benefits to a financier's encouraging specific additional cases. Investment-grade cases almost uniformly focus on defendants that have actually committed underlying torts.[135] As mentioned above, we can—and scholars often do—dispute whether enforcing these torts, or remedying them with injunctions or punitive damages, generates any social welfare at a certain margin.[136] But to the extent tort law even loosely tracks prohibiting harmful conduct, investment-grade cases focus on defendants who have actually harmed business plaintiffs, and have almost certainly harmed other potential plaintiffs, either consumers or rival businesses, in the past.[137] Litigation financing therefore encourages tort suits against these defendants. These suits serve two familiar deterrence dimensions: specific deterrence, by increasing the defendant business's expected costs for committing similar harms against other businesses or consumers, and general deterrence, by increasing similarly positioned firms' estimation that victims will litigate perceived claims.[138]

It suffices to say that even if one concedes that third-party litigation financing may increase meritorious litigation, it far from suffices to assert this fact as if it self-evidently condemns third-party litigation financing as a practice. It is possible that litigation financing encourages, for example, patent suits that harm social welfare.[139] In fact, it is even likely. But this is a fault of patent law more than litigation financing. By contrast, it is also likely

[135] *See* Shepherd, *supra* note 1, at 595–97.

[136] *See, e.g.*, Keith N. Hylton, *The Economics of Third-Party Financed Litigation*, 8 J.L. ECON. & POL'Y 701, 709–10 (2012) (explaining that while "[t]he first lawsuit may be worthwhile in terms of the deterrence benefits it brings to society, . . . the one hundredth lawsuit may be undesirable . . . [b]ecause of diminishing deterrence returns," and demonstrating that in many cases "the marginal social benefit from litigation (based on deterrence benefits) is just equal to its marginal social cost (based on litigation expenses).").

[137] *See* Lyon, *supra* note 9, at 593–94.

[138] *See* Kidd, *supra* note 39, at 625–26.

[139] *See* Shepherd, *supra* note 1, at 601–04 (noting that "many patent infringement cases are opportunistic—initiated not to protect property rights, but to bully quick settlement agreements out of defendants").

that litigation financing encourages antitrust suits against price-fixing arrangements.[140] These suits almost certainly increase social welfare.[141] Between these two extremes lie numerous potential cases with complicated social-welfare implications, contingent on the relative values of various public and private goods, distributional concerns, and a host of other trade-offs broadly (and properly) considered a legislature's province.[142] Third-party litigation financing's critics should first acknowledge that many of their concerns are with specific legal doctrines or business torts; barring that, these critics should at least demonstrate—rather than merely assert—that litigation financing *on net* harms social welfare. We believe this position is theoretically unlikely to prove true and virtually impossible to demonstrate.

But to justify restricting litigation financing, the critics' model could not even stop there: at, say, attempting to compare social benefits from a class of litigation-financed cases with social costs from other potential litigation-financed cases. That would be challenging enough. As we have established, third-party litigation financing has a complicated relationship with overall litigation levels: it causes some cases to exist that otherwise would not, and encourages some cases to settle that might otherwise go to trial. And these cases have an equally complicated relationship with social welfare: some cases are almost certainly socially beneficial, while others are probably socially harmful. But third-party litigation finance's opponents must also consider litigation finance's proximate substitutes, both public and private.

The private sphere contains several obvious substitutes; insurance subrogation is clearly the nearest. The typical insurance contract includes a subrogation clause, which provides that if an insured enjoys any claim against any other party for damages the insured seeks recovery for under the policy, the insured surrenders those claims to the insurance company.[143] Subrogation actually enables the insurance company to conduct the litigation directly against the tortfeasor; the insured no longer controls the litigation, directs attorneys, or decides when or whether to settle.[144] Subrogation is therefore

[140] *See id.* at 604–07.

[141] *But see id.* (explaining that because antitrust law provides for treble damages, joint and several liability for defendants, and no right of contribution from co-conspirators, plaintiffs have so much bargaining power in settlement negotiations that there is the potential for inefficient case outcomes).

[142] *See id.* at 611 (acknowledging that third-party litigation financing has the potential to improve access to justice, but calling upon legislatures to take steps to prevent third-party financing from threatening the compensatory and deterrent goals of the legal system).

