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THIRD-PARTY LITIGATION FUNDING IN EUROPE

*Cento Veljanovski**

INTRODUCTION

Third-party litigation funding (TPLF) is where an investor otherwise unconnected with a legal action finances all or part of a claimant's legal costs. If the case fails, the funder loses its investment and is not entitled to receive any payment. If the case succeeds, the investor takes an agreed-upon success fee. While not entirely new, the emergence of TPLF has recently been put in the spotlight with the entry of dedicated firms investing in commercial litigation in the U.K., Europe, and further afield.

This study aims to shed light on the reality of TPLF. It is based on interviews with the leading dedicated TPLF investors based in the U.K.,¹ and dedicated TPLF group action investors in Europe.² It explores the development and rationale of TPLF in Europe, with a focus on the position in England and Wales,³ and the emerging funding of group actions in Europe.⁴

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¹ The following were interviewed mainly during July 2011 with subsequent follow-up discussions and emails: Neil Brennan (Chief Executive Officer, ILF Advisors), Neil Purslow (Managing Director, Therium), Nick Rowles-Davies (Consultant, Vannin Capital), Mark Wells (Managing Partner, Calunius Capital), Brian Raincock (Chairman, Commercial Litigation Funding), Ben Hawkins (Managing Director, Commercial Litigation Funding), Susan Dunn (Head of Litigation Funding, Harbour Litigation Funding), Dr. Arndt Eversberg (Managing Director, Allianz ProzessFinanz GmbH), Christopher Bogart (Managing Director, Burford Capital), Jonathan Barnes (Director, Woodsford Litigation Funding), Michael Zuckerman (Managing Partner, Redress Solutions), John Walker and Clive Bowman (Executive Directors, IMF (Australia) Ltd), Richard Fields (Juridica), Bob Gordon (1st Class Legal) and David Rae (Synergy Solutions/Axiom Legal Financing).

² Interview with David Burstyner, Senior Legal Counsel, Omni Bridgeway (July 2011). CDC declined to be interviewed on the grounds that "it was not in its interests," and CFI did not respond to several requests for an interview.

³ Although England and Wales, Scotland, and Northern Ireland all are part of the U.K., their legal systems differ. It is therefore necessary to distinguish these jurisdictions—though, in reality, the differences are not great, and TPLF investors effectively operate across the U.K.

⁴ This is the first quantitative study of TPLF investors and their activities in the U.K. The only other industry-wide study, albeit largely qualitative, is by lawyers. FOX WILLIAMS, THE NEW, NEW THING: A STUDY OF THE EMERGING MARKET IN THIRD PARTY LITIGATION FUNDING (2010), *available*

Part I of the discussion below provides some background to the development of TPLF in Europe. Part II is an overview of the TPLF funders in England and Wales based on interviews conducted in the second half of 2011. Part III examines group litigation funding in Europe. Part IV discusses the justification for and likely impact of TPLF, together with some of the policy issues. Part V looks at the anecdotal criticisms of TPLF that have been made by U.S. commentators and compares them to hard evidence.

I. BACKGROUND

A. Overview

Economists like markets and are therefore naturally suspicious when laws impede their development. Historically, this was the legal position in common and continental European civil legal systems. Funding or supporting the litigation of another was banned, prohibited, and outlawed. These prohibitions were abandoned in European continental civil law countries some time ago. Third parties can now finance litigation in nearly all civil law jurisdictions in Europe, apart from Greece and Portugal.⁵ In most common law countries, the ban on third-party funding of legal actions continued until recently, and still exists in some jurisdictions.

The common law torts of maintenance—where a stranger supports litigation in which he has no legitimate concern—and champerty—when the person maintaining another receives a share of the gains from the legal action—prevented the funding of and trading in legal claims.⁶ Historically, such actions were criminalized in order to prevent a frequent abuse of the legal system.⁷ During the Middle Ages, wealthy landowners often funded litigation in order to seize land from weaker parties.

Restrictions on TPLF have progressively been removed and decriminalized across common law countries. In England and Wales, the laws of maintenance and champerty were decriminalized in 1967. Since the mid-1930s, the Australian states of South Australia (1935), Victoria (1950),

at <http://www.lawfirmalliance.org/assets/attachments/738.pdf>; LORD JUSTICE JACKSON, REVIEW OF CIVIL LITIGATION COSTS ch. 11 (2010). The Law Society of England and Wales publishes *Litigation Funding* each quarter. It lists TPLF funders, brokers and ATE insurance providers.

⁵ LOVELLS LLP, AT WHAT COST? A LOVELLS MULTI JURISDICTIONAL GUIDE TO LITIGATION (2010), available at <http://www.hoganlovells.com/files/Publication/c940bb4b-a67f-4e63-a5b8-ced6198b2125/Presentation/PublicationAttachment/fff33267-29d5-4230-a140-cf2eeb7d4a05/LitigationCostsReport.pdf>.

⁶ Max Radin, *Maintenance and Champerty*, 24 CALIF. L. REV. 48, 58-64 (1935).

⁷ Percy H. Winfield, *History of Maintenance and Champerty*, 35 LAW Q. REV. 50, 57-68 (1919).

New South Wales (1993), and the Australian Capital Territory (2002)⁸ have decriminalized them as well. They have also been removed in many states in the U.S.

Today, there is growing support for TPLF as a means of providing increased access to justice. The costs and complexity of litigation can discourage many meritorious claimants from seeking redress through the courts. Only those who feel particularly aggrieved or determined—or with deep pockets and a sufficient stake—will be inclined to embark on litigation. Thus, many see easing the path to litigation as attractive, believing it will achieve a number of goals, including greater access to justice.

This is particularly true in common law jurisdictions where there is a growing concern over the high costs of litigation. The Oxford Study⁹ provided estimates of the legal and court costs for a “large commercial case”¹⁰ involving a complex breach of contract with a €7 million (USD 6 million) lost profits claim in twenty-seven countries. The joint costs of pursuing this claim to full trial in the English and Welsh courts were estimated at USD 3 million, or 50% of the value of the claim.¹¹ According to the study, the legal costs of suing in England and Wales were by far the largest, by many orders of magnitude, of all twenty-seven countries (e.g., thirty times greater than in Germany).¹² The Jackson Committee in the U.K. was a response to the growing concern that London was losing its place as the global center for commercial litigation because it was literally pricing itself out of the market.

As a result of the costs and uncertainty of litigation, various insurance products, public support, and legal fee arrangements have grown up to spread and defray the costs of pursuing or defending against legal actions. The position in continental Europe is different, but the issues are the same.

In the U.K., there has been official support for increased use of TPLF. The Civil Justice Council (CJC) has given its support: “Properly regulated

⁸ Maintenance and champerty laws were abolished in South Australia by the *Criminal Law Consolidation Act 1935*, in Victoria by the *Wrongs Act 1958* and the *Crimes Act 1958*, in New South Wales by the *Maintenance, Champerty and Barratry Abolition Act 1993*, and in the Australian Capital Territory by the *Civil Law Act 2002*. The Australian states of Western Australia, Queensland and Tasmania, and the Northern Territory continue to criminalize these actions.

⁹ CHRISTOPHER HODGES ET AL., *THE COSTS AND FUNDING OF CIVIL LITIGATION: A COMPARATIVE STUDY* (2009).

¹⁰ The “large commercial case” is described as a “[s]ubstantial and complex breach of contract claim between two large companies over supply of defective machinery worth 2 million euro, with 5 million euro loss of profit.” *Id.* at 107.

¹¹ *Id.* at 110.

¹² The legal costs estimates reported in the Oxford Study for other common law jurisdictions, namely Australia, New Zealand, and Ireland, are, in the author’s opinion, gross underestimates and have not been used. The author has independently sought advice which suggests that the legal costs of bringing this claim in Australia would be a minimum of AUD 500,000 or AUD 1 million for both parties. This estimate is ten times that reported in the Oxford Study.

third-party funding should be recognized as an acceptable option for mainstream litigation.”¹³ The Jackson Report on civil litigation costs, which sought to increase access to justice, expressed approval of TPLF, saying that it “may be the most effective means of promoting access to justice for a claim against, say, a multinational pharmaceutical company.”¹⁴ The Oxford Study¹⁵ was more circumspect, viewing TPLF as only likely to be used for large-scale commercial litigation rather than personal and consumer litigation.

On the other hand, there are those who see the development of TPLF as (1) imposing unnecessary costs on industry, (2) unnecessary to deter alleged misconduct, and (3) creating a compensation culture driven by profit-seeking financial entities trafficking in legal claims.¹⁶

B. *Third-party Funding Options*

TPLF comes in many guises and operates in many areas of the claims process, such as personal injury. This overview is confined to the financing of complex and typically high-value commercial litigation.

One useful categorization of TPLF is between passive and active TPLF investment:

* *Passive Funding.* The TPLF entity is a passive investor in an actionable claim that obtains a performance-based return if the claim is successful. It is the responsibility of the claimant’s legal advisers to manage and prosecute the claim. As the case progresses, the funder is kept informed and periodically pays invoices for legal and other costs. This is the predominant model of TPLF in Europe and particularly in the U.K., where the residual laws of champerty and maintenance prevent third parties from intermeddling and controlling the conduct of litigation.

* *Active Funding.* In some jurisdictions, the TPLF investor purchases or is assigned the legal claim, and enforces and funds the claim to trial or settlement. In this model, the funder may also conduct the initial investigation of the claim, build a book of claimants, select the lawyers, and actively manage and run the litigation. This approach exists in Australia, the U.S., and has been used in Europe for group litigation.

In addition, lawyers may also fund part of the costs of litigation through discounted, or “no-win-no-fee,” arrangements. These lawyer-based success fees consist of two types:

¹³ CIVIL JUSTICE COUNCIL, IMPROVED ACCESS TO JUSTICE – FUNDING OPTIONS & PROPORTIONATE COSTS, Recommendation 3, 12 (2007).

¹⁴ LORD JUSTICE JACKSON, REVIEW OF CIVIL LITIGATION COSTS 335, ¶ 4.4 (2010). The Lord Chancellor, the U.K.’s chief legal officer, established the Jackson Committee. *Id.*

¹⁵ HODGES ET AL., *supra* note 9.

¹⁶ *See* Part IV *infra*.

* Conditional Fee Agreement (CFA). The lawyer discounts his or her standard fee in return for an uplift expressed as a percentage of the standard fee if the claim succeeds. If the case is lost, no further fees are payable. In the U.K., the success fee is capped at 100% of the lawyer's usual billing rate. This is also referred to as a no-win-no-fee arrangement.

* Contingency fees. A contingency fee is where the lawyer discounts or commutes his or her fee in return for a share of the damages or out-of-court settlement should the action succeed. Contingency fees are permitted in the U.S., Taiwan, Canada, Estonia, Hungary, Italy, Japan, Lithuania, Slovakia, and Slovenia, and permitted but rarely used in Finland, Germany, and Spain. They are banned or severely limited in many jurisdictions such as Australia; the U.K. until late 2011, but have been permitted in the administrative courts and in pre-action work; Austria; Belgium; Cyprus; Czech Republic; Denmark; France; Greece; Ireland; Luxembourg; Malta; the Netherlands; Norway; Poland, where they exist in practice; Portugal; Romania; Russia; Singapore; and Sweden, where they are permitted in special circumstances, like a class action lawsuit.

Further, the parties or funders can take out before-the-event, after-the-event, or both, litigation expenses insurance:

* Before-the-event insurance (BTE). This type of insurance is purchased prior to a claim to cover legal and associated costs should the insured be sued. BTE policies are common for a variety of civil and personal injury claims, and can be purchased in addition to household contents, a car, holiday and credit or bank cards insurance, or coverage under directors' liability, professional negligence, product liability and other insurance policies

* After-the-event insurance (ATE). This type of insurance covers the claimant against liability for adverse costs in the event that the case is lost and the claimant is liable for the winning party's legal costs. This loser-pays rule, sometimes erroneously called the English rule, exists in most common law countries, except for the U.S., and most civil law legal systems. ATE insurance is available at any time between the beginning of a dispute to a trial's end. The cost of ATE insurance is the premium, which is a percentage of the sum insured, and depends on the level of coverage sought and an assessment of the risk. The premium does not have to be paid if the case is lost, but is payable in the event of success. This means that the insured claimant or TPLF investor is only liable to pay the premium if the claim is won, in which case all or part of it can be recovered from the losing party. ATE premium payments are recoverable only in England and Wales, and only until the Jackson reforms are implemented, which is expected toward the end of 2012. If the insured claimant loses the case, he or she does not pay the ATE premium. ATE insurance will cover the claimant's liability to pay the defendant's legal costs. ATE insurance is also available in other European jurisdictions, but the premium may be payable upfront and is not recoverable. Although it is a relatively new product, it

has become popular amongst TPLF investors, and many of them will not fund a case without ATE insurance in place.

In most countries, with the notable exceptions of the U.S. and the Russian Federation, there is also publicly funded legal aid given to impecunious parties to pay their lawyers' fees and other out-of-pocket expenses. Legal aid is mostly confined to criminal and civil actions (but rarely for commercial cases). Therefore, it has a minor impact on TPLF market.

II. THIRD-PARTY LITIGATION FUNDING IN EUROPE

A. *Preliminary Issues*

It is difficult to give a comprehensive overview of TPLF across Europe for several reasons. The TPLF market is in its formative stages and differs across jurisdictions—the latter for historical and procedural reasons. Further, there is limited data about the extent and structure of the TPLF market, as most dedicated TPLF investors have only recently entered the market, and most are private entities or part of a hedge fund or financial institution, with no legal obligation to report their activities, often keeping their activities confidential for legal and competitive reasons. Thus, describing the market has necessarily focused on the visible segment consisting of dedicated TPLF entities, and therefore omitting those hedge funds, financial institutions, family offices, and others that may also fund litigation.

B. *Market Structure*

There are fifteen TPLF funders that have publicly stated that they supply or have raised funds in the U.K. in mid-2011 (Table 1). However, the number of active investors funding commercial claims in England and Wales is much lower. IM Litigation Funding has ceased operations. While Argentum advertises its services in the U.K., it appears not to have financed any claims to date.¹⁷ Two large TPLF investors—Juridica and Burford—have raised funds and are listed on the London Alternative Investment Market (AIM) but fund litigation mostly outside the U.K., principally in the U.S. IMF, the largest Australian based TPLF investor, while it entered to fund group litigation in 2001,¹⁸ withdrew its presence in Europe, and to date is only co-funding two claims. On the other hand, the litigation division of the German financial conglomerate Allianz, which funds considerable liti-

¹⁷ Argentum Capital Limited was incorporated in Jersey in the Channel Islands in June 2011 and listed in December 2011 on Channel Islands Stock Exchange (CISX).

¹⁸ See IMF AUSTRALIA, <http://www.imf.com.au/about.asp>.

gation in Germany, Austria, and Switzerland, entered the U.K. market in 2002. In contrast to its continental operations, Allianz's U.K. presence focused on high-value commercial litigation only, largely due to the higher cost of litigation in the U.K.¹⁹ This means that there are ten active dedicated TPLF investors operating in the U.K., with three additional investors, Juridica, Burford, and IMF, making occasional investments.

The market is also in a state of flux. Several dedicated TPLF investors have left the sector—IM Litigation Funding, which had been very active in the insolvency area, Managers & Processors of Claim Ltd. (MPC), which funded several high profile cases, and Allianz announced that it was withdrawing from the TPLF business in the UK and Europe in late 2011 due to the conflict with its main insurance business.²⁰ On the other hand, a number of investors have indicated that they will enter the market including Burford,²¹ and still others are in the process of raising funds to expand into the provision of commercial TPLF.²²

Most funders operating in the U.K. are relatively new, with the exception of Allianz, which has been funding claims since 2002. These funders therefore have only a handful of years of trading experience, small case loads, and few finalized investments.

¹⁹ The main TPLF investors in Germany are Allianz ProzessFinanz GmbH, Roland Prozessfinanz AG, Foris AG and DAS Prozessfinanzierung AG. Collectively, they have an estimated 95% market share. Morpurgo also identifies Juragent and Exactor AG as TPLF providers in Germany, and AdvoFin Prozessfinanzierung AG and Lexdroit in Austria, and Prozessfinanz in Switzerland. Marco de Morpurgo, *A Comparative Legal and Economic Approach to Third-party Litigation Funding*, 19 CARDOZO J. INT'L & COMP. L. 343 (2011).

²⁰ See Christian Stuerwald, *An Analysis of Allianz's decision to discontinue its litigation funding business*, Calunius Capital News and Archive, Jan. 2012. Available at <http://www.calunius.com/media/2747/cs%20-%20calunius%20article%20on%20allianz%204%20january%202012.pdf>.

²¹ In mid-December 2011 Burford announced the GBP10.3 million acquisition of Firstassist Legal, an ATE insurance provider as a foundation of its entry into funding UK claims. Edward Machin, *Burford Capital acquires ATE insurance provider for GBP10.3 million*, COMMERCIAL DISPUTE RESOLUTION, (Dec. 14, 2011), <http://www.cdr-news.com/litigation/109-articles/1656-burford-capital-acquires-ate-insurance-provider-for-gbp-103-million>.

²² These include Fulbrook Management LLC, based in New York and co-founded by U.S. lawyer Selvyn Seidel who previously co-founded and until recently was a chairman of Burford Capital, Investec Bank which launched a litigation funding arm at the end of 2011, and the Tangerine Fund, part of Axiom Legal Financing, which is based in London and incorporated in the Cayman Islands, which at the time of this writing was fund raising.