[143] *See* Steinitz, *Whose Claim Is This Anyway?*, *supra* note 81, at 1295–96, 1295 n.95 (2011).

[144] *See id.*

literally a third-party litigation financing arrangement: an insurance company advances a third party (the insured) the expected recovery and not only assumes a portion of the recovery, but assumes *all* of the recovery *and* directs the conduct of the litigation going forward.[145] Instead of charging a percentage of the recovery for a portion of the litigation expenses, insurance companies charge premiums and limit litigation expenses (in some sense, the insurance company's litigation-finance investment) per the insurance policy.[146] Other private substitutes exist as well. Patent assertion entities (PAEs) monetize litigation risk simply by purchasing patents to gain the right to sue for those patents' infringement.[147] As mentioned above, contingency-fee firms essentially bring third-party litigation financing in-house, financing litigation for business plaintiffs by carrying costs directly.[148] And small-scale litigation financing for personal injury cases has occurred for decades.[149] Third-party litigation financing merely performs the same private function as each of these decades-old (or older) arrangements.[150]

Third-party litigation finance even occurs in the public sector. Nearly every politically or ideologically motivated litigation entity champions either a public right or a class of private rights by soliciting donations—*sometimes from governmental entities*—to prosecute or defend specific cases.[151] These entities, ranging from the Institute for Justice to the Center for Reproductive Rights, quite literally facilitate *and* direct litigation financed by third parties.[152] These organizations recruit clients on behalf of a given right enjoyed by some (or all) of the public to use as a named plaintiff; donors

[145] *See id.*; *see also* Michelle Boardman, *Insurers Defend and Third Parties Fund: A Comparison of Litigation Participation*, 8 J.L. ECON. & POL'Y 673, 673–75, 673 n.2, 674 n.6 (2012) (asserting that "insurers are litigation funders in the same relevant sense as that term is used to apply to third-party litigation funders").

[146] *See* Boardman, *supra* note 145, at 677 ("An insurer is more like a contingency fee lawyer in the sense that it must decide how much to spend on the litigation as the case unfolds. An insurer is dissimilar from both a litigation investment fund and a contingency fee lawyer in that the insurer's funds are on the hook for the eventual settlement or court award.").

[147] *See* Hylton, *supra* note 136, at 703; Shepherd, *supra* note 1, at 604.

[148] *See* GARBER, *supra* note 3, at 30 ("[M]any corporate law firms, including some of the most respected ones in the country, do at least some litigation work on a contingency-fee basis for plaintiffs in commercial litigation.").

[149] *See* Shepherd, *supra* note 1, at 593 ("The cash advance industry offers pre-settlement funding agreements that loan a few thousand dollars to personal injury victims while their lawsuits are pending.").

[150] *See id.* ("Third-party litigation financing is not an entirely new phenomenon in the United States; indeed certain forms have been in practice since the 1980s.").

[151] *See* Paul H. Rubin, *Third-Party Financing of Litigation*, 38 N. KY. L. REV. 673, 679 (2011).

[152] *See id.*

underwrite the litigation, which the ideological entity prosecutes directly.[153] To the extent that either rights or politically contentious outcomes may be reasonably considered at least *partially* fungible with money, the parallels to third-party litigation financing are both stark and unexpected. Donors pay for a private party to finance a case on behalf of a right the party enjoys, but only in common with others; the party continues to direct the litigation—sometimes—but the ideological organization practically steers both the individual's case *and* the litigation strategy in service of the donors' ideological goals. The donors' analogous return on investment is of course an injunction against whatever undesirable governmental action or law the representative plaintiff sought to prohibit in the first place.[154] Much like with insurance subrogation, public interest entities exercise *more* control over an individual case than their third-party litigation financier counterparts.