TABLE 1. TPLF INVESTORS IN THE UK, JULY 2011

Company	Start	Domicile	Offices	Structure	Source(s) of funding	Value of funds
Harbour Litigation Funding	2007	Cayman Islands	London	Harbour Litigation Investment Fund L.P.	Institutional investors, family offices, educational institutions, high net worth individuals	£60m over two years
Calunius Capital	late 2006	Guernsey	London	Calunius Litigation Risk Fund LP	Institutional investors	£40m
Vannin Capital	Jan-11	Isle of Man	IoM, BVI	Backed by IoM private equity house Bramden Investments	Private equity	£25m annually for five years
ILF Advisors	Jan-10	UK	London	Jersey-based Libra Litigation Fund One	Institutional investors, hedge funds, family offices, management team	£10m
Therium Capital Management	Jan-09	UK	London	Specialist financial platform of City of London Group plc (COLG) listed on London Stock Exchange	High net worth individuals	£9.77m
Woodsford Litigation Funding	2010	UK	London	UK limited company	IoM investment companies	£5m
Commercial Litigation Funding Ltd (CLFL)	2007	Jersey	London	Jersey protected cell company	High net worth individuals, private equity, hedge funds, family office	Redacted
Allianz Litigation Funding	2002	Germany	London, Munich	Allianz ProzessFinanz GmbH	Allianz Versicherungs AG	Undisclosed
IM Litigation funding	2002	UK	London	Ceased Operating in 2011		
Redress Solutions	2008	UK	London	Backed by two family offices	Primary funder is Charterhouse Square Finance Company Limited, a company in the Corob group. Also funded by a high net worth individual based in Monte Carlo which is in joint venture with Redress Solutions	Undisclosed
1st Class Legal	2006	UK	Shrewsbury	Underwriting House. Cover holder for Authorised ATE Insurer	Via other funders or directly from institutional investors, high net worth individuals, etc	Undisclosed
Juridica Investments	Dec-07	Guernsey	London	Listed AIM	Institutional shareholders - Invesco (31.61%), Jupiter Asset Management (14.59%), Baillie Gifford & Co (14.24%), Henderson Global Investors (7.1%), M&G Investment Management (5%), + others	£115m (over \$200m). £4.8 in the UK
Burford Capital	Oct-09	Guernsey	London, New York	Listed AIM	Institutional shareholders - Invesco (44.77%), Eton Park International (9.96%), Baillie Gifford & Co (9.03%), Reservoir Capital Group LLC (6.33%), Fidelity (5.57%), + others	£190m (over \$300m)
Argentum Litigation Investments	2009	Hong Kong	Hong Kong, Singapore, London, Luxembourg	NA	NA	Reported £15m invested but unclear whether in UK
IMF	Jun-01	Australia	Australia	Listed Australian Securities Exchange	Substantial shareholders: Acorn Capital (14.11%), Hugh McLernon (7.73%), Warrakirri Asset Management (6.26%) & John Walker (5.59%)	£2.3m in the UK

Source: Funders' websites and interviews. ¹ Argentum did not respond the figure was taken from *Litigation Funding Magazine* (June 2011).

Active TPLF providers in the U.K. can be “tiered” on the basis of their capital and size:

* A number of providers have significant funds generated from special fundraising efforts or from their parent company. These include Har-

bour,²³ Calunius, ILF Advisors, Vannin Capital,²⁴ Woodsford Litigation Funding, Therium, and Allianz. Redress Solutions is backed by two family offices. Juridica and Burford are also included in this tier, as they have raised significant funds in the U.K., but have presently only funded a handful of cases in the U.K. However, even within this group, the financial capacity to fund claims differs significantly from several millions to well over £100 million.

* The second group has some seed money, and is able to fund or co-fund on a case-by-case basis, but has no significant investible funds of their own. This group includes 1st Class Legal, which is largely an ATE insurance provider, and CLFL, which is raising funds.

There are also hedge funds, financial institutions, and other entities that have substantial funds, but are not dedicated TPLF investors. Investment banks Credit Suisse and Deutsche Bank, and hedge funds Alchemy and Elliott, among others, have been mentioned in this context. These investors have operated for some time, and may be fairly active, but do not publicize their activities. Therefore, it has not been possible to verify the size and extent of their investments. Indeed, opinions seem polarized as to their significance, with some in the U.S. claiming that the capital flows from these investors dwarf those of the newer dedicated TPLF investors in the U.S., while others, such as IMF, claiming that this is largely a myth and that these activities are non-existent in Australia.²⁵

The funds raised by TPLF investors come from private capital raisings either (1) directly from individuals, family offices, institutions, or from all three, or (2) via private equity and hedge funds (Table 1). Several TPLF investors, such as Burford, Juridica, and Therium via COLG, have raised funds through public listings, with dispersed shareholders and significant minority stakes held by major U.K. financial institutions like Invesco, Ballie Gifford, Fidelity, Eton Park, Scottish Widows in Burford Capital's case, and Jupiter Asset Management in Juridica's case. In most cases, management has an equity stake and performance incentives.

The structure of the U.K.-based TPLF investors varies. All are private companies with the exception of Juridica and Burford, which are public companies listed on the AIM. This is also the case for Therium which is backed by City of London Group PLC., also a public company with a full LSE listing (although only a small proportion of Therium funds are supplied by COLG). Interestingly, Juridica and Burford are the largest dedicated TPLF investors in the U.S. Most investors from the first group are domiciled in low tax jurisdictions, such as the Channel Islands, Isle of Man, and Cayman Islands.

²³ Harbour plans to raise a further £60 million in 2012.

²⁴ Vannin has stated that it has a commitment from their investors of £25 million annually over five years.

²⁵ Interview with Christopher Bogart, Managing Director, Burford Capital (July 2011).

The management teams, and typically founders, come from legal backgrounds, including those teams at Harbour, Therium, Burford Capital, Vannin, Calunius, and Woodsford. TPLF investors also have insolvency practice and accounting experience, as is the case with Redress Solutions, and financial, in ILF Advisors's case or insurance background, in Commercial Litigation Funding Limited's case.

There are also now a small number of brokers specializing in TPLF. The broker obtains prospective funding options from TPLF investors that are presented to the claimant and his lawyer. These funding packages may include ATE insurance (see below) and CFAs. The broker's commission is paid by the funder or the claimant from the award, if the case is successful. Some funders deal with brokers, but are reluctant to do so, and question their value and whose interests they represent. The latter issue comes up because the broker acts for the claimant, but expects to be paid by the TPLF investor. There are four active brokers offering TPLF in the UK—Ligata, Maxima, The Judge, and Global Arbitration and Litigation Services.²⁶

C. *Size of the Market*

The U.K.-dedicated TPLF market is relatively small. Table 2 shows the funds currently available, committed, or both, to TPLF investors operating in the U.K. based on publicly available information and interviews. This excludes the funds raised by Juridica and Burford in the UK—over USD200 million²⁷ and USD300 million in two capital raisings, respectively—as well as IMF, given that the funds are used to finance litigation outside the U.K. Nevertheless, Juridica has committed around £4.8 million to three U.K. claims and IMF £2.3 million to two co-funded U.K. claims.

The figures suggest a modest pool of confirmed investable funds in the U.K. of around £157 million, as of late 2011, based on information supplied by eight of the fifteen TPLF investors (Table 2). In addition, some of the smaller investors have access to funds when they identify a suitable investment. Others, such as hedge funds and financial institutions, invest in litigation, but the amount is not publicly available. This means that £157 million is potentially a low estimate. Some in the industry have estimated that the total pool of funds is around £500 million, but this estimate is impossible to verify and is not supported by the evidence.

²⁶ Exchange Chambers, barristers based in Liverpool, Manchester and Leeds, have formed a partnership with broker Maxima in June 2011. EXCHANGE CHAMBERS, <http://www.exchangechambers.co.uk/> (last visited Jan. 18, 2012).

²⁷ Juridica was the first to list on London's AIM in December 2007. Greg Bousfield, *Third-party Funders Eye Up Europe*, FULBROOK MGMT., LLC (Feb. 17, 2010), <http://www.fulbrookmanagement.com/news/100217.html>.

TABLE 2. DEDICATED TPLF FUNDING (£ MILLION) 2010–2011

Investor	Funds (£m)
Harbour	60.0*
Calunius Capital	40.0
Vannin Capital	25.0**
ILF Advisors	10.0
Therium	9.8
Woodsford	5.0
Juridica	4.8
IMF	2.3
Total	156.9

Source: Funders' websites and interviews.

*Allocated over two years.

**Annually, over five years.

There are several aspects to note about the UK dedicated TPLF investment market:

* Three dedicated TPLF investors, Harbour, Calunius, and Vannin, dominate the sector with £125 million, or 80%, of the estimated investable U.K. funds.

* The £305 million in capital raised in London by U.S. based Burford and Juridica dwarfs the estimated funds available for investment by the nine other active dedicated TPLF U.K. investors. Juridica and Burford have together raised almost twice the estimated funds of the nine other active dedicated TPLF investors in the UK. This suggests that there are more opportunities available for funding U.S. litigation.

The overall number of cases recently funded by TPLF investors is unknown. Some TPLF investors have published or supplied figures, while others treat this information as commercially confidential.

The CJC estimated that by mid-2010 that no more than 100 cases had received third-party financing in the U.K., adding that “some of these cases may have been pursued by other forms of funding; some may not have been brought at all.”²⁸ Others have suggested that this is an underestimate, and they put the figure at two or three times higher.

It is possible to offer some crude estimates of the number of claims currently funded. Most, but not all, TPLF investors focus on claims with a value in excess of £1 million. For example, Harbour Litigation Funding,

²⁸ CIVIL JUSTICE COUNCIL, A SELF-REGULATORY CODE FOR THIRD PARTY FUNDING 11 (2010), available at http://www.instituteforlegalreform.com/sites/default/files/images2/stories/documents/pdf/international/tpf_consultation_paper.pdf.

which raised £60 million in funds in 2010, has committed these to funding thirty claims.²⁹ This suggests an average investment of £2 million per claim. If this average is extrapolated across to the active TPLF investors in the U.K. with banked funds,³⁰ this gives those investors the ability to fund around seventy-five claims. This estimate excludes Juridica and IMF, which only make occasional investments in the U.K. Adjusting for a number of investments in smaller claims, such as £1 million claims, allows for funding for an estimated eighty-five cases.³¹ Assuming that this funding is over a two-year period, the six TPLF investors active in the U.K. likely fund an estimated forty-three claims per year. Assuming further that an additional eight claims are funded by the remaining four active TPLF investors, these investors likely fund an estimated fifty-one claims annually.

This seems broadly in line with the figures given by those active TPLF investors interviewed. Those figures suggest an estimated sixty-two claims funded in 2011 in the U.K. This estimate differs from the previous estimate due to the average two-year duration of each claim, which leads to a carry-over of claims initially funded in prior years to the current year when they are nearing finalization. The estimate needs to be qualified by several other factors. It is only an estimate—claims may have been counted twice, as individual TPLF investors may be co-funding the same actions, and a number of the claims funded by U.K.-dedicated TPLF investors are in other jurisdictions, e.g., U.S. and Australia.

This estimate can be put in context using an early 2008 analysis conducted by consulting firm LEK.³² The analysis estimated that there were between 500 and 1,000 commercial cases, and about 250 insolvency cases of claims commenced in 2006, that were potentially suitable for TPLF. LEK's estimates were based on published judicial statistics of claims commenced in the English and Welsh high courts, specifically the Queens Bench and Chancery divisions, thus excluding those that were not set down for trial. Further, these estimates do not indicate whether the claims would have needed or wanted TPLF or have satisfied the selection criteria of TPLF investors. However, accepting these figures as crude estimates suggests that there were a maximum of 1,250, or 1,000 if insolvency claims are excluded, potentially fundable cases. Assuming these estimates were valid today, the dedicated TPLF industry is funding a mere 4%, or 5% excluding insolvency claims, of commercial cases.

²⁹ Interview with Susan Dunn, Head of Litigation Funding, Harbour Litigation Funding (July 2011).

³⁰ See *supra* Table 2.

³¹ Ten claims at a value of £2 million from the sample of seventy-five cases is equivalent to twenty claims at a value of £1 million.

³² L.E.K. CONSULTING, LITIGATION FUNDING: MARKET REVIEW (2008) (PowerPoint presentation).

D. *TPLF as an Investment*

TPLF is not insurance—it is an investment. The funds are provided to claimants on a no-win-no-pay basis in return for a success fee.

As an investment TPLF is attractive for a number of reasons. Most of those interviewed stated that TPLF was uncorrelated with other asset classes, perhaps mildly counter-cyclical, and offered potentially high but risky rewards. Its downsides include that it is a bespoke financial product requiring extensive due diligence, is not scalable, is high risk, the timing of outcomes/returns is not controllable or predictable, and is generally illiquid. One exception to the illiquidity are those publicly listed TPLF investors who have their shares traded on a stock exchange. However, these shares are thinly traded and are not likely to be very liquid either.³³

The prospectuses of the publicly listed funders—Juridica³⁴ and Burford³⁵—shed further light on the risks faced by investors:

- * Investors are not able to raise additional funds if the company invests in claims in excess of total funds.

- * Investors face fluctuations in operating results due to different timing of collection of recoveries, changes and values of investments, etc. As a result, a company's profits in one period will not be indicative of the future.

- * Both companies are aware of legal restrictions in different jurisdictions and their potential difficulties. Burford states: “There is also the risk that the [c]ompany may make an investment or otherwise engage in a business or financial transaction despite the uncertainty around a certain jurisdiction, leading to that investment being at risk by virtue of its investment agreement being found to be unenforceable.”³⁶

- * Networking is crucial to company's investment strategy.

- * Investors face a risk of bad case selection.

³³ For share prices, see *Stock Summary for Juridica Investments Limited*, LONDON STOCK EXCHANGE (Dec. 27, 2011), <http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary.html?fourWayKey=GG00B29LSW52GGGBXAIM>; *Stock Summary for Burford Capital Limited*, LONDON STOCK EXCHANGE (Dec. 27, 2011), <http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary.html?fourWayKey=GG00B4L84979GGGBXASQ1>; *Stock Summary for I.M.F. (Australia) Limited*, AUSTRALIAN SECURITIES EXCHANGE (Dec. 27, 1011), <http://www.asx.com.au/asx/research/companyInfo.do?by=asxCode&asxCode=IMF>.

³⁴ See generally JURIDICA INVESTMENTS LIMITED, ADMISSION DOCUMENT TO TRADING ON AIM (2007), available at http://www.juridicainvestments.com/investor-relations/-/media/Files/J/Juridica/pdfs/Admission_Documentation.pdf.

³⁵ See generally BURFORD CAPITAL LIMITED, ADMISSION DOCUMENT TO TRADING ON AIM (2009), available at <http://www.burfordfinance.com/pdf/Burford-Admission-Document.pdf>.

³⁶ *Id.* at 12.

* Investors face liability for costs, especially in loser-pays jurisdictions, or when ATE insurance was not purchased.

* Investors face difficulties in recovery collection when a defendant is unable to pay.

* Investors must rely on lawyers' skills, as he or she cannot control the prosecution.

* Juridica states that conflicts can arise because lawyers owe legal professional duties to the court and their clients. There could be circumstances in which the lawyers are required to act in accordance with these duties, which may be contrary to other responsibilities to the company or inconsistent with firm's investment strategy.

E. *Case Selection*

Table 3 summarizes the case selection criteria, success fee arrangements, types of cases funded, and experience to date of U.K.-based TPLF investors.

Until recently, the primary focus of TPLF has been insolvency cases. These were typically small to medium-sized claims with fairly predictable outcomes. Funders who invest in insolvency cases include IM Litigation Funding, which is no longer operating, Harbour, Redress Solutions, Therium, ILF Advisors, and 1st Class Legal. Some funders, such as Harbour and ILF Advisors, also deal with tax claims.

Most dedicated TPLF investors will fund only commercial litigation—mainly contract and commercial disputes. Nearly all stated that they do not fund complex multiparty construction, patent trolling, matrimonial, personal injury, defamation, or clinical negligence claims. Several fund arbitration claims, and several European funders specialize in group actions, especially follow-on cartel damage claims.³⁷

Most of the TPLF investors interviewed stated that they only funded large commercial claims in the U.K. and often more narrowly in England and Wales. This is because most are London-based litigators who feel most comfortable with the law and procedural rules of England and Wales High Court. A number were prepared to fund cases outside England and Wales, but often this was limited to common law jurisdictions, including Australia, New Zealand, Canada, U.S., and Caribbean. It is evident that this narrow focus arises from investors staying within their comfort zone, and perhaps from the availability of an attractive case flow, given the nascent stage of the industry's development, which does not yet require searching wider for attractive claims.

³⁷ See *infra* Tables 4-5.

The minimum and actual values of the claims that are, or will be, funded varies considerably, but tends to be high.³⁸ The minimum threshold set by many TPLF investors exceeds a claim of £1 million, and some have larger minimum claims exceeding £5 million. However, in practice, claims with a lower value will be funded if they are particularly attractive in terms of the soundness of the case and the prospect of a quick resolution. Some TPLF investors have guidelines, while others have strict minimum thresholds. Often, “proportionality” was used to describe the relationship between the prospective investment and the anticipated award/success return. The investment per claim ranges from a low of £50 thousand (in the case of Vannin Capital and Therium, to a maximum of £6 million in Harbour’s case.³⁹ Only claims with a financial remedy are funded. Actions for specific performance and injunctive relief are not considered for the obvious reason that there is no financial outcome in which to share.