Other criticisms focus not on litigation finance's effect on overall litigation levels writ large, but on the practice's potential effects on the attorney-client relationship. One noteworthy version of these concerns is the potential that adding an additional party to the attorney-client relationship could adversely affect the litigation, the relationship, or both. This criticism has some theoretical justification. Attorney-client privilege is typically violated, for example, by disclosures on a case to any third party. And financiers, even with benign motives, have good reason to want to know confidential information about cases.[155] Similarly, some more-thoughtful criticisms of third-party litigation financing target the practice's potential effects not on any particular client, but on the integrity of the attorney-client relationship itself.[156] This logic is straightforward: attorneys that know of the external financing relationship are likely to make litigation decisions in response to it, or to seek the litigation financier's approval before key decisions in the litigation.[157]

Litigation financiers anticipate these concerns and conspicuously attempt to avoid any direct influence over clients' actions, relying instead on the *ex ante* screens and *ex post* contractual terms to align incentives. Litigation financiers have an interest in controlling the outcome of litigation in one broad, obvious sense: in that they want to ensure their repayment and

[153] *See id.*

[154] *See* Elizabeth Chamblee Burch, *Procedural Justice in Nonclass Aggregation*, 44 WAKE FOREST L. REV. 1, 17–19 (2009) (describing the goals of group-oriented litigation).

[155] *See* Lyon, *supra* note 9, at 604–05.

[156] *See id.* at 601–08.

[157] *See id.* at 607–08.

maximize the risk-adjusted return on investment.[158] But litigation financiers conspicuously avoid interfering in the day-to-day litigation decisions otherwise, deliberately advancing all potential investment in the case at the investment's outset to avoid potentially controlling either attorneys or clients afterwards.[159] Even monitoring of attorneys' billed hours takes place only at the client's behest and for the client's benefit.[160] Litigation financiers appear to construct contracts with the knowledge that informally pressuring attorneys after an investment could compromise privilege or otherwise impair the client's case. The litigation financier cannot alter or terminate the attorney/client relationship, and only has the power to discipline attorneys by virtue of providing the client information.

And though litigation financiers in some sense direct the course of the litigation by contractual terms—specifically, to ensure financiers' repayment—it is worth noting that these contractual terms potentially reduce *other* external pressures on clients to settle claims. Pure contingency-fee arrangements, for example, can result in situations where attorneys pressure clients to accept settlements in part based on the firm's cash-flow issues or ability and willingness to carry the case's expenses. Defendants naturally pressure less-capitalized business plaintiffs with the threat of increasing litigation expenses strategically; discovery is notoriously expensive, and better-capitalized parties can obviously exploit asymmetrical financial positions through litigation expenses.[161] In fact, parties requiring litigation financing are necessarily *especially* sensitive to these costs: they aggravate the problem litigation financing is designed to mitigate.[162] Much as with social welfare concerns surrounding litigation finance, it is anything but clear that litigation finance's critics can establish that the financier/client relationship interferes, on net, with the litigation when one considers the potential economic forces the investment offsets.

V. CONCLUSIONS

This is, in short, the story of litigation finance: though the benefits are clear, even the claimed risks remain ambiguous on net. Considered alongside other economically and legally familiar risk-sharing mechanisms, the poor understanding of third-party litigation financing is downright mysterious. Litigation financing has existed for decades in smaller-claim format. Its most

[158] *See* GARBER, *supra* note 3, at 23–24; Shepherd, *supra* note 1, at 595.

[159] *See* Molot, *supra* note 1, at 178–79.

[160] *See* Burch, *supra* note 1, at 1315–17.

[161] *See* Lyon, *supra* note 9, at 599.

[162] *See id.*

proximate substitute, insurance subrogation, is significantly older still. What little attention third-party litigation financing attracts focuses almost entirely on implausible harms to the civil justice system or the attorney-client relationship rather than on the not only plausible, but real, benefits both business plaintiffs and law firms enjoy through this alternative financing arrangement.