TABLE 3. CASE SELECTION, FEES AND CASE LOAD OF UK FUNDERS

Company	Minimum Claim	Success fee	Types of claims	Claims funded and reviewed
UK				
Harbour Litigation Funding	£3m	Greater of multiple of funding and % of proceeds	Breach of contract, cartel damage, professional negligence; Insolvency Act claims; misrepresentation; intellectual property; breach of fiduciary duty; tax and employment tribunal claims. No matrimonial and construction cases	650 reviewed, 60 funded (30 in current fund); no more than of the fund in any one case
Vannin Capital	£5m (but can be as low as £500k)	Multiple of funding or % of proceeds	International arbitration, breach of contract, negligence, commercial. Also look at negligence and commercial cases. Has considered group actions but decided not to invest	Invested £8m in 7 claims (1 international); 1 IP case in the UK; breach of contract, 2 breach of commercial contract)
Calinius Capital	Ideally £3m or 6 times investment. Rarely less than £1m	Usually a combination of multiple and % proceeds	All commercial areas: breach of contract such as confidentiality agreements, trade and distribution agreements, breach of fiduciary duty; professional negligence. Also commercial IP cases. No divorce, personal injury, construction	122 reviewed, 15 funded in 2011
ILF Advisors	£1m	10% to 20%	Contract disputes, tax, insolvency, tort, professional negligence, shareholding, group and single actions. No arbitration cases or complicated cases (medical, divorce, defamation, misfeasance, construction)	7 funded (2 judgments expected, 2 settled; 2 ongoing, 1 awaiting defendant reply); 10 under consideration, many in pipeline
Therium Capital Management	£1m	Multiple of funding or % of proceeds.	Large commercial litigation and arbitration claims. Also insolvency cases. No matrimonial, defamation, privacy, multi-party construction. Parent Accounts state 4 cases completed generating 207% return on investment	244 reviewed (might fund 4-6), 15 funded between £50k-£2.4m investment, most still running)
Woodsford Litigation Funding	£3m	Multiple of funding 3 or greater or 10% to 50% of proceeds.	Commercial litigation and arbitration and expert determined disputes, specifically: general commercial litigation, e.g. contractual disputes; shareholder and company matters; financial services, financial markets and commodities; banking, commercial property; tax competition; professional negligence; insurance; fraud/dishonesty; intellectual property	c. 40 reviewed in 2011. 1 arbitration funded (£0.5m investment)
Commercial Litigation Funding Ltd (CLFL)	Above £2m	Multiple of funding or 25% to 30% of proceeds	Commercial and group actions. No clinical negligence and private injury	c. 200 reviewed. Funded or partly funded 12 (2 outstanding, lost, 2 full trial)
IM Litigation Funding	Above £3m		Breach of contract, professional negligence, breach of directors’ duties, wrongful or fraudulent trading and transactions at an undervalue, insolvency	50 insolvency claims funded
Redress Solutions	£250k	Multiple of funding and/or % of proceeds	Insolvency litigation specialist. Work with Insolvency Practitioners. Commercial disputes, breach of contract, shareholder action, claims against former customers or suppliers, claims against directors, recovery of book debts and many other types of action. No case they would not consider	Ratio of funded to reviewed cases is 1 in 10. Claims reviewed/funded included building, family law, shareholder and inadequate compensation
1st Class Legal Litigation Funding	£150k	Fixed fee plus daily interest agreed upfront	Contract disputes, professional negligence claims, trustee and insolvency related claims, directors and partner disputes, intellectual property cases, international & domestic arbitration matters, class actions	Funded less than 1 in 5 claims

³⁸ See *infra* Table 3.

³⁹ Interview with Neil Purslow, Managing Director, Therium (July 2011); interview with Nick Rowles-Davies, Consultant, Vannin Capital (July 2011); interview with Susan Dunn, Head of Litigation Funding, Harbour Litigation Funding (July 2011). Burford Capital’s maximum investment per claim is \$15 million. Interview with Christopher Bogart, Managing Director, Burford Capital (July 2011).

While the other selection criteria varied, and were expressed by those interviewed with different scientific precision and rigor, there were a number of common and relatively obvious criteria. These included:

- * legal merits of the claim,
- * prospective investment in relation to likely financial outcome,
- * likelihood of success,
- * defendant's solvency and ability to pay costs and any award/settlement,
- * claimant's motivation, commitment, and (dis)honesty,
- * experience and deliverability of legal team, and
- * portfolio risk management constraints in terms of proportion of investable funds committed to an individual case and risk profile.

The selection of cases involves considerable due diligence from the management team, their legal advisers, and, often, forensic accountants. Funders with a private equity background, e.g., Calunius Capital and Therium, used financial modeling to select cases.⁴⁰ Others used risk assessments, while others implemented more informal methods. Most of this time and effort was upfront and relatively fixed, regardless of the size of the claim.

For those who have a significant deal flow, only a small number of prospective claims are funded. The TPLF investors interviewed indicated that they fund around one in ten of the claims reviewed. Harbour, Calunius, Therium, Allianz, CLFL, and Woodsford collectively reviewed around 1,446 potential claims and agreed to fund 118, or only 8% of those reviewed.⁴¹

F. *Customers*

The focus of this research has been on the supply of TPLF investment. As a result, there is less knowledge of the users of TPLF. Nonetheless, the demand for TPLF comes from claimants. Typically, claimants' dealings are with lawyers who have relationships with TPLF investors, and who

⁴⁰ Interview with Neil Purslow, Managing Director, Therium (July 2011); interview with Mark Wells, Managing Partner, Calunius Capital (July 2011).

⁴¹ Caution must be exercised in relying on these figures because individual TPLF investors may have reviewed the same claims, and because multiple TPLF investors may have co-funded some of the claims. Additionally, some of the reviewed claims may have been rejected outright as being totally unsuitable, such as personal injury claims. Interview with Susan Dunn, Head of Litigation Funding, Harbour Litigation Funding (July 2011); Interview with Neil Purslow, Managing Director, Therium (July 2011); Interview with Mark Wells, Managing Partner, Calunius Capital (July 2011); Interview with Brian Raincock, Chairman, Commercial Litigation Funding (July 2011); Interview with Ben Hawkins, Managing Director, Commercial Litigation Funding (July 2011); Dr. Arndt Eversberg, Managing Director, Allianz ProzessFinanz GmbH (July 2011); Jonathan Barnes, Director, Woodsford Litigation Funding (July 2011).

advise their clients about the suitability of TPLF and its different providers. Occasionally, TPLF investors are approached directly by claimants, or, in the case of group litigation, the TPLF investors may approach prospective claimants. All those interviewed stressed a need to develop a close working relationship with solicitors as a key to their business and deal flow.

Demand for TPLF comes from those who either cannot or prefer not to fund their own litigation. Some claimants do not have access to sufficient funds; others see TPLF as a way of managing their cash flow, keeping litigation costs off their balance sheet, or both. By obtaining TPLF to cover legal costs, claimants do not incur upfront costs; rather, they only incur a contingent profit to write-up against realized losses. Thus, it cannot be assumed that TPLF investors fund only cash strapped claimants who would not otherwise have litigated.

It has not been possible to get a profile of lawyers and claimants who have used, or are likely to use, TPLF. Generally, lawyers who have used TPLF are not from the “Magic Circle” law firms but, as described by one TPLF funder, are from the 100–500 ranked law firms. However, the profile of law firms differs among funders. Similarly, it is rare for a Financial Times Stock Exchange 100 (FTSE100) firm to use TPLF, given the focus on small and medium-sized enterprises. Generally, though, individual TPLF investors each have different client and lawyer profiles.

Two factors the TPLF industry struggles with are low customer awareness and misconceptions about TPLF. The product is relatively new—apart from insolvency cases, see below—and there is no reliable track record, given that most TPLF investors have operated for two years or less, and that many have not finalized many of the cases they are funding.

These struggles are partly self-inflicted. TPLF investors differ in the extent they advertise or even wish to publicize their services. Most rely on developing extensive relationships with law firms. In England and Wales, a solicitor has a professional duty to advise clients on the litigation funding options as set out in Rules 2.02 and 2.03 of the Solicitors’ Code of Conduct.⁴² Indeed, a number of major legal firms provide information and promote various financing options for litigation, including Addleshaw Goddard, Irwin Mitchell, and Taylor Wessing. Also, a recent survey commissioned by Harbour and published in September 2010 showed that, of the top 200 U.K. law firms, over 90% of respondents either always or sometimes discuss litigation funding options with their clients.⁴³

A number of TPLF investors stated that they regarded publicity as undesirable for commercial confidentiality. This is particularly so in specific

⁴² Solicitors’ Regulation Authority Code of Conduct 2011 2.02-03 (Dec. 23, 2011) (Eng. & Wales), available at <http://www.fassit.co.uk/pdf/solicitors-code-of-conduct-full.pdf>.

⁴³ Press Release, Harbour Litigation Funding, Harbour Litigation Funding Announces Results of First Annual UK Litigation Survey 2 (Sept. 7, 2010), available at <http://www.harbourlitigationfunding.com/assetmanager/images//harboursurveypressrelease7sept10.pdf>.

cases where there is a reluctance to inform even opposing counsel that the claimant is funded.

This assertion is borne out by recent surveys. An Ipsos Mori poll, conducted for Addleshaw Goddard, a second-tier U.K. law firm, and based on interviews held in June 2008 with more than fifty senior executives, including heads of litigation and counsel for Financial Times Stock Exchange 350 (FTSE350) companies, found that 34% had not heard of ATE insurance and that 30% had not heard of TPLF.⁴⁴ Only 2% of the respondents had used TPLF, with 46% saying they were very unlikely to use TPLF.⁴⁵ This stance may be changing. A survey by Harbour found that 50% of respondents had direct experience with TPLF.⁴⁶ Either these findings are difficult to reconcile or great progress has been made in less than two years.

G. *Managing Legal Costs*

Approaches to funding commercial litigation differ. The investment may cover the full costs until settlement, a part of the costs, or specific components of the costs such as expert witness fees. Those TPLF investors who operate in the U.K. often cover the full costs from the date of the funding agreement. Typically, they will cover legal costs, expert witness' costs, adverse costs like ATE premiums, and any other out-of-pocket expenses. These covered costs may not comprise the full costs of running a case, since a TPLF investor may be approached, and may agree, to invest at some intermediate stage of the litigation process.

TPLF investors are very concerned with the management of the legal costs. In the U.K., the costs of litigation are high and generally unpredictable because they are dependent on a number of substantive and procedural factors, which vary considerably and can have a significant impact on the ultimate return. This contrasts with a civil legal system like Germany, where lawyers are paid according to a schedule of set legal fees and costs which makes budgeting of legal costs, and hence the level of investment needed, fairly predictable. Further, U.K. lawyers are generally not good at budget management and cost control. One TPLF investor described them as "like builders" exhibiting a tendency to under-quote legal costs, and then, once "on-site," to go over budget. This is not conducive to TPLF, and one task and major role of the TPLF investor is to pin down the budget.

⁴⁴ Over a third of respondents in the sample came from FTSE100 firms. ADDLESHAW GODDARD LLP, LITIGATION FUNDING: UNDERSTANDING THE STRATEGIES AND ATTITUDES OF CORPORATE UK 5, 15 (2008).

⁴⁵ *Id.* at 22-23.

⁴⁶ Harbour Litigation Funding Announces Results, *supra* note 43, at 2.

Indeed, lawyers who did not respond professionally to a TPLF investor's request to provide well-formulated budget estimates were often not funded.

TPLF investors' attitudes toward legal budgets and cost overruns differ. A number of funders—usually those with investment banking backgrounds—ask for estimates of maximum costs, with the TPLF funder stating that cost overruns will not be accepted unless they are critical to the case, such as when it subsequently becomes necessary to appoint an expert witness. Others, usually ex-litigators, show more tolerance toward budget overruns, seeing them as almost inevitable. To avoid budget overruns, funders often take a pessimistic approach and pick the worst-case budget estimate. They also monitor legal costs at each stage of the case with ongoing updates.

Most dedicated TPLF investors interviewed did not see liability for adverse costs as a particular issue. While it increased the costs of litigation and the variability of outcomes, and decreased net settlements, it also made TPLF more attractive to potential claimants. As the defendant's legal costs are often equal to that of the claimant, this effectively doubles the TPLF investors potential exposure to legal costs. Typically, TPLF investors take out ATE insurance and the premia tend to range from 40% for pre-paid ATE coverage to 60% for outcome-based ATE coverage.⁴⁷ Allianz, whose management team has German legal background and experience, did express concerns about adverse costs and said that these, together with the generally high costs of litigation in England and Wales, were the principle factors for their decision to only fund high-value claims in the U.K., unlike their business in other jurisdictions. Juridica said high costs were one of the principle reasons it did not invest in the U.K.

H. *Return or Success Fees*

The return to TPLF investors is paid out of damages or out-of-court settlements. The structure of the success fee differs, as do the underlying commercial rationales. While the broad terms are listed in Table 3, the precise terms vary considerably for individual TPLF investors, and often on a case-by-case basis.

The basis of the success fee was explained in different terms by those interviewed. Some regarded it as a risk–reward payment, with the success fee reflecting the likelihood of success and failure. One example was given where a low success fee was negotiated for a claim that was nearly guaran-

⁴⁷ ILF Advisors stated that ATE insurance constituted around 40% of costs covered by the funder. Allianz said that it varied from 40% to 60%. Interview with Neil Brennan, Chief Executive Officer, ILF Advisors LLP (July 2011); Interview with Dr. Arndt Eversberg, Managing Director, Allianz Prozessfinanz GmbH (July 2011).

teed to succeed. Others did not accept this explanation. They took the position that their due diligence and case selection dealt with risk, and thereafter the success fee was determined by a return-on-investment ratio. As one investor put it, even sure fire winners have lost at trial, citing the example of *Stone & Rolls*.⁴⁸

There are three methods of pricing the return on a TPLF investment: a multiple of the investment as described above, a percentage of the award or settlement, or some mixture of both. Most TPLF investors will look for a return in terms of a multiple of the funds invested. This can vary from 1.5 to 6 times the investment made. This suggests a fairly high return, but the return must also cover the losses of claims that fail.

It is more common for the return to be expressed as a percentage of the award or settlement in the funding arrangement with claimants. In the U.K., this typically ranges from 20% to 40% of the award or settlement, but can be 50% or higher in some cases. In Austria, Germany, Ireland, and the Netherlands, the experience is similar—a success fee from 20% to 40%.⁴⁹ These ranges are lower than in Australia, where TPLF investors' success fees range from 30% to 60%.⁵⁰

A number of TPLF investors emphasized that their success fee is set in a way that does not leave the claimant with less than 50% of the claim value.⁵¹ A higher success fee would de-motivate the claimant, and would not be seen as a fair or acceptable commercial split. This may be hard to achieve if the damages or the out-of-court settlement is less than what was anticipated in the funding agreement. It is a reality of litigation that most cases are settled before trial, often for sums less than the claim or the damages at trial might have been. While it can be expected that those claims seeking funding are more likely to go to trial,⁵² the success fee component may well be much higher if the settlement is lower than projected. This will also be the case since settlements will often be an all-in offer, where the individual components of damages, costs, claimants' legal expenses including lawyers' conditional fee payments, ATE, and other elements are not broken down separately. This requires that the various claims of the settlement sum be prioritized.

⁴⁸ See *Stone & Rolls Ltd. v. Moore Stephens*, [2007] EWHC (Comm) 1826 (Eng.), available at <http://www.bailii.org/ew/cases/EWHC/Comm/2007/1826.html>.

⁴⁹ HODGES ET AL., *supra* note 9.

⁵⁰ Daniel L. Chen & David S. Abrams, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes* 15 (Working Paper, July 2011), available at <http://www.duke.edu/~dlc28/papers/MktJustice.pdf>.

⁵¹ A survey of FTSE100 in-house counsel found that almost half of the respondents thought that a 25% success fee was too high, and almost 60% thought that a 40% success fee was too high. ADDLESHAW, *supra* note 44, at 12.

⁵² Susan Dunn commented that Harbour tends to fund "harder cases" that have a "much higher percentage [of] going to trial." Interview with Susan Dunn, Head of Litigation Funding, Harbour Litigation Funding (July 2011).

Despite this, most TPLF investors interviewed said that the potential rewards were high. The actual returns are hard to estimate given that those in the industry do not yet have a solid track record. There have also been some significant recent losses (see below). However, a brief, but optimistic, glimpse is provided by Therium, which has reported that the four cases finalized at the beginning of 2011 generated a 207% return on their investments.⁵³ Financial data covering the period 2001–2010 for Australia's biggest TPLF investor, IMF, showed an internal rate of return of 75% before overhead expenses.⁵⁴

It is important not to be mesmerized by the headline success fees. Despite due diligence and the selection of strong cases, a large number will fail given the uncertain nature of litigation. Indeed, if one accepts the rule of thumb, given by several of those interviewed, a case should have a 70% or greater chance of success to be considered. This suggests a failure rate of 30% or less. It is therefore interesting—or simply coincidental—that IMF's failure rate is 24%. Thus, fees generated on the successful actions must cover the investment on those claims that have been lost across TPLF investors' portfolio of cases. Given that most TPLF investors have relatively small caseloads and will have invested differing sums, a few failures can wipe out the net returns. Several interviewees stressed that this made case selection, risk diversification, and risk management crucial to the success of the investment strategy. Others noted that whatever attractive returns materialized from the claims funded to this point, returns would be under greater pressures as more investors entered the market.

Several recent high profile losses to TPLF investors underscore these risks. One of the largest TPLF-funded claims to date was *Stone & Rolls Ltd. v. Moore Stephens*, an £89 million professional negligence claim brought by liquidators to the insolvent company Stone & Rolls in 2007.⁵⁵ The liquidators alleged that the company's auditor, Moore Stephens, failed to detect its owner's fraudulent activities that resulted in the company's liquidation. IM Litigation Funding funded the claim, which it estimated had a 70% chance of success, and stood to receive a £40 million award.⁵⁶ The High Court ruled in Stone & Rolls's favor, but in June 2008, the Court of Appeal dismissed the claim, holding that a company liable for fraud

⁵³ Press Release, City of London Group PLC, Preliminary Results 4 (June 27, 2011) available at <http://www.cityoflondongroup.com/pressreleases/City%20of%20London%20Group%20plc%20-%20Prelim%20Results%202011.pdf>.

⁵⁴ Chen & Abrams, *supra* note 50, at 24.

⁵⁵ *Stone & Rolls Ltd. v. Moore Stephens*, [2007] EWHC (Comm) 1826 (Eng.), available at <http://www.bailii.org/ew/cases/EWHC/Comm/2007/1826.html>.

⁵⁶ Rachel Rothwell, *Major Third-party Funding Case Fails in House of Lords*, LAW SOC'Y GAZ., Aug. 6, 2009, <http://www.lawgazette.co.uk/news/major-third-party-funding-case-fails-house-lords>. The author was reliably informed that this is a gross over-estimate.

committed by its director to third parties could not bring a claim for damages against its auditors.⁵⁷ The House of Lords affirmed in 2009.⁵⁸

Arkin,⁵⁹ described by the judge as a “disastrous piece of litigation,”⁶⁰ showed the potential costs of failure. Arkin’s lawyers agreed to work on a conditional fee basis and a TPLF investor, MPC,⁶¹ funded the costs of the expert witness, forensic accountants Ernst & Young. Ernst & Young agreed to provide a report on the quantum costs of organizing documents in return for a 25% share of the damage/settlement sum up to £5 million and 23% thereafter, plus any recovery of experts’ costs from the defendants.⁶² MPC could withdraw if the expert’s report indicated that damages would not cover their investment, and its consent was needed on settlements or compromises. However, if there were a dispute over these decisions, Arkin’s counsel would prevail.⁶³ MPC estimated its total outlay to the end of the trial would be about £600,000 and the probable settlement to be between \$5 million and \$10 million.⁶⁴ MPC’s actual outlay was over double this amount, at around £1.3 million, which it lost. The claimant’s lawyers lost an undisclosed sum, and the claimant and MPC were confronted with the possibility of indemnifying the defendants’ entire adverse costs of nearly £6 million.⁶⁵ In the end, the court limited MPC’s payment of adverse costs to £1.3 million, an amount equal to the sum it invested. This is known as the “Arkin rule.” Thus, MPC’s total loss was £2.6 million.⁶⁶ That is, MPC’s investment was four times greater than initially estimated, and it could have been exposed to £7.3 million in costs had the court ordered it to pay the entire adverse costs of the defendant.⁶⁷

⁵⁷ See *Moore Stephens v. Stone & Rolls Ltd.*, [2008] EWCA (Civ) 644, [1] (Eng.), available at <http://www.bailii.org/ew/cases/EWCA/Civ/2008/644.html>.

⁵⁸ See *Stone & Rolls Ltd. v. Moore Stephens*, [2009] UKHL 39, [2009] 1 A.C. (H.L.) 1391 (appeal taken from Eng.), available at <http://www.publications.parliament.uk/pa/ld200809/ldjudgmt/jd090730/moore.pdf>.

⁵⁹ *Arkin v. Borchard Lines*, [2005] EWCA Civ 655. Mr. Arkin sought damages for anti-competitive actions from members of a number of shipping conferences, alleging that they had been guilty of predatory pricing which had driven Mr. Arkin’s shipping company from the market. The European Commission began proceedings against members of the Shipping Conferences but drop the case in early 1991 because the Conference agreements had been amended. In 1996, after going into liquidation, Mr. Arkin had the claims against members of the conferences assigned to him for breaches of Articles 81 and 82 agreeing to share any proceeds 50:50 with the creditors.

⁶⁰ *Id.*

⁶¹ *Id.* MPC was an early funder also providing accounting services. It no longer operates. The case was originally funded by legal aid but this was withdrawn for undisclosed reasons.

⁶² *Arkin*, EWCA Civ. 655.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

I. *Forum Shopping*

Forum shopping, where the claimant chooses the jurisdiction that is the cheapest, has the most favorable law or procedures, or both, was not a major consideration among U.K.-based TPLF investors. Most investors only confined their investments to commercial disputes in England and Wales, and a subset to claims in other common law jurisdictions where they had previous experience. This was because they understood the legal procedures, could better anticipate the risks and costs involved, could evaluate the lawyers and likelihood of success of the claim, and had confidence in the quality of judicial resolution provided by the courts. Even where there was foreign legal expertise and experience, there was not a tendency to forum shop. For example, Calunius has a senior and highly experienced German lawyer, but does not actively seek to fund German cases. Others, such as Therium and Vannin, were prepared to fund litigation and arbitration further afield in North America, Australia, and Europe.

The other factor emphasised by many of those interviewed was that for most commercial litigation, there is a limited scope for forum shopping. This was because the legal jurisdiction had been determined in the pre-existing relationship of the parties, such as a term in a contract governed by the nature of the dispute, by the lawyers prior to seeking TPLF, or both. The exception to this comes from those specializing in group litigation. Because these often involved parties across Europe and globally—and infringed European, EU Member State, U.S., and other laws—the action could be brought in any one of a number of jurisdictions.

III. GROUP ACTIONS

Group actions are a relatively new phenomenon in Europe. This section examines the development and extent of group actions, and the role played by TPLF investors. While an attempt has been made to interview this group of TPLF investors, they have been less forthcoming.⁶⁸ With the exception of Omni Bridgeway, the discussion below is based on publicly available information.

A. *Background*

While many jurisdictions offer some form of collective redress, this is often very circumscribed, and not attractive to litigants or funders. None-

⁶⁸ CDC declined to be interviewed and CFI failed to respond to various emails and letters for an interview.

theless, a number of TPLF funders have entered this specialist sector in the last several years largely on the back of the European Commission's aggressive cartel prosecution program.⁶⁹

There has been an extensive debate in Europe over the legislative framework for collective actions. Unfortunately, the European Commission's support for collective redress has floundered. In April 2008, the European Commission published the White Paper on Damages Actions for Breach of the EC Antitrust Rules.⁷⁰ Its proposals for class actions failed to gain support from the European Parliament and the effort lapsed. The consultations on more general reforms to introduce collective redress were relaunched in early 2011.⁷¹

In the meantime, a number of EC Member States have reformed their national laws to permit group actions, again with varying success. Some have adopted new laws permitting class actions while some have only provided a possibility of class or group action, without changing the legislation. So far, there have been a number of proposals, some of which have resulted in a change.⁷²

* Laws permitting class actions have recently been introduced in Italy in 2010, Sweden in 2003, Poland in 2010, and draft legislation exists in Belgium.

* In the Netherlands, the Collective Settlement of Mass Claims Act 2005 allows claimants, through a representative association, and defendants to agree to a settlement which they can then petition the court to make binding. The Act allows for the claimants to opt out, but those who do not are denied the right to appeal.⁷³

⁶⁹ Cento Veljanovski, *Cartel Fines in Europe Law, Practice and Deterrence* 29 WORLD COMPETITION 65 (2007); Cento Veljanovski, *European Cartel Fines under the 2006 Penalty Guidelines—A Statistical Analysis*, (Dec. 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1723843. Cento Veljanovski, *Deterrence, Recidivism and European Cartel Fines*, 7 J. COMPETITION L. & ECON., 2011, 871-915.

⁷⁰ COMM'N OF THE EURO. CMTYS., *White Paper on Damages Actions for Breach of the EC Antitrust Rules*, COM (2008) 165 final (Apr. 2, 2008).

⁷¹ EURO. COMM'N, *Commission Staff Working Document Public Consultation: Towards a Coherent European Approach to Collective Redress*, SEC (2011) 173 final (Feb. 4, 2011). The consultation closed in April 2011. Some of the trial obstacles to class actions faced by claimants include the costs of passing on defense, the length and cost of the process, and weak disclosure and discovery rules. For example, most cartel damage claims are follow-on actions from a European Commission's finding of liability. However, the Commission is not required to open the file to claimants. Recently, the European Court of Justice ruled that documents relating to a leniency program may be disclosed to claimants seeking damages in civil antitrust actions. It is up to the national courts to determine, on a case-by-case basis, whether to disclose leniency material to cartel damages actions. See, e.g., *Pfleiderer AG v. Bundeskartellamt* [2011] C-360/09.

⁷² FRESHFIELDS BRUCKHAUS DERINGER, *RECENT DEVELOPMENTS IN CLASS ACTIONS AND THIRD PARTY FUNDING OF LITIGATION* (Feb. 2008), <http://www.freshfields.com/publications/pdfs/2008/feb20/21722.pdf>.

⁷³ *Id.* at 19-20.

* The German Federal Government opposes the class action model proposed by the European Union (EU), although group actions are possible in Germany.⁷⁴

* In the U.K., no real progress has been made. In July 2006, the Department of Trade and Industry published a consultation paper on representative actions in consumer protection legislation to consider whether representative bodies should be permitted to bring actions on behalf of consumers.⁷⁵ It recognized TPLF as a potential area of growth for class action claims. But it has not progressed much since then.

The U.K. does not offer a hospitable legal environment for group actions. It allows for so-called representative actions, and the more limiting joined actions, that require that the claimants have the “same interest,” which appears to mean an identical interest.⁷⁶

The legal position was clarified in *Emerald Supplies v. British Airways*,⁷⁷ where the English and Wales Court of Appeal placed a restrictive interpretation on the same interest requirement. Emerald Supplies and Southern Glass House Produce, importers of cut flowers, used British Airways (BA) to freight its products and sought damages from BA for overcharging for air cargo services due to BA’s status as a member of an alleged airfreight cartel.⁷⁸ The claim was originally launched by US class action lawyers Hausfeld & Co. LLP in September 2008, at a time when the European Commission was still considering whether an infringement had occurred.⁷⁹ Hausfeld agreed to a conditional fee arrangement and took out ATE insurance.⁸⁰ Two claimants sued as representatives of all direct and indirect purchasers who suffered loss from the air cargo cartel.⁸¹ The High Court ruled that all those represented in the action must have the same interest as required by the civil procedure rules of the High Court, specifically CPR19.6.⁸² Because the class included direct and indirect purchasers, the amount of damages, if any, for the direct purchasers depended on whether the alleged overcharges were passed on to a downstream buyer, also known

⁷⁴ *Id.* at 16.

⁷⁵ In November 2007, the U.K. Office of Fair Trading published its recommendations following its April 2007 discussion paper *Private Actions in Competition Law*. This found little political support. See UK OFFICE OF FAIR TRADING, PRIVATE ACTIONS IN COMPETITION LAW: EFFECTIVE REDRESS FOR CONSUMERS AND BUSINESS (Nov. 2007), http://www.offt.gov.uk/shared_offt/reports/comp_policy/oft916resp.pdf.

⁷⁶ *Emerald Supplies Ltd. v. British Airways Plc* [2010] EWCA Civ 1284.

⁷⁷ *Id.*

⁷⁸ *Id.*; COMP/39.258 *Airfreight*, 9 November 2011. The European Commission fined British Airways and 10 other airlines almost €800 million for fixing the air cargo price in the period 1999-2006.

⁷⁹ *Emerald Supplies Ltd.*, [2010] EWCA Civ 1284.

⁸⁰ *Id.*

⁸¹ There were 250 claimants. *Class Dismissed*, THE LAWYER (Nov. 24, 2010), <http://www.thelawyer.com/class-dismissed/1006210.article>.

⁸² *Id.* at 75.

as the passing on defense. Further, CPR19.6 states that all the claimants who belong to the class action must be identifiable at the time the claim is issued and at all stages of the proceeding. Hausfeld's strategy of adding more claimants later in the proceeding did not satisfy this requirement. The Court of Appeal ruled that the only factor linking the claimants was that they might all have a claim against BA, but the claimant did not manage to establish BA's liability with respect to each claimant. The appeal was denied. Hausfeld subsequently signed a cooperation agreement with Claims Funding International to coordinate the pursuit of *Air Cargo* cartel claims within the EU.⁸³

B. *TPLF-Funded Group Actions*

A number of third-party funders have formed to invest in group actions largely in the antitrust and shareholder claim areas. Three funders specialize in this type of emerging litigation.⁸⁴ Cartel Damages Group (CDC), based in Brussels and formed in 2001; Omni Bridgeway, the oldest company with twenty-five years experience in emerging country sovereign debt recovery which set up a group actions division in 2007; and Claims Funding International (CFI), established in Ireland (Table 4 below). Omni Bridgeway's group litigation division is funded primarily from proprietary capital and, more recently, institutional funds. CDC specializes in purchase and enforcement of cartel damage claims. CFI was launched by IMF, which subsequently pulled out, and the Australian class action law firm Maurice Blackburn in 2008, but does not seem to be very active.

These TPLF investors do not rely on specific class action legislation or reforms. Instead, they rely on Special Purpose Vehicles (SPVs), which purchase or are assigned claims, which SPVs then prosecute in their own right.⁸⁵ SPVs are legal entities created for a number of purposes, including the acquisition, financing, or both, of a project or the set up of an investment. They are usually used because they are free from preexisting obligations and debts, and are separate from the parties that set them up for tax and insolvency purposes. The assignment of claims to such SPVs, as well as their standing, has been endorsed by the Dutch and German courts.

⁸³ *BA Brings 32 Other Airlines into Its London Air Cargo Litigation*, HAUSFELD LLP (July 23, 2010), http://www.hausfeldllp.com/pages/press_releases/414/ba-brings-32-other-airlines-into-its-london-air-cargo-litigation.

⁸⁴ The only TPLF investor to participate in the survey was Omni Bridgeway. The information for CFI and CDC has been collected from their websites and other public sources.

⁸⁵ These are unincorporated associations formed under Dutch law.

TABLE 4. THIRD-PARTY GROUP LITIGATION FUNDERS

Company	Start	Domicile	Offices	Funding	Value of funds
Cartel Damages Claims	2002	Belgium	Germany, Ireland, Brussels	Undisclosed	Undisclosed
Omni Bridgeway	2007	Netherlands	Hague, Geneva, London	Internal & external	Undisclosed
Claims Funding International	2008	Ireland	Dublin	Undisclosed	Undisclosed

Source: Funders' websites and interviews.

Table 5 below provides further details of fees charged, minimum claim requirements, and case experience of TPLF providers engaged in group actions. To date the three group action TPLF investors have mounted seven follow-on cartel damage claims in the German, Dutch, and French courts with no settlement or award yet.⁸⁶

CDC has the largest caseload, with four group actions:

1. In 2001, CDC through a SPV brought the first funded collective action in the Regional Court of Dusseldorf against German cement manufacturers convicted of a price-fixing conspiracy. CDC purchased the claims of twenty-eight companies—mostly small and medium enterprises active in the concrete production and manufacturing sector. The claim is reported to be valued at €176 million before interest. Despite the elapse of a decade, this claim is reportedly no nearer to a resolution.

2. In April 2011, CDC Hydrogen Peroxide SA commenced an action in the Regional Court of Dortmund against several hydrogen peroxide manufacturers that were successfully prosecuted by the European Commission for price fixing. This SPV purchased the damage claims of thirty-two pulp and paper makers who bought hydrogen peroxide during the period of the cartel. CDC agreed to give the claimants 75% of the value of any eventual proceeds plus an undisclosed initial payment. The damage claim is reported to be €645 million plus interest, which compares with the €388 million fine levied by the European Commission.

⁸⁶ Information taken from funders' websites. CLAIMS FUNDING INT'L (CFI), <http://www.claims-funding.eu/>; CARTEL DAMAGES CLAIMS (CDC), <http://www.carteldamageclaims.com/>; OMNI BRIDGEWAY, <http://omnibrigeway.com/>.

TABLE 5. CASE SELECTION, FEES AND CASELOADS OF GROUP ACTION FUNDERS

Company	Minimum Claim	Success fee	Types of claims	Cases funded to date	Where
Cartel Damages Claims	NA	30%	Follow-on cartel damage claims	4 follow-on cartel damage claims related to <i>German Cement</i> , and <i>EU Hydrogen Peroxide</i> , <i>Sodium Chlorate & Paraffin Wax</i> cartels	Europe
Omni Bridgeway	\$1m but preferably around \$50m	10% to 45% (30% to 35% for Air Cargo damages action)	Follow-on cartel damage, shareholder and mass tort actions	3 group action - 2 cartel damages (<i>Airfreight</i> , <i>Elevators</i>) 1 mass tort (<i>Abalone Virus</i> in Australia); 11 in pipeline. Dozens of claimants in each follow-on action and 80 in <i>Abalone Virus</i> action	Europe, Australia, Japan, South Korea & Turkey
Claims Funding International	€5m with min. 70% success rate	7% in <i>Dugal v. Manulife</i> on \$10m investment	Group actions and other significant legal claims - cartel damages, shareholder actions against corporate misconduct, group actions against investors	<i>Airfreight</i> €400m cartel damage claim against Air France-KLM and Martinair. Shareholder claim in <i>Dugal v. Manulife</i>	Europe & Canada

Source: Funders' websites and interviews.

3. CDC has also purchased sodium chlorate cartel damage claims from ten pulp and paper companies.

4. CDC has also filed a damages claim in Netherlands after eight candle producers assigned their damage claims to CDC as a result of the Paraffin Wax Cartel.

Omni Bridgeway's group claims division also uses the SPV approach for its two European cartel claims in the Netherlands—Air Cargo and Elevators. Both consist of dozens of participants and both are co-funded—the former with CFI, and the latter with Hausfeld. The Air Cargo claim has an estimated value of €200–€300 million. Omni Bridgeway is also funding an Australian mass tort class action in relation to the Abalone virus, but this uses the standard TPLF approach.

CFI set up a SPV called Equilb for its group action against Air France–KLM for fixing air cargo prices. The claim is reported to be in excess of €400 million with interest on behalf of victims all over Europe, including Phillips and Ericsson, in a Dutch court. CFI is experiencing difficulties with their use of the Equilb model in France. CFI has also invested in a shareholder class action in Canada adopting the usual success fee structure.

This brief overview of cartel group action in Europe demonstrates the infrequency of these actions. Some are over a decade old—*German Cement* for example—while others are new and have encountered significant procedural problems. CFI has effectively funded only one European group claim, which has encountered difficulties. IMF pulled out as a shareholder of CFI because of the lack of progress in group redress in Europe and the complexity of follow-on cartel damage claims. The investment environment does not seem attractive.

Group actions are an area where TPLF investors face direct competition from lawyers. The much-publicized entry into London market of plaintiff and class action U.S. law firm Cohen, Milstein, Hausfeld & Toll was a direct response to the anticipated growth of private and class action lawsuits in Europe, especially follow-on cartel damage claims. This initiative faltered and the high cost of the firm's foray into Europe is believed to

be the reason why Michael Hausfeld left the partnership. The newly-formed Hausfeld & Co LLP has continued in the market both competing and cooperating with dedicated TPLF investors. It has drawn on its U.S. class action experience, joined European claimants in its U.S. actions, and advertises funding solutions. In the event that extra funding is needed, Hausfeld offers help in finding a TPLF provider. Hausfeld has been involved so far in four follow-on cartel damage group actions: Air Cargo together with CFI; Marine Hoses; Carbon Graphites;⁸⁷ and the Elevators claim with Omni Bridgeway.

C. *The Evidence from Australia*

Australia has the longest experience with TPLF.⁸⁸ Australia is a jurisdiction with a very similar legal system, but does have some significant differences, such as the possibility of class actions. It may therefore be instructive to compare the experience of the largest Australian TPLF investor IMF, to those emerging in the U.K. and Europe.⁸⁹

IMF is by far the largest and oldest TPLF investor in Australia, with a reported 50% market share.⁹⁰ In addition to IMF, there are five other dedicated TPLF investors operating in the Australian market: Litigation Lending Services, Quantum Litigation, LCM Litigation Fund, Comprehensive Legal Funding LLC, and Hillcrest Litigation. Other investors make single investments.⁹¹ Both IMF and Hillcrest are listed on the Australian Stock Exchange (ASX). Most of the funders in Australia initially invested in insolvency cases⁹² but have now expanded to commercial litigation, including class actions and representative proceedings. They generally do not fund personal injury cases. In addition, Australia has some very active plaintiffs

⁸⁷ Hausfeld also provides ATE insurance in conjunction with First Assist Insurance Group, and its lawyers work on a no-win-no-fee basis and claim to have existing relationships with providers of litigation services thus are able to lower the disbursement costs. HAUSELD & CO. LLP, <http://www.hausfeldllp.co.uk/>.

⁸⁸ In Australia, the area has been subject to more official and academic investigations. See, e.g., Law Council of Australia, *Regulation of Third Party Litigation Funding in Australia—Position Paper*, June 2011; Vicki Waye & Vince Morabito, *The Dawning of the Age of the Litigation Entrepreneur*, 28 CIVIL JUST. Q. 389 (2009); Vicki Waye, *Trading in Legal Claims: Law, Policy and Future Directions in Australia, UK and US* (Presidian 2008); Vicki Waye, *Conflicts of Interests between Claimholders, Lawyers and Litigation Entrepreneurs*, 19 BOND L. REV. 225 (2007).

⁸⁹ IMF (Australia) Ltd, *Annual Report*, 2011.

⁹⁰ Abrams & Chen, *supra* note 50, at 6.

⁹¹ Some of the single investors include Wasserman, Comden & Casselman LLP (U.S.) and Julian Hammond (New York Attorney).

⁹² A statutory exception to champerty was introduced in 1995 through the *Corporation and Bankruptcy Act 1995* for insolvencies, which allowed administrators in bankruptcy to sell parts of a claim in return for funding litigation. This triggered the emergence of TPLF for insolvency cases and explains why such cases dominated the sector in the early part of the 2000s.

law firms, which initiate lawsuits and fund or co-found them through conditional fee arrangements. These law firms include Slater & Walker, which is also listed on the ASX, Maurice Blackburn, and, Piper Alderman.

Given the size of the Australian market, it appears fairly competitive. Several dedicated TPLF investors only fund a few claims. For example, Hillcrest listed four claims in 2010, reflecting a decline from around thirteen claims in 2007. Given the relative size of IMF, it appears that a successful funder may need a decent throughput of cases to remain viable.

IMF, as a publicly listed company, reports figures on its investments, which give an insight into the operation of the Australian dedicated TPLF investment market. Since 2001, IMF funded and closed 123 claims. This is an average of twelve closed cases a year. Assuming, as reported, that IMF has 50% of the Australian TPLF market, this suggests an average of twenty-four funded claims per annum. Adjusting for differences in population, as Australia is one-third the size of the U.K., this suggests, all things equal, that in a more mature setting, the annual caseload for the U.K. should be around seventy-two funded claims per annum. However, the number is likely to be less given the absence in the U.K. of a favorable class action regime.

Based on more detailed figures for February 1999 to June 2007—a slightly different and longer period—IMF funded ninety of the 763 claims it reviewed, implying a rejection rate of 88%, or funding of about one in every ten cases reviewed.⁹³ This suggests a greater funding rate than has so far been experienced in the U.K.

Of the 123 claims fully or partially funded and closed by IMF, eighty-three were settled out of court, twenty-five were withdrawn or dropped, five lost at trial, and ten won at trial. This indicates a relatively high drop rate—over 20% of the cases IMF has partially funded. Taking the dropped and lost at trial cases together suggests an overall failure rate of over 24%. Further, over this period and assuming one has read the data correctly, fifteen claims, or over 12% of IMF's funded claims, went to trial, a relatively high percentage. At trial IMF, experienced a 33% failure rate. Around 67% of total funded claims were successfully settled out of court. Interestingly, IMF's 76% overall successful outcomes rate is close to the practice of some U.K. dedicated TPLF investors, which is to select cases with a 70% or greater probability of winning. This may be pure coincidence, but could be based on the experience of profitable operations.

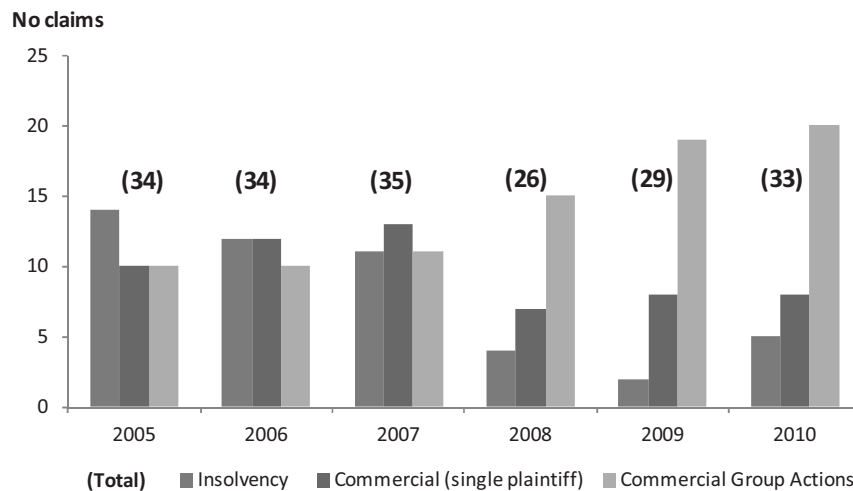
IMF will not consider claims less than AUD2 million. Based on reported figures for finalized claims from 2010 and 2011, the average value of claims is well above this at over AUD33 million and AUD45 million, respectively. IMF aims to complete cases within 2.5 years with a gross

⁹³ Hillcrest's 2007 Annual Report states that from late 2004 to August 2007 it received 115 prospective claims, and funded fifteen, or about one in ten. HILLCREST LITIGATION SERVICES LTD., 2007 ANNUAL REPORT 4 (2007).

return of three times its investment, excluding overheads. The average duration of processing its claims to finalization over the last two years was roughly 2.3 years, with success fees between 20% and 45% of proceeds.

The aggregate figures in Figure 1 disguise the change in the composition of IMF's caseload. It shows the number of ongoing cases each year to which IMF committed funds, divided into three main groups: insolvency, commercial single claimant, and commercial group actions.⁹⁴ IMF's focus has moved from insolvency cases to group actions. In 2005, IMF invested in fourteen insolvency cases. In 2010, however, there were only five such cases in their portfolio, a decrease of 64%. During the same period, the number of group action claims increased by 100%. For example, IMF lists twelve "principal investments" for 2011: eight shareholders group actions, or related or standalone claims against advisers; one cartel damage class action; one consumer class action against the ANZ Bank for unfair "exception fees;" and one patent infringement against Microsoft in the U.S.

FIGURE 1. IMF FUNDED BUT NOT FINALIZED CLAIMS BY CATEGORY, 2005–2010



Source: IMF Annual Reports, 2005-2010.

The IMF's activities reveal its small caseload and increasing focus on group actions surrounding securities law and auditors' liability. This arose from changes in the law allowing group or class actions, so-called Part IVA representative actions under the Federal Court of Australia Act 1976

⁹⁴ Note that the differences between totals in each year does not necessary indicate the number of finished cases. For example, in 2007 the Allstate shareholders' claim was abandoned. See Michael Kunzelman, *Couple Drops Suit Against Allstate Over Katrina Damage*, AP (Feb. 16, 2007), <http://www.law.com/jsp/article.jsp?id=1171533775972&slreturn=1>.

(Cth),⁹⁵ and some very high-profile corporate failures. The impact of this reform is clear from IMF's caseload. A recent study found an increase in shareholder class actions in Australia, rising from one in 1999 to six in 2009.⁹⁶ Prior to 2004, all securities group claims were funded by claimants, law firms, or both. By 2009, 67% of securities class actions were financed by TPLF investors.

Interestingly, while group litigation funders have focused on antitrust damage actions in the U.K. and U.S., IMF has shied away from such actions. Discussions with IMF clarified that these actions were unattractive, as they entailed complex legal and factual issues, and greater uncertainty as to quantum due to the availability of a passing-on defense. This emphasizes the rather obvious fact that TPLF's role and impact depends principally on local legal and procedural factors, which differ significantly between the U.K., Australia, and the U.S., and more significantly within Europe.

D. *Main Findings*

The data above show the following about the TPLF sector in England and Wales and Europe:

- * It is new, small, fragmented, and investors have highly varied financial capacities and some are already exiting.

- * It is an attractive investment because it is not correlated with other classes of investment, and there are prospects of high returns.

- * TPLF investors' approach and access to funds vary, and the industry can be "tiered" in terms of capital backing or lack of it.

- * The funding capacity of the industry currently stands at over £157 million, which can annually fund an estimated fifty-one claims.

- * Burford and Juridica, the two largest dedicated TPLF investors in the U.S., raised their funds in London. They raised £305 million, or double the funds reportedly raised by U.K.-focused TPLF investors.

- * Less than one in ten of reviewed claims are funded, and information from sample investors suggests that an estimated one in twelve, or 8%, are accepted.

⁹⁵ Part IVA currently prescribes an "opt-out" system for representative proceedings. Under this regime, class action proceedings can be commenced if three threshold requirements are met: (1) seven or more persons have claims against the same respondent; (2) the claims of all those persons are in respect of, or arise out of, the same, similar, or related circumstances; and (3) the claims of all those persons give rise to a substantial common issue of law or fact. *Federal Court of Australia Act 1976* (Cth) pt IVA.

⁹⁶ GREG HOUSTON ET AL., TRENDS IN AUSTRALIAN SECURITIES CLASS ACTIONS: 1 JANUARY 1993–31 DECEMBER 2009 3 (2010).

* The investment per claim varies, from Therium's £50,000 to Harbour's £6 million.

* The value of claims funded varies, from a low of Allianz's £100,000 to Harbour's £600 million. However, the focus is typically on claims of £2 million or more.

* Success fees range between 20% to 40% of the realized value of claims, between 1.5 to six times a claim's investment, or mix of both. However, this fee can be higher if there are budget overruns, lower settlement/damage awards, or both.

* There is some evidence of forum shopping, apart from those funding group actions in the cartel area, and a lot of evidence of parochialism with funding focused on English and Welsh cases.

* The demand for TPLF is complex and does not appear to come predominantly from impecunious plaintiffs. There are strong commercial and accounting reasons for the costs of litigation to be funded by TPLF.

* TPLF funders expressed concerns about the lack of knowledge of TPLF options among lawyers and claimants.

* TPLF investors do not appear to be inhibited by the residual law on champerty and maintenance, and prefer to take a passive role.

* There are concerns about the level of costs, budgeting, and adverse cost rules.

* The growth of group actions has been inhibited by a lack of legal reforms, poor disclosure requirements, and other procedural obstacles.

* Group action TPLF investors face competition from plaintiff law firms. Generally, however, there is no common view that lawyers will compete directly in light of legal reforms that will allow contingent fees, multidisciplinary partners, and possibility of external funding and listing.

IV. POLICY AND ECONOMIC ISSUES

A. *Justification and Likely Effects of TPLF*

The judicial and public policy support for TPLF is that it gives greater access to justice. Of course, this is relative since, as shown above, TPLF investment is typically in high-value commercial litigation where the claimant will often have greater access to funds and legal support.

The economic case for TPLF is that the volume of litigation, and other forms of dispute resolution are inefficiently low in terms of a social cost and benefits. Benefits may be measured in terms of the greater efficiency of compensation, but more centrally the increased effectiveness of the law in deterring inefficient contract breaches, law-breaking, and commercial activities. This would be the case if: the costs and/or the risks of litigation

were excessive; and/or there were significant positive externalities not captured by the parties.⁹⁷

TPLF clearly has some benefits. For single claimant actions, the high costs of litigation may prevent redress and create a legal system that inadequately imposes the costs of wrongdoing and contract-breaking on the parties who can best avoid them. Where TPLF facilitates group actions, then, it serves to internalize the costs of wrongdoing on perpetrators who would not otherwise bear these costs. This is arguably the case for group follow-on cartel damage cases and group shareholder claims.

Price-fixing by cartels is characterized by a number of firms secretly agreeing to overcharge their customers. One of the features of price-fixing is that it is a secret conspiracy that often imposes losses on hundreds if not thousands of purchasers, and to those who have bought the goods and services produced by inputs that have been overcharged. The secrecy and dispersion of harm often over decades creates a large number of potential claimants with individually small but collectively large losses. It is expensive and complex to gain compensation for these losses along traditional tort damage principles. The aggregation of these diverse claims into one action is an efficient procedural device which serves the economic functions of compensation and deterrence. Thus, in principle, there are potential external benefits for those group actions funded by TPLF investors.⁹⁸ Similarly, shareholder claims for non-disclosure, misleading representations, fraud, auditor and director negligence, or breach of fiduciary duties may act as a discipline on management and improve corporate governance.

B. *Impact of TPLF*

Basic economics dictates that if the costs of litigation are reduced, there will be more of it. Therefore, holding other variables equal, the availability of TPLF investment should increase the rate of litigation rate all things equal. However, the litigation process and the role played by dedicated TPLF investors is not that simple, and does not lend itself to such

⁹⁷ The law and economic literature on litigation and legal process is vast. *NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE—A LEGAL, EMPIRICAL AND ECONOMIC ANALYSIS* (Mark Tuil & Louis Visscher, eds., 2010). But this is largely theoretical and descriptive, with little empirical research of the effects of different procedural rules, funding options, or both. This is noted by Fenn and Rickman, who summarize the publicly available studies. *Id.* at ch. 7.

⁹⁸ There are major differences between damage recovery for price-fixing in Europe and the U.S. In the U.S., private actions are the principal means of antitrust enforcement, and are encouraged by the award of triple damages and a permissive class action regime. In Europe and EU Member States, the principal method of enforcement is the prosecution of cartels by the antitrust authorities, with the European Commission imposing very high administrative fines, limited class actions based on opt-in requirements and relatively few private actions. Thus, the importance of class actions and compensatory damages as a deterrent is arguably less in Europe.

unqualified predictions. Indeed, generally there is very little hard empirical evidence of the impact of different legal cost payment and funding schemes.

There is an urgent need to properly characterize the nature of TPLF investment. TPLF investment does not directly address the high costs of litigation as a barrier to justice. It transfers litigation costs to a third party who is better able to fund it, or is the more efficient risk bearer. This may increase aggregate litigation and settlement costs, or it may lower them. Indeed, both forces are likely to exist simultaneously so that definitive predictions about the impact of TPLF on performance indicators of the legal system, including litigation rate, settlements, drop rate, duration of disputes, gross and net compensation, etc., cannot be made. If litigation funded by a third party allows the pursuit of a claim that would not have otherwise been pursued, it increases the courts' caseload, legal costs, court costs, and congestion. Additionally, even though it affords compensation to more claimants, the net sum paid to successful claimants will, all things equal, be less than if the case had been self-funded.

However, there are a number of factors that point in the other direction. First, as previously mentioned, a proportion of TPLF goes to potential litigants, which may have otherwise pursued their claim but have used outside funding for cash flow and balance sheet reasons. They are not impecunious. Thus, the net impact on litigation and other outcomes of the claims process will be lower than the gross number of claims funded. Second, all other things being equal, the presence of a TPLF investor may result in a higher settlement rate, as defendants realize that the claimant can fully finance the costs of taking the case to court. This decreases the litigation rate, and conserves both legal and other related costs. Third, a factor missed by most commentators is that TPLF may deter some claims which may otherwise have been pursued. Claimants seeking funds must first persuade a TPLF investor to fund their claim. Very few of those who seek TPLF are funded after being subject to an investors' due diligence. A TPLF investor will seek to determine whether the case represents value for money, the quality of the legal team, the strength and risks associated with the case, and how it is pleaded by the lawyers, in relation to the potential payout. In short, the investor will perform a thorough external objective assessment of the claim. If, as shown above, TPLF investors reject over 90% of the claims they review, it may signal that the case is relatively weak. Claimants who have been denied funding will want to know why, and this may lead to a reassessment of the merits of the case, a modification of the claim, the claim being dropped, or the legal team being replaced. The claimant may ask why funding has been denied, and the TPLF investor will have to tread carefully since the law firm will often be a major source of its potential future claims. Despite this, TPLF investors' filtering process may deter a proportion of claims from being pursued not because they lack funding, but because they lack merit.

TPLF may also act to reduce the legal costs per claim. While there has been much academic discussion about TPLF investors' potential interference with the client–attorney relationship and its sanctity, lawyers, like TPLF investors, are profit maximizers. In cases where lawyers are retained on a time-and-expenses basis, they have a weak pecuniary incentive to settle cases early, to plead others expeditiously, or to advise against pursuing more speculative claims. The only constraints are reputation, ethics, and the prospect of repeat business. The presence of a TPLF investor acts as an additional restraint on legal costs, and in some jurisdictions also leads to much better budgeting and accountability.⁹⁹ Thus, while the availability of TPLF may increase the number of cases brought and settled, the legal costs associated with each case may be lower on average.

The area where TPLF may have a more pronounced impact is group actions. Large coordination and funding problems are associated with group actions in Europe. As indicated above, the different legal systems in Europe are not particularly supportive of group actions, unlike those of the U.S. and Australia. This has led to forum shopping and innovative responses by the TPLF sector to facilitate these actions, which arguably would not otherwise have been pursued. Moreover, the active role of these group action funders has increased the number of actions mounted. Therefore, litigation or settlement rates will be higher, as will the net payments by defendants. Thus, one would expect that the more straightforward prediction that TPLF increases the level of litigation, settlements, or both, and net compensation paid compared to the status quo ante, would be valid.

There is some empirical evidence of the effects of TPLF investment, although this research must be treated with caution. Abrams and Chen report the results of a statistical analysis using the case files of IMF Litigation Funding, Australia's largest TPLF investor. By matching these with court data, the authors try to capture the effect of IMF's litigation funding on the litigation process in Australia.¹⁰⁰

Abrams and Chen's provisional reported study finds no statistically significant relationship between IMF's level of investment in claims and the volume of litigation over the period 2002–2008, based on an analysis of litigation in the Australian states that permit TPLF with those which did not. This is not surprising given the low proportion of overall commercial litigation funded by IMF. The study found some evidence that IMF funded

⁹⁹ There is evidence that lawyers on contingent fee arrangements screen cases more carefully than those who are not, and that the removal of contingent fees tends to reduce the net payout for successful cases. *See id*; *see also supra* note 97.

¹⁰⁰ Abrams and Chen use two data sets: (1) 113 cases funded by IMF over the period 2001–2010; and (2) 763 claims considered and ninety-one funded over the period 1999–2007. The regression is based on state-year observations for the years 2002–2008 collected from Lexis-Nexis Australia on all published cases considered for funding by IMF between 2002 and 2008. Abrams & Chen, *supra* note 50, at 5.

claims, especially class actions, took longer to finalize, increased court “congestion”¹⁰¹ and increased court expenditures. Interestingly, Abrams and Chen suggest an external benefit from TPLF supported actions. Cases funded by IMF were, on average, cited in more judgments than unfunded cases, indicating that they established new points of law or procedure. They therefore appear to generate external benefits for the legal system by clarifying and developing the law.

Unfortunately, the Abrams and Chen study is somewhat strained and suffers from selection bias. As noted above, IMF’s caseload represents only about 50% of all cases funded by third-party investors in Australia. Some estimates of the total volume of litigation suggest that its participation in the litigation process is minimal funding a very small fraction of commercial cases. Further, as noted above, the composition of IMF’s caseload has radically changed in recent years from insolvency claims to group shareholder suits. Thus, the historical experience may provide little guide to the present impact of TPLF in Australia.

While Abrams and Chen’s research has not been published or peer reviewed, even if their approach is accepted, their research suffers from ambiguous interpretations and implications. The estimate that TPLF increased the duration of actions and court expenditures may reflect the fact that a disproportionately greater number of more complex and costly claims attract TPLF funding. Interviews with TPLF investors and the high claim value threshold set by TPLF investors anecdotally confirm this proposition. Indeed, Abrams and Chen suggest that these effects may be transitory following the introduction of TPLF because defendants who recognize that the claimant is backed by a TPLF investor are induced to settle the case earlier. This is supported by other research which shows that TPLF cases are generally settled out of court. Morabito’s¹⁰² study of class actions in Australia found that between 1992 and 2009, there were eighteen class actions funded by TPLF investors, eleven were settled and the remaining seven are still in progress.¹⁰³ More importantly, Morabito found that, at 100%, the settlement rate for funded cases was much higher than the 43% of all resolved class actions. This suggests that TPLF-backed claims had more merit than the

¹⁰¹ John Walker and Clive Bowman at IMF suggested during an interview that the idea that TPLF increases court congestion was “unreal” and paled in comparison to the excessive use that insurers make of the courts as a claim management device.

¹⁰² VINCE MORABITO, AN EMPIRICAL STUDY OF AUSTRALIA’S CLASS ACTION REGIMES: FIRST REPORT ON CLASS ACTION FACTS AND FIGURES (2009); VINCE MORABITO, AN EMPIRICAL STUDY OF AUSTRALIA’S CLASS ACTION REGIMES: SECOND REPORT ON LITIGATION FUNDERS, COMPETING CLASS ACTIONS, OPT OUT RATES, VICTORIAN CLASS ACTIONS AND CLASS REPRESENTATIVES (2010).

¹⁰³ Vince Morabito & Vicki Waye, *Reining in Litigation Entrepreneurs: A New Zealand Proposal*, 2011 N.Z. L. REV. 323, 346 (2011). The eleven settled proceedings generated a total of approximately \$378.5 million. *Id.* Around 30.67% (\$116.1 million) of these settlement funds went to the relevant litigation funders. *Id.* The remaining \$262.4 million was shared between the solicitors for the Part IVA applicants and the class members. *Id.* at 347.

average. Morabito also found, in sharp contrast to Abrams and Chen, that there was no major difference in the time taken to resolve funded and unfunded group actions.

C. *Passive vs. Active TPLF investors*

As noted above, in England and Wales TPLF investors cannot actively manage a claim, purchase a claim, or otherwise interfere in a claim that they fund. This limitation on the assignment of legal claims, or to use the more emotive term the trading and “trafficking” in unmatured legal claims, seems inefficient.¹⁰⁴

In the U.K., maintenance and champerty were decriminalized under the Criminal Law Act, 1967.¹⁰⁵ Nonetheless there are residual aspects of the common law offences which remain. These include a prohibition on the litigation funder interfering in the management and conduct of the case. This means that the degree of control that a funder can exercise is limited, and purchasing claims by the funder is prohibited. All TPLF funders in England and Wales interviewed saw no difficulties posed by the residual rules on maintenance and champerty and were happy taking a passive role in the conduct of litigation.

The Court of Appeal in *Regina v. Secretary of State for Transport*¹⁰⁶ indicates how English and Welsh courts currently treat passive role in TPLF. The case involved Spanish fishermen (Factortame Ltd.) who were unlawfully banned from fishing in British waters despite having the appropriate licenses. In order to quantify their damage claim, the fishermen appointed the accounting firm Grant Thornton in return for 8% of the proceeds if the case succeeded. The Secretary of State claimed that the arrangement was champertous because it was a percentage of any damages recovered. The Court of Appeal ruled that because Grant Thornton only provided assistance, which was not an expert opinion and did not seek to control the proceedings, it should be allowed to charge for its services on a contingency fee basis. The judgment therefore established that a third-party funding agreement will not be regarded as unlawful simply because the rewards to the third party are expressed as a percentage of the damages.

The case also offers an insight into the competitive process at work. Grant Thornton and Ernst & Young, another accounting firm, offered the claimants accounting services on an hourly basis, as did MPC, but on a contingency fee arrangement. Notably, MPC also funded the claimant in

¹⁰⁴ Robert Cooter, *Liability rights as Contingent Claims*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, VOL. 2 575, 577 (Peter Newman, ed., 1998).

¹⁰⁵ Criminal Law Act, 1967, c.58 (Eng.).

¹⁰⁶ *Regina (Factortame Ltd. and others) v. Sec’y of State for Transp., Local Gov’t & the Regions* (No 8), [2002] EWCA (Civ) 932.

Arkin. The claimants wanted to avoid “the prospect of incurring an open-ended liability for accountancy fees” and were keen to appoint MPC. Only then did Grant Thornton offer to work on a success fee of 8% of the damage award.

While the foregoing may suggest otherwise, unmatured legal claims can be assigned in England and Wales. Such an assignment is permissible in the insolvency and insurance areas and has been for many decades. It is also the case that insurance companies can have claims assigned to them by those they insure under the principle of subrogation.

D. *Adverse Costs*

Liability for adverse costs is another important factor. While in the U.S. this is described as the “English Rule,” it is the usual cost allocation rule, and the “American Rule” of each party bearing their own legal costs is the exception. A recent multi-country survey found that the loser-pays rule existed in forty-nine, or 87.5%, of the fifty-six largest jurisdictions.¹⁰⁷

The rule requiring the losing party to indemnify the costs of the successful litigant has a strong public policy rationale. It internalizes the costs on the party responsible for a failed claim or defense, thus ensuring that parties who are blameless do not end up shouldering avoidable costs. It should be noted, however, that indemnification by the losing party is not an automatic rule but one invoked at the discretion of the court.

Many think that a party’s potential liability for adverse costs, which imposes what can be a large penalty on failure, decreases the likelihood of litigation and filters out unmeritorious claims. The effects in theory are more complex than this, but clearly it is less favorable to a claimant or defendant with a weak case, and it would tend to lower the litigation and raise the settlement rates.

The relationship between TPLF and liability for adverse costs is interesting. The legal position and its practical effects are in a state of flux in England and Wales. The Court of Appeal in *Arkin* held that the TPLF investor “should be potentially liable for the costs of the opposing party to the extent of the funding provided.”¹⁰⁸ That is, if a TPLF funder invests £1 million in an unsuccessful claim, it would only be liable for up to an additional £1 million of adverse costs, thus potentially doubling its exposure.

The court in *Arkin* set out clear public policy grounds for this limitation. It recognized the trade-offs involved between the general rule that costs follow consequences and the need to encourage TPLF investors to finance cases and thereby provide greater access to justice. In *Arkin*, the

¹⁰⁷ LOVELLS LLP, AT WHAT COST? A LOVELLS MULTI-JURISDICTIONAL GUIDE TO LITIGATION COSTS 4 (Graham Huntley et al. eds., 2010).

¹⁰⁸ *Id.* at 55, ¶ 41.

TPLF investor only funded part of the costs and the court was concerned that full exposure to adverse costs would deter TPLF investors. It invested £1.3 million to cover the professional fees and disbursements of the expert witness and without such an investment would have been exposed to adverse costs of in excess of £6 million. However, the court also said that it saw no reason why the rule should not apply where the TPLF investor funded all the claimants' legal costs. The court also said that TPLF investors were likely to cap their exposure and thereby have a "salutary effect in keeping costs proportionate," and insuring that the claim had sufficiently good prospects.¹⁰⁹

The Jackson Report, which recommended that third-party funders be fully exposed to adverse costs, criticized the *Arkin* rule. This is incorporated in the Code of Conduct for Litigation Funders, which followed the Jackson proposals.¹¹⁰

There are pros and cons to Jackson's proposal. First, it *may* deter TPLF investors from partially funding an action if, as a result, it has a disproportionate exposure to adverse costs. This is uncertain because the investment exercise will balance the total exposure against the likely returns, so it will have the effect of requiring a higher success fee and the funding of cases with larger damage claims.

The Jackson proposal also creates an anomalous situation where solicitors under conditional and contingent fee arrangements are not liable for adverse costs and TPLF investors are liable, even though both solicitors and TPLF investors could be seen as encouraging the litigation and imposing avoidable costs on defendants. Indeed, this is the problem with the *Arkin* rule also where the successful defendant may only get a fraction of its legal costs from the TPLF investor.

Surprisingly, the TPLF investors interviewed did not see the prospect of indemnifying defendants for the full adverse costs as a major inhibition to their activities. This is partly because their business plans focuses on high value damage claims. Some did see the prospect as an inhibition in the English and Welsh situation because of the high absolute level of costs, and others suggested this may lead them to fund cases outside England and Wales.

Another view expressed by some of those interviewed was that the debate over adverse costs was overblown. This is because most cases settled

¹⁰⁹ *Id.* at 55, ¶ 42.

¹¹⁰ The code was developed by CJC Working Group. It is generally voluntary, but mandatory if funders seek to join the newly-formed Association of Litigation Funders of England and Wales. The code deals with capital adequacy (funders agree to "pay all debts when they become due and payable," and must ensure they have enough capital to cover all the arrangements on their books for a minimum period of 36 months), liability for adverse costs provided expressly agreed with claimant, and a funder's ability to cancel the agreement (funders must agree not to terminate a funding agreement "without good reason"). ASS'N OF LITIG. FUNDERS OF ENGLAND AND WALES, CODE OF CONDUCT FOR LITIGATION FUNDERS (2011), available at <http://www.calunius.com/media/2540/alf%20code%20of%20practice.pdf>.

for sums well below the potential award and without an express discount for adverse costs or a separate settlement of the defendant's legal costs. Whatever the formal rule, there was rarely a payment of adverse costs. This, however, seems questionable or reflects a high-risk strategy. As we have seen, ATE is often purchased and the premiums are very high. Where a TPLF investor has not taken out ATE, the consequences can be fairly major.

V. THE CASE AGAINST TPLF

The generally warm reception to TPLF in Europe contrasts with the U.S.¹¹¹ In the U.S., some see TPLF as harmful to an already flawed legal system, which will encourage unmeritorious and excessive litigation, particularly for class actions.¹¹² This is particularly true where the TPLF investor is allowed to take an active part in the trial process. Indeed, Juridica has publicly stated and pursued a strategy of not investing in class actions. The claims underpinning these concerns need to be closely examined, as does the difference between the U.S. legal system and those of Europe.

A basic premise underlying the criticism is that TPLF investors typically and intentionally fund weak and unmeritorious cases. Interviews of European TPLF investors make clear that they devote considerable time to screening potential cases they have been asked to fund, reject most, and only fund those which have both a very high probability of succeeding and a high monetary value. Unmeritorious cases have the opposite features—a low or negligible probability of winning and negative expected returns if they go to trial. Thus, given the professional commercial approach to screening cases, it would be bizarre if a significant amount of unworthy or frivolous cases were funded. The investment TPLF investors make is very risky, and rests on the skills and commitment of the legal team and claimant they decide to fund. The discussion above demonstrates that TPLF investors have sustained heavy losses, which reflects the inherent riskiness of litigation, even where it is agreed that the case has strong merits. Even in

¹¹¹ STEVEN GARBER, ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES—ISSUES, KNOWN, AND UNKNOWN ix (Rand Corp., Occasional Paper, 2010), *available at* http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf; THIRD-PARTY LITIGATION FUNDING AND CLAIM TRANSFER TRENDS AND IMPLICATIONS FOR THE CIVIL JUSTICE SYSTEM (Rand Corp., Conference Proceedings, 2010), *available at* http://www.rand.org/content/dam/rand/pubs/conf_proceedings/2010/RAND_CF272.pdf. *See also* NEW YORK CITY BAR ASS'N., FORMAL OPINION 2011-2: THIRD PARTY LITIGATION FINANCING (2011), *available at* <http://www.nycbar.org/ethics/ethics-opinions-local/2011-opinions/1159-formal-opinion-2011-02>.

¹¹² U.S. CHAMBER INST. FOR LEGAL REFORM, SELLING LAWSUITS, BUYING TROUBLE—THIRD PARTY LITIGATION FUNDING IN THE UNITED STATES (2009).

the abstract, it does not make commercial sense and will not yield positive returns, to fund unmeritorious cases.

This is not to deny that TPLF may be used strategically and opportunistically. Sometimes, a claimant will enter into discussions with a TPLF investor and announce this to the defendant before any funding has been secured in order to encourage a settlement or push for a more favorable settlement. However, the use of funding to simply push a highly speculative claim at the instigation of the TPLF investor seems a minor consideration, unless the checks and balances in the legal system generally permit this (see below).

Second, the fact that TPLF investment increases the litigation rate for some classes of claims is not bad in itself. The demand for TPLF comes from two broad categories of claimants—those who would not otherwise have pursued their claim, and those who would have pursued their claim but see TPLF as a better method of funding. Thus, it is likely that the presence of TPLF investors will increase the net litigation rate, but by less than the gross number of TPLF funded actions. For both categories, the funding fills a gap in the market. It may bring more complex cases into the legal system, or cases which, for financial reasons, would not have been litigated and settled in favor of the defendant. This does not mean that the increase in the number of cases is evidence of some malfunction or perversity. The Jackson Report's endorsement of TPLF indicates that the judiciary is not afraid of this increase in the number of cases, at least in the context where TPLF investors are entirely passive.

In areas where investors can exercise an active or controlling role, or can buy claims, there is not yet much evidence that this has led to abuses that the courts have not controlled. There is no direct evidence from Australia, the U.S., or Europe. As an example, some have focused on the facts surrounding *Fostif*,¹¹³ decided by the High Court of Australia in 2006.

Fostif involved claims for the recovery of amounts paid by tobacco retailers to tobacco wholesalers, allegedly for the purposes of the wholesalers paying a license fee which was later found to be unconstitutional. Over 2,000 claimants signed an agreement for TPLF from Firmstone. Firmstone sought out retailers with claims, and bought the rights to the claims, which gave it control of the litigation in return for a success fee of one-third of the proceeds if the case was successful. The defendants alleged that profiting from the success of the litigation was an abuse of the judicial process. The trial judge agreed, but the Court of Appeal held that the presence and actions of the TPLF did not justify ending the proceedings. The licensed wholesalers appealed to the High Court, which held by majority that in Australian states where the laws of champerty and maintenance had been

¹¹³ *Campbells Cash & Carry Pty Ltd. v. Fostif Pty Ltd.*, [2006] HCA 41. The Court did not decide the funders' position for those states where maintenance and champerty had not been abolished—namely, the Northern Territory, Queensland, Tasmania and Western Australia.

abolished, TPLF was not contrary to public policy and is not an abuse of the judicial process. However, the High Court stopped the class action because the tobacco retailers did not have the same interests in the proceedings as required by the law of New South Wales.

How is *Fostif* to be viewed? First, there is nothing inherently wrong with aggregating legitimate actions in one class, even if at the TPLF investor's instigation. Second, the action failed because it did not comply with the procedural requirement that all claimants have the same interest. This is the same requirement discussed for English and Welsh representative actions. Third, *Fostif* does not appear to have led to any discernible increase in the number of class actions filed in Australian courts. In fact, after *Fostif*, the number of Australian class actions fell, although perhaps for other reasons.¹¹⁴ As already noted, the unpublished empirical study by Abrams and Chen found no statistically significant evidence that TPLF increased the volume of litigation in Australia.

Further, the claim that TPLF providers are solely driven by the profit motive while lawyers and commercial claimants are not, is far-fetched. At issue is the alignment of funder and lawyers' interests to that of the claimant(s) in a meritorious case; that is, arrangements that better resolve the inherent principal-agent problem seen when a professional lawyer, acting as an agent, represents the interests of a claimant. It is not self-evident that this alignment is achieved by banning risk-sharing arrangements with TPLF investors.

This is not to deny that, given the very different structure of the U.S. legal systems at the federal, state, and local levels, TPLF may exacerbate existing flaws. Rubin¹¹⁵ has argued that there are limited economic efficiency grounds for TPLF in the U.S., and indeed, a case against it. This is because the combination of class actions, contingency fees, and the American Rule that each party bear their own legal costs, suggests that the litigation rates are probably optimal, if not inefficiently high. There seems little shortage of funding for claims in the U.S. Arguably, funding generates external costs, because plaintiffs under the American Rule do not take into account the defendants' legal costs, thus engaging in excessive litigation. Further, because of the more politicized nature of the legislature and judiciary, which makes rent seeking by special interest groups more effective,

¹¹⁴ Morabito's study found that the number of Australian class actions decreased by 15.8% between the December 2004 and March 2009 quarters. The study also looked at the potential abuse of litigation by TPLF providers. Between 1992 and 2009, there were eighteen cases funded by TPLF investors in Australian courts, and all of ten cases resolved were settled (eight were still in the process of settlement). MORABITO, FIRST Report, *supra* note 102, at 12; MORABITO, SECOND Report, *supra* note 102.

¹¹⁵ PAUL H. RUBIN, ON THE EFFICIENCY OF INCREASED LITIGATION: PUBLIC POLICY ROUNDTABLE ON THIRD PARTY FINANCING OF LITIGATION I (2009), available at <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

law is often more inefficient, and hence enforcement is likely to generate greater external costs, or losses, and inefficiencies.

The concerns expressed in some quarters of the U.S. over the private funding of litigation cannot easily be carried over to Europe. As Hensler has observed: "Virtually every aspect of financing civil litigation in the [U.S.] differs from the European model."¹¹⁶ This also applies to the legal and procedural rules. In the U.K., which is a common law legal system like the U.S., the adverse cost rule applies; there is limited disclosure; until very recently, contingency fees were prohibited; and there are no jury trials, higher legal costs, no class actions, and where group actions have taken place, they are opt-in actions. For example, the rules of discovery/disclosure in the European civil law countries are weak and less extensive than in England and Wales. The latter, however, are nowhere near as intrusive and disruptive as U.S. disclosure rules. The U.S.'s liberal rules governing disclosure can be used strategically to increase costs and delay proceedings, which is one criticism made of the U.S. litigation system. These factors all create a tougher legal environment for plaintiffs.¹¹⁷

CONCLUSION

Despite the fact that TPLF is a relatively new development in Europe, the last several years have seen many new entrants to the market, especially in the U.K., and an increasing number of cases funded. All TPLF investors interviewed were buoyant, saw high returns, and expected an intensification of competition which will at least drive down the level of success fees.

The evidence shows that overall there have been little discernible adverse effects. The courts and policymakers have taken a favorable view of TPLF, but continue to apply a rigorous approach to the procedural and substantive rules of funded actions. The existing rules do impose obstacles to TPLF, but these generally may be seen as consistent with the requirements of the good administration of justice. However, what has emerged in Europe is a rather parochial industry where TPLF investors, imbued with the legal principles and practices of their national jurisdictions, have confined their funding to national cases.

Group or class actions are the exception. These actions often have a pan-European dimension and have seen the emergence of specialist group action TPLF investors and lawyers. To date, these have played a limited role in most European legal systems. In the U.K., they are circumscribed by the same interest rule, and as a result these actions have been com-

¹¹⁶ NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL, EMPIRICAL AND ECONOMIC ANALYSIS *supra* note 97, at 149.

¹¹⁷ J. Robert S. Prichard, *A Systemic Approach to Comparative Law: The Effect of Cost, Fee, and Financing Rules on the Development of Substantive Law*, 17 J. LEGAL STUD. 451 (1988).

menced in other jurisdictions, such as Germany and the Netherlands. There are other inhibitions, such as the passing-on defense in antitrust actions and the requirement for claimants to opt-in rather than the U.S. opt-out rule for class actions. Yet this is a formative period, since no TPLF-funded group actions have succeeded or settled to date. The law is in the process of reform and clarification, and it is difficult to predict its evolution. Nonetheless, there is considerable political and legal resistance to the development of class actions, and certainly U.S. style class actions, in Europe.



THIRD-PARTY LITIGATION FUNDING IN AUSTRALIA AND EUROPE

*Dr. George R. Barker**

INTRODUCTION

Third-party litigation funding (TPLF) arises when someone not otherwise involved with specific litigation¹ pays the cost of the litigation for one party. The funder may also accept the risk of paying the other party's costs if the case fails.² If the case succeeds, the third-party litigation funder usually receives a success fee, often a share of the proceeds—usually after reimbursement of costs. TPLF is thus distinguishable from legal expenses insurance (LEI), where an insurer is paid a premium for either before-the-event (BTE) or after-the-event (ATE) insurance of legal expenses. TPLF is also distinguishable from situations where lawyers for a claimant may accept a conditional fee agreement (CFA)³ or a contingency fee.⁴

Some media reports and papers on the topic over recent years give the impression that TPLF has become commonplace outside the U.S. For example, in a paper presented at a conference convened by the UCLA–RAND Center for Law and Public Policy⁵ in 2009, a presenter commented:⁶

Two countries have had significant experience in this industry. Australia kicked things off over 20 years ago. Today, it has an established and respected presence. The United Kingdom was next. It saw the beginning of the industry about 10 years ago. Today, according to

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¹ I.e., a person or entity not party to the litigation, nor the parties' lawyers.

² When the so-called English rule, or "loser pays" cost-shifting regime applies.

³ Where the lawyer discounts his or her standard fee in return for an uplift expressed as a percentage of the standard fee if the claim succeeds. BLACK'S LAW DICTIONARY 335-36 (9th ed. 2009).

⁴ Where the lawyer discounts or commutes his or her fee in return for a share of the damages or out-of-court settlement should the action succeed. *Id.*

⁵ GEOFFREY MCGOVERN ET AL., RAND INSTITUTE FOR CIVIL JUSTICE PROGRAM, CONFERENCE PROCEEDINGS, THIRD-PARTY LITIGATION FUNDING AND CLAIM TRANSFER: TRENDS AND IMPLICATIONS FOR THE CIVIL JUSTICE SYSTEM (2010), available at http://www.rand.org/content/dam/rand/pubs/conf_proceedings/2010/RAND_CF272.pdf.

⁶ *Id.* app. B, at 69.

media reports,⁷ it is “exploding” and the top tier law firms are active in it or promoting it . . . the industry in the UK has received thousands of applications for Funding. It has financed hundreds of claims. The Courts have increasingly supported it, although with precautions.⁸

This paper seeks to address two questions. First, focusing on the U.K., is litigation financing truly commonplace across Australia and Europe? Second, what types of cases are funded by third-party sources? This paper is part of a broader research program involving a comparative law and economics analysis of collective redress and litigation funding—covering the U.S., U.K., and Australia. Co-researchers include Professor Peta Spender of Australian National University, Australia, Professor Paul Fenn of the University of Nottingham, U.K., and Professor Ted Eisenberg of Cornell University, U.S.

The paper begins with a simple economic model that briefly provides a framework for organizing the factors affecting the prevalence of litigation funding and reviews possible measures for the prevalence of litigation funding. Part II examines both the evolution of legal rules, and the nature of the market, in litigation funding in Australia. Part III looks at the situation in U.K. and Europe.

Australia has led the world in the TPLF market, as it was the first jurisdiction to develop a robust TPLF market and its TPLF market has a twenty-year history.⁹ However, as we show in Part II, it is still too early to say it is commonplace, especially since it constitutes less than 0.1% of the overall Australian civil litigation market by volume per annum. For the same reason, in the U.K., it seems inappropriate to describe TPLF as commonplace.¹⁰ The European market for TPLF still appears to be in its infancy. We outline a number of reasons why there are differences in TPLF between countries, focusing on the evolution of legal rules. Nevertheless, more work is required to measure TPLF and assess its determinants. It seems clear, however, that a historically hostile legal environment towards TPLF severely limited its early development in Australia and the U.K. While the legal environment in these jurisdictions has become more accommodating over time, ongoing uncertainty about the legal rules that apply to TPLF may continue to hinder its development. In terms of the cases

⁷ *Id.* (citing Claire Ruckin & Sofia Lind, *External Funding Booms as Litigators Plot Upturn*, LEGAL WEEK, (Mar. 20, 2008), <http://www.legalweek.com/legal-week/news/1145812/external-funding-booms-litigators-plot-upturn>; Evan Weinberger, *3rd-Party Funding Fuels European Litigation Growth*, LAW 360 (Nov. 8, 2008), <http://www.law360.com/insurance/articles/77298/3rd-party-funding-fuels-european-litigation-growth->).

⁸ *Id.* (citing Rachael Mulheron & Peter Cashman, *Third Party Funding: A Changing Landscape*, 27 CIV. JUST. Q. 312-41 (2008); Neil Rose, *Drive for Transparency on Third-Party Funding*, LAW GAZETTE (Feb. 14, 2008), <http://www.lawgazette.co.uk/news/drive-transparency-third-party-funding>).

⁹ *Id.*

¹⁰ *See id.*

that are funded, the focus is on commercial and insolvency cases. However, the cases that are funded depend to some extent on the legal rules in the jurisdiction and particularly the extent to which class actions have been permitted to develop.

I. ECONOMICS OF LITIGATION FUNDING¹¹

This paper does not examine the normative economic analysis of TPLF or its welfare effects. It remains an open question how TPLF will affect the twin aims of any system of litigation of which it forms a part: efficiency—through efficient deterrence, and equity—through compensation. However, Keith N. Hylton presents a paper in this journal that identifies the potential sources of welfare gains and losses associated with a system of TPLF.¹² While previous studies have discussed the risk-sharing benefits of a market in claims, Hylton suggests that the social gains of such a market should be understood in light of the economics of litigation—specifically the divergence between private and social incentives to litigate and the market mechanisms for correcting this divergence.¹³ This perspective points to some important sources of TPLF-related social costs, such as socially undesirable waivers, socially undesirable litigation, and the entry of litigators who have a stake in the generation and continuance of injuries. Any empirical assessment of the welfare consequences of expanded TPLF will have to take these costs into account. A number of other papers in this journal separately address relevant issues for normative analysis of litigation funding, including papers by Joanna Shepherd Bailey,¹⁴ Michelle

¹¹ Articles on the economics of TPLF include: Roland Kirstein & Neil Rickman, “*Third Party Contingency*” *Contracts in Settlement and Litigation*, 160 J. INST. & THEORETICAL ECON. 555 (2004); Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697 (2005); Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J. LEGAL STUD. 329 (1987); Robert Cooter, *Towards a Market in Unmatured Tort Claims*, 75 VA. L. REV. 383 (1989).

¹² Keith N. Hylton, *The Economics of Third-Party Financed Litigation*, 8 J.L. ECON. & POL’Y 701 (2012).

¹³ *Id.*

¹⁴ Joanna M. Shepherd, *Idea Versus Reality in Third-Party Litigation Financing*, 8 J.L. ECON. & POL’Y 593 (2012).

Boardman,¹⁵ Alexander Bruns,¹⁶ and Geoffrey J. Lysaught.¹⁷ In addition, papers by Michael Faure and Jef De Mot compare TPLF with LEI.¹⁸

Literature on the topic of litigation funding is clearly burgeoning.¹⁹ For example, Fenn and Rickman (2010)²⁰ review the empirical analysis of litigation funding. They first establish the theoretical potential for litigation funding to affect litigation itself using a model of litigation popularized by Gravelle and Waterson (1993).²¹ This model is itself a version of Bebchuk's (1984)²² one-shot model of litigation with asymmetric information. Fenn and Rickman identify the key effects and variables that might be involved, including: the probability and timing of settlement, the size of the settlement outcome, the likelihood of a claim being filed, and the probability of events such as accidents giving rise to claims and hence the volume of litigation itself.²³ They then review the empirical evidence, focusing on econometric studies.²⁴ Finally, Kritzer²⁵ provides other complementary perspectives.

¹⁵ Michelle Boardman, *Insurers Defend and Third-Parties Fund: A Comparison of Litigation Participation*, 8 J.L. ECON. & POL'Y 673 (2012).

¹⁶ Alexander Bruns, *Third Party Financing in the Perspective of German Law—Useful Instrument for Improvement of the Civil Justice System or “Speculative Immoral Investment?”*, 8 J.L. ECON. & POL'Y 525 (2012).

¹⁷ 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 (2012).

¹⁸ Michael Faure & Jef De Mot, *Comparing Third Party Financing of Litigation and Legal Expenses Insurance*, 8 J.L. ECON. & POL'Y 743 (2012).

¹⁹ See, e.g., NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL EMPIRICAL AND ECONOMIC ANALYSIS, (Mark Tuil & Louis Visscher eds., 2010). A law and economics approach to cost shifting, fee arrangements and legal expense insurance in the book, for example, present a normative law and economics approach to LEI that is also relevant to TPLF. On the benefit side, Louis Visscher and Tom Schepens focus on how LEI may alleviate rational apathy problems of plaintiffs with claims whose private costs may exceed expected private benefits, and thereby generate social benefits by providing better incentives for potential defendants to take care, refrain from infringements, fulfil contractual obligations, etc. They suggest LEI is expected to increase the level of suit because the plaintiff does not bear the costs, is shielded from risk, and does not have a liquidity problem. *Id.* at 12-13. They also note, however, that LEI may introduce costs associated with adverse selection and moral hazard problems and introduce complicated principal-agent problems in the context of asymmetric information between insurer, lawyer, and client. *Id.* at 13-14. These problems are also relevant to TPLF.

²⁰ Paul Fenn & Neil Rickman, *The Empirical Analysis of Litigation Funding*, in NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL EMPIRICAL AND ECONOMIC ANALYSIS 131 (Mark Tuil & Louis Visscher eds., 2010).

²¹ Hugh Gravelle & Michael Waterston, *No Win, No Fee: Some Economics of Contingent Legal Fees*, 103 ECON. J. 1205 (1993).

²² Lucian A. Bebchuk, *Litigation and Settlement under Imperfect information*, 15 RAND J. ECON. 404 (1984).

²³ Fenn & Rickman, *supra* note 20, at 132-33.

²⁴ *Id.* at 144.

²⁵ Herbert M. Kritzer, *Lawyer Fees and Lawyer Behaviour in Litigation: What Does the Empirical Literature Really Say?*, 80 TEX. L. REV. 1943 (1990).

This paper complements the foregoing work by focusing on the positive analysis of the nature of specific legal rules. This analysis includes the residual uncertainties surrounding the rules and the role they play in influencing both the prevalence of TPLF across countries and the selection of cases. To frame the discussion and evaluation of differences in TPLF between countries, the paper draws on Fenn, Rickman, and Stewart,²⁶ who proposed a simple demand and supply framework for modelling the determinants of litigation funding across countries. In their framework, demand is determined by a number of factors, including:

Returns required by the funder (P). The lower (higher) the return required by the funder (P), the higher (lower) the demand for TPLF. This can be understood to entail movements along the demand curve.

Returns required by alternative funding options (P'). The lower (higher) the return required by alternative substitute funding options (P') the lower (higher) the demand for TPLF.

Costs of being involved in TPLF (c). The lower (higher) the costs of being involved in TPLF (c) the higher (lower) the demand for TPLF.

Law, including Regulatory Rules (R). These may increase or decrease demand for litigation funding, possibly imposing costs or benefits. The legal and regulatory consumer protections (R) may increase the demand for TPLF. Legal penalties for involvement in certain activities may reduce demand.

Risks of TPLF (σ^2). The risks associated with TPLF (σ^2) can have offsetting effects. It may deter demand for a funded litigation service, but increase demand to the extent risk is shared with the funder as a form of insurance.

This means that demand can be expressed algebraically as a function of the above variables, as in equation (1) below. The direction of the effect of the variables on demand is shown in brackets underneath each in equation (1), as either positive (+) or negative (-) or mixed (+/-).

$$(1) \quad D = F (P, P', c, R, \sigma^2)$$

(-) (+) (-) (+/-) (+/-)

Similarly, supply can be expressed algebraically as a function of the above variables, as in equation (2) below. Of course, the direction of the effect of some factors on supply is different.

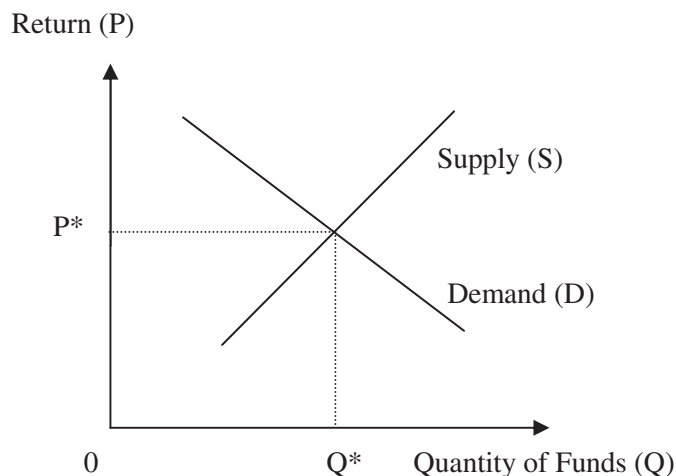
$$(2) \quad S = F (P, P', c, R, \sigma^2)$$

(+)(-) (-) (-/+) (+/-)

²⁶ Paul Fenn, Neil Rickman & Malcolm Stewart, *Third Party Funding of Commercial Disputes: A Framework for Comparative Analysis* (2011) (unpublished manuscript) (paper presented to the European Association of Law and Economics Conference 2011). An earlier version of the paper also exists: Paul Fenn & Neil Rickman, *Third Party Funding of Commercial Disputes* (2009) (unpublished manuscript) (paper presented at the ANU Conference on Collective Redress and Litigation Funding 2009).

The diagram below presents a simple example of the above demand and supply model of litigation funding with the required return (P) on the vertical axis and the amount of litigation funding (Q) on the horizontal. As shown, demand is downward sloping, and supply is upward sloping as a function of P . The amount of litigation funding (Q^*) and return (P^*) at market equilibrium is shown at the intersection of demand and supply curves. Changes in any of the factors affecting demand or supply outlined above will then give rise to shifts of the demand and supply curves, as well as changes in equilibrium levels (Q^*) and returns (P^*) to litigation funding. Changes in the factors outlined then may explain variations between countries, or they may explain variations over time in equilibrium levels and returns to litigation funding in any country.

FIGURE 1. THE DEMAND AND SUPPLY OF LITIGATION FUNDING



This simple framework potentially provides a means of predicting—as well as understanding—differences between countries' rates of litigation funding. One of the key factors affecting outcomes has been the applicable legal regimes (R), which may affect demand and supply both directly, as in the above equations, and indirectly, by affecting other variables such as P' or alternative sources of finance. Differences in legal regimes directly and indirectly affecting litigation funding may thus affect the relative prevalence of TPLF between jurisdictions and how relative prevalence changes over time. In what follows, we shall examine the law of maintenance and champerty that directly affects litigation funding in Australia and the U.K. We examine how they have changed over time and the degree of remaining uncertainty about TPLF's ongoing role. We then explore the extent to which this uncertainty may be used to explain differences in the prevalence of TPLF over time and between countries.

To assess the prevalence of TPLF and differences between countries, however, one also needs to measure these differences. The analysis above focuses on total quantity of funds and returns. In the short run, however, it is likely easier to measure the total number of cases than total value of cases. This suggests an initial focus on constructing the following index over time and across countries:

$$(3) \quad \textit{TPLF Incidence} = \frac{\textit{Number of Cases with TPLF}}{\textit{Total Number of Cases}}$$

To apply the framework, we need data on the frequency and value of TPLF. To explain any differences, we need to collate information on factors affecting variation in the frequency and value of litigation funding. This report is a snapshot of the results of on-going research on this topic. In the first instance, the focus has been on the nature of the legal rules and case law directly affecting litigation funding, as well as the number of funders, the volume, and the broad nature of the cases they fund. The focus here is on Australia and the U.K., where it is reported to be more common.²⁷ We make brief mention of some information on Europe that was readily available to the public at the time of writing.

II. LITIGATION FUNDING IN AUSTRALIA

This section discusses litigation funding in Australia. It is divided into two parts. Part A reviews the evolution of the rules of litigation funding in Australia. Part B examines the litigation funders in the market and their selection and management of cases.

A. *The Evolution of Legal Rules on Litigation Funders in Australia*

The origins of Australian law on litigation funding lie in the relevant English common law, and they were established prior to the Europeans' discovery of Australia. Blackstone's statement explains the reception of such English laws in each of the Australian states:²⁸

[if] an uninhabited country be discovered . . . by English subjects all the English laws then in being . . . are immediately in force . . . [and] colonists carry with them only so much of the English law as is applicable to the new situation and the condition of the infant colony.²⁹

²⁷ Lysaught & Hazelgrove, *supra* note 17.

²⁸ Alex C. Castles, *The Reception and Status of English Law in Australia*, 2 ADEL. L. REV. 1, 5 (1966). See also *Constitutional Foundations Reception of British Law*, in THE LAWS OF AUSTRALIA (LBC Thomson-Reuters). Of course, it is beyond the scope of this paper to explore why Australia was not "uninhabited" (*cf. Mabo v. Queensland (No 2)* (1992) 175 CLR 1 (Austl.)).

²⁹ 1 WILLIAM BLACKSTONE, COMMENTARIES *108 (10th ed. 1787).

While this enunciation of Blackstone's is, strictly speaking, only a statement of principle, that principle was encompassed within the Australian Courts Act of 1828 (Australian Courts Act).³⁰ The Australian Courts Act was passed to "provide for the Administration of Justice in New South Wales and Van Diemen's Land."³¹ Section 24 provided that "all Laws and Statutes in force within the Realm of England at the Time of passing of this Act . . . shall be applied in the Administration of Justice in the Courts of New South Wales Van Diemen's land . . ."³²

It is a somewhat involved task to pin down with any measure of precision the applicability of the Australian Courts Act to the various Australian colonies and their judicatures outside of New South Wales and Tasmania.³³ However, it is sufficient to note that the Australian Courts Act represents the first formal legislative statement regarding the reception of English law—both statutory and general—into the colonies.³⁴

In what follows, we discuss the nature and effect of the law on three key topics: (1) maintenance and champerty, (2) liability for adverse cost orders, and (3) federal regulation.

1. Maintenance and Champerty

Although it has evolved over time, the ancient doctrine of maintenance originally made it a crime and a tort for strangers—or third parties—to support litigation in which they had no legal standing. On the other hand, the law of champerty, a form of maintenance, made it an offence for any person to receive a share of any gains from legal action in return for maintaining a case. Contracts to maintain an action were generally considered illegal.

Moreover, it is clear that maintenance and champerty operated as common law torts and crimes in Australia at the time of colonization and they survived federation. This is supported by the High Court's observation in 1960 in *Clyne v. NSW Bar Association*,³⁵ "that it may be necessary some day to consider whether maintenance as a crime at common law ought to be regarded as 'obsolete.'" This indicates the survival of the doctrine at common law despite the High Court's misgivings about obsolescence. In the specific context of maintenance and champerty, the New South Wales (NSW) Law Reform Commission expressly recognized that the Australian Courts Act is the original source of the statutory prohibition³⁶ contained

³⁰ *Australian Courts Act 1828* (ACT) s 24.

³¹ *Id.*

³² *Id.*

³³ Castles, *supra* note 28, at 5. See also *Quan Yick v Hinds* (1905) 2 CLR 345 (Austl.).

³⁴ See generally Castles, *supra* note 28.

³⁵ *Clyne v. NSW Bar Assoc.* (1960) 104 CLR 186 (Austl.).

³⁶ NSW LAW REFORM COMMISSION, L.R.C.4, APPLICATION OF IMPERIAL ACTS [hereinafter NSWLR] 71-73 (1967).

within 3 Edward I-(1275) St. 1 c. 23, which was re-enacted throughout history until its repeal in the U.K. by the 1967 Act.³⁷ Of course, the Colonial Laws Validity Act³⁸ enabled the Australian colonies to pass their own laws, provided they were not repugnant to Imperial laws expressed to apply to colonies.

Not until long after the colonies became states did they eliminate the doctrines of champerty and maintenance.³⁹ In 1967, the NSW Law Reform Commission recommended the repeal of the laws of maintenance and champerty in NSW, in line with their repeal in England in the English Criminal Law Act 1967.⁴⁰ Although the law of maintenance is significantly limited, it still however *directly* affects the market for third-party litigation funding.

In the rest of this paper, I will explore the nature of maintenance and champerty in Australia and their likely effects on the TPLF market.

a. Common Law Origins

A.H. Dennis (1890)⁴¹ and P. H. Winfield (1919)⁴² are early, useful accounts of the origins of maintenance and champerty in English law. The origins however, are somewhat obscure and difficult to trace.⁴³ Maintenance and champerty operated as common law torts and crimes and were codified in many early English statutes.⁴⁴ In Coke's opinion, the statutes merely increased the punishment against maintainers, reinforcing the common law through the enunciation of specific penalties and remedies.⁴⁵

The ancient common law of maintenance made it an offense for strangers to support litigation in which they had no legitimate concern. The offense of champerty, a form of maintenance, was to maintain for a share of the proceeds.⁴⁶ Maintenance was also akin to common barratry, the chief difference being that barratry was "the frequent stirring up of disputes between the Kings subjects," either at law or otherwise.⁴⁷

³⁷ Criminal Law Act, 1967, c. 58, § 10, sch. 3.

³⁸ *Colonial Laws Validity Act 1865* (Qld).

³⁹ *Supreme Court Act 1935* (SA).

⁴⁰ NSWLR, *supra* note 36, at 74.

⁴¹ A.H. Dennis, *The Law of Maintenance and Champerty*, 6 LAW Q. REV. 169 (1890).

⁴² Percy Henry Winfield, *The History of Maintenance and Champerty* 35 LAW Q. REV. 50 (1919).

⁴³ *Id.* at 50-52.

⁴⁴ NSWLR, *supra* note 36, at 74 (citing *Pechell v Watson* (1841) 8 M & W 691, 700 (Austl.)).

⁴⁵ Winfield, *supra* note 42, at 56.

⁴⁶ "[T]o maintain to have part of the land, or anything out of the land, or part of the debt, or other thing in plea or suit." *Id.* at 50.

⁴⁷ The offense of embracery (another form of maintenance) was defined as "when one laboureth a jury, if it be but to appeare, or if he instruct them, or put them in feare, or the like he is a maintainer." *Id.*

In accordance with accepted principle, given that maintenance and champerty were a crime, any contract to maintain an action was therefore illegal and unenforceable. Furthermore, maintenance and champerty were tortious acts giving rise to an action for damages under the common law.

The common law thus made TPLF a crime—a tort—and rendered any associated contracts unenforceable. Nevertheless a “black market”—indeed a very corrupt market—existed at the close of the middle ages involving costly rent-seeking behavior by nobles who, “deprived of the power of taxing and judging vassals, and of demanding their assistance in private wars,” turned to “corruption, intimidation or other perversion of courts of law.”⁴⁸ This background set the stage for the introduction of statutes that strengthened the penalties for maintenance and champerty in the fourteenth century. Nobles formed “armed retinue with which they could ‘impress the judges’” or could “seize on disputed lands, and so frighten away a better claimant; the lord would maintain the causes of his followers in the courts, enable them to resist a hostile judgment, and delay a hazardous issue; the costliness of litigation was an inducement to the poor to adopt a patron.”⁴⁹ Similarly, feudal lords initiated and underwrote suits against their enemies as a form of “private war” to financially weaken their opponent.⁵⁰ Often, the plaintiff sued for title to a disputed parcel of land. When the suit was successful, the sponsoring feudal lord would demand a share of the property as repayment for his support.⁵¹

Expressing his thoughts on maintenance and champerty in the early nineteenth century, Jeremy Bentham said:

[W]hat everybody must acknowledge is, that to the times which called forth these laws, and in which alone they could have started up, the present are as opposite as light to darkness. A mischief, in those times it seems but too common, though a mischief not to be cured by such laws, was, that a man would buy a weak claim, in hopes that power might convert it into a strong one, and that the sword of a baron, stalking into court with a rabble of retainers at his heels, might strike terror into the eyes of a judge upon the bench. At present, what cares an English judge for the swords of a hundred barons?⁵²

Bentham’s view was that maintenance and champerty were obsolescent in the nineteenth century, and that their continuation as legal doctrines were having adverse effects—“[w]ealth has indeed the monopoly of justice

⁴⁸ Dennis, *supra* note 41, at 173.

⁴⁹ *Id.*

⁵⁰ Max Radin, *Maintenance By Champerty*, 24 CALIF. L. REV. 48, 64 (1935).

⁵¹ *Id.* at 61. It appears this may be in keeping with the origin of the word in the middle English “champartie,” which is derived from the Old French champart, the lord’s share of the tenant’s crop, which in turn is from Medieval Latin campars, camp pars: Latin camp, genitive of campus, *field* + Latin pars, *part*.

⁵² JEREMY BENTHAM, *Letter XII Maintenance and Champerty*, in 3 THE WORKS OF JEREMY BENTHAM 19, 19 (John Bowring ed., 1843).

against poverty; and such monopoly it is the direct tendency and necessary effect of regulations like these to strengthen and confirm . . . The law created this monopoly: the law, whenever it pleases, may dissolve it.”⁵³

b. The Exceptions

In 1769 Blackstone had labelled maintenance and champerty as offenses “in a suit that no way belongs to one.”⁵⁴ In the *Parcel Case*,⁵⁵ these offenses were held to involve “intermeddling with the disputes of others in which the defendant has no interest whatsoever, and where the assistance he renders to one or the other party is without justification or excuse.”⁵⁶ Subsequently, in *Martell v. Consett Iron Co Ltd.*, Lord Justice Jenkins noted “the giving of such aid will not be criminal if it is justifiable in law by reference to one of the specific exceptions, . . . or if the person giving such aid has such an interest in the action as can be held in law sufficient to justify him in giving it.”⁵⁷

Clear exceptions to maintenance and champerty evolved over time. These exceptions included aid for a near kinsman or servant and for charitable purposes.⁵⁸ Assignment of the future proceeds of litigation by way of charge were also eventually permitted where, for example, an ordinary creditor could take an assignment of the fruits of a cause of action as could a solicitor as security for his costs. Objections were not raised to assignments of the proceeds of an action⁵⁹ because such an assignment would not give the assignee the right to intervene in the action and so be contrary to public policy.⁶⁰ Despite the often-stated concern about conferring control over the litigation to third parties, as the law became more liberal in its approach to what was lawful maintenance, so it became more liberal in its approach to the circumstances in which it would recognize the validity of an assignment of a cause of action and not strike down such an assignment as one only of a bare cause of action.⁶¹ The circumstance where the law permitted assignment of a cause of action included the following:

⁵³ *Id.*

⁵⁴ BLACKSTONE, *supra* note 29, at *134-36.

⁵⁵ *British Cash & Parcel Conveyors, Ltd. v. Lamson Store Serv. Co.*, [1908] 1 K.B. 1006 (Eng.).

⁵⁶ *Id.* at 1014.

⁵⁷ *Martell v. Consett Iron Co., Ltd.*, [1955] Ch. 363 at 400 (Jenkins, L.J.) (Eng.).

⁵⁸ Two Australian cases of particular interest here in relation to the charitable purpose exemption to maintenance include *Stevens v. Keogh* [1946] 72 CLR 1 (Austl.) and *Brew v. Whitlock* [1967] VR 449 (Austl.).

⁵⁹ For example, defamation, as in *Glegg v. Bromley*, [1912] 3 K.B. 474 (Eng.).

⁶⁰ *Trendtex Trading Corp. v. Credit Suisse*, [1982] A.C. 679 (H.L.) 702 (appeal taken from Eng.) (citing *Glegg v. Bromley*, [1912] 3 K.B. 474 at 488-89 (Eng.)).

⁶¹ *Id.*

1. *Property*: Thus, if an assignee can show that he has a legitimate property interest in the subject matter of the cause of action, the court will give effect to an assignment of it.⁶² This is because the court regards the cause of action as incidental to the transfer of the property, for example, an estate or land and buildings, as part of the property transferred and necessary for its proper enjoyment. Effect is also given to the assignment of a debt, which equity regards as property capable of assignment.⁶³

2. *Insolvency*: A trustee in bankruptcy always took and takes an assignment of all causes of action vested in the bankrupt by virtue of the provisions of the Bankruptcy Acts. Under the same statutes, the trustees could and can assign a bare cause of action to a third party or creditor of the bankrupt in order to realize as fully as possible the assets of the bankrupt for the benefit of creditors.⁶⁴

3. *Insurance*: An insurer who pays out his insurance claim has a right of subrogation to any claim that the insured may have against third parties in respect of the loss indemnified. The law therefore allows and gives effect to an assignment of such causes of action by the insured to the insurer.⁶⁵

c. Australian Partial Statutory Abolition

In Australia, the states of Queensland, Western Australia, and Tasmania have not yet abolished the torts and crimes of maintenance and champerty and thus, for them, contracts of maintenance or champerty remain unenforceable. However, three other Australian states, Victoria,⁶⁶ South Australia,⁶⁷ and NSW,⁶⁸ and one territory, the Australian Capital Territory (ACT),⁶⁹ have abolished the common law crimes and torts of Maintenance and Champerty.⁷⁰

⁶² *Ellis v. Torrington*, [1920] 1 K.B. 399 (Eng.).

⁶³ *Fitzroy v. Cave*, [1905] 2 K.B. 364 (Eng.).

⁶⁴ *See Guy v. Churchill*, [1888] 40 Ch.D. 481 (Eng.).

⁶⁵ *See Compania Colombiana de Seguros v. Pac. Steam Navigation Co.*, [1965] 1 Q.B. 101 (Eng.).

⁶⁶ In 1969 in the *Abolition of Obsolete Offences Act 1969* (Vic) (Austl.). The effect of the Victorian law was addressed by Justice Byrne in *Roux v Austl. Broad. Comm'n* [1992] 2 V.R. 577, discussed *infra*.

⁶⁷ In 1992, schedule 11 was inserted into the *Criminal Law Consolidation Act 1935* (SA) sch 11 (Austl.).

⁶⁸ *Maintenance, Champerty and Barratry Abolition Act 1993* (NSW) (Austl.). The effect of this law was discussed in 2006 in *Campbells Cash & Carry Pty. Ltd. v Fostif Pty. Ltd.* (2006) 229 CLR 386 (Austl.), discussed below.

⁶⁹ *Statute Law Amendment Act 2002 (No. 2)* (ACT) pt 3.2 (Austl.) (inserting s 146A, now s 221 in the *Civil Law (Wrongs) Act 2002* (ACT) (Austl.)).

⁷⁰ And often Barratry, but not Embracery.

These three states and the ACT, however, also continued with the English position⁷¹ that a third-party funding arrangement may still involve an illegal or unenforceable contract. The U.K. Criminal Law Act sections 13 and 14, which, while abolishing criminal and tortious liability for champerty, “expressly preserves any rule of law as to the cases in which a contract involving champerty is to be treated as contrary to public policy and/or otherwise illegal.”⁷² Although they abolished the torts and crimes of champerty, Victoria, South Australia, and ACT still each retained explicit reference in their legislation regarding the effect of maintenance and champerty on the illegality of contracts.⁷³ This legislation maintains that the abolition of the torts and crimes of champerty shall not affect: “any rule of law as to the cases in which a contract is to be treated as contrary to public policy or as being otherwise illegal . . . on the ground that its making or performance involved or was *in aid of maintenance of champerty*” (Victoria); “any rule of law relating to *the avoidance of a champertous contract* as being contrary to public policy or otherwise illegal” (South Australia); and, “any rule of law about the illegality or avoidance of contracts that are *tainted with maintenance, or are champertous*” (ACT).

In *Roux v. ABC*,⁷⁴ a Victorian state decision regarding the effect of the Victorian legislation, the court commented:

The position then in England, and Victoria is that *the illegality of contracts of maintenance and champerty is preserved*, notwithstanding that the criminal and civil law foundation for this illegality has been swept away. The illegality, therefore, to the extent that it exists, must again depend upon public policy. This public policy is not that of medieval times, but a modern public policy which must have regard to litigation and its funding in the contemporary world, (*Stevens v Keogh* [1946] HCA 16; (1946) 72 CLR 1, at 28, per Dixon J.) but it is of some assistance to look at the abuses which the medieval lawyers sought to remedy by the application of the criminal law proscribing maintenance, champerty and barratry.

Unlike Victoria, South Australia, and ACT, section 6 of the New South Wales (NSW) Maintenance, Champerty and Barratry Abolition Act of 1993 (the Abolition Act) does not explicitly mention maintenance and champerty as relevant to the illegality of contracts. Instead, it provides more generally that “[t]his Act does not affect any rule of law as to the cases in which a contract is to be treated as contrary to public policy or as otherwise illegal, whether the contract was made before, or is made after, the commencement of this Act.”

⁷¹ Criminal Law Act, 1967, c. 58, §§ 13-14.

⁷² *Trendtex Trading Corp