But the economic functions of third-party commercial litigation financing explain both its origins and its benign, even productive, purposes. Commercial litigation financing neither takes advantage of vulnerable plaintiffs nor burdens the justice system. Instead, it arises almost exclusively between sophisticated business plaintiffs and law firms, in litigation targeting also-sophisticated business defendants. These business defendants have almost certainly committed torts, yet by virtue of law firms' undercapitalization and business plaintiffs' aversion to investing immediate capital for a potentially distant and uncertain payout, these businesses cannot afford to prosecute the resultant litigation on their own. Litigation financiers assume all of the business plaintiff's risk—and a substantial portion of the law firm's risk—in exchange for a portion of the prospective payoff from the lawsuit. The litigation financier shares risk with both parties, encouraging risk-neutral decision-making; he helps align incentives between law firm and business plaintiff; he quells adverse incentives within the business plaintiff by removing the need to fund a lawsuit continuously. Each of these functions is well-understood in other contexts, and it appears the litigation financier merely suffers the curse of relative, and only apparent, novelty.

Hesitation regarding third-party litigation financing suffers from two unintended ironies. First, third-party litigation financing is made possible through antiquated rules that prohibit law firms from raising capital through the traditional and broadly understood equity markets. These restrictions reminisce of law firms as guilds, rather than businesses, and, rather than ensuring law firms act as guilds, they render law firms merely poorly capitalized businesses. Opponents of third-party litigation financing should consider the proximate alternatives: the consequences, for example, of parties owning common stock in law firms. Of course, litigation finance's critics do not seriously consider making equity markets available to law firms as a viable alternative; they simply prefer law firms remain relatively undercapitalized. Whatever the merits of this position as a normative preference, litigation finance's critics should first understand the business needs the financial arrangement provides law firms as well as business plaintiffs.

The second irony is that third-party litigation financing is, in fact, already incredibly common; an enormous swath of American litigation already receives third-party financing. Insurance companies routinely require insured parties to file and subrogate claims against wrongdoers, and the insurers assume not only financial responsibility for the litigation, but provide representation directly. In fact, insurance companies assert exponentially more direct control over nominally third-party litigation than any litigation financier has yet aspired to accomplish. Patent assertion entities are simply third-party litigation financiers that specialize in intellectual property litigation and purchase underlying property rights entirely rather than simply one-off claims. And many of the most prominent public interest litigation boutiques exist precisely to raise funds for and prosecute litigation on behalf of whole classes of third parties. The United States has already substantially deviated from the plaintiff-versus-defendant-only model of wholly bilateral litigation.

Yet two major concerns persist, and though both are understandable, neither one is a persuasive reason to curtail or prohibit third-party litigation financing. First, opponents assert that third-party litigation financing encourages frivolous litigation. This is obviously incorrect: litigation financing as an investment vehicle relies on cases with a high chance of substantial damages, which broadly necessitates a high chance of winning on the merits. But to the extent we refine this concern to that litigation financing encourages meritorious cases, the social welfare and efficiency implications for litigation financing grow ambiguous. Litigation financing encourages some additional cases, but also reduces the agency costs in many cases, and surely facilitates a speedy end to some cases through settlement. Litigation financing also offers some deterrent effect against third-party tortfeasors; to the extent we assume that tort law roughly tracks blameworthy or inefficient conduct, this deterrent effect must generate some social welfare to non-litigants. The second criticism, that litigation finance invades the attorney-client relationship, appears unfounded. Litigation financiers structure transactions specifically to respect the attorney-client relationship’s bounds, and neither need nor are able to assert control in that relationship to ensure repayment.

These concerns are ultimately misplaced. Third-party commercial litigation financing may be viewed as, at worst, the private expansion of a recent American trend towards third-party involvement in legal disputes. More plausibly, third-party commercial litigation financiers offer an attractive substitute to both business plaintiffs and law firms from already-established options. For business plaintiffs, litigation financiers compete with pure contingency-fee law firms and insurance companies as litigation dispute resolution sources. For law firms, litigation financiers compete with other creditors and financiers, including banks and other investors.

But what is certain is that third-party litigation financing is neither novel nor unfamiliar, and it will behoove both commentators and regulators to familiarize themselves with the underlying economic quandaries inevitably fueling this industry's growth. Attempts to inhibit third-party commercial litigation financing out of naïve surprise or a fundamental misunderstanding as to the industry's economic functions will, at best, cause business plaintiffs and law firms to struggle to find one of a menu of alternatives to satisfy their interlocking economic problems. It is easy to understand the origins of these economic problems because they are each old and quite familiar. The only real quandary is why the practice is so poorly understood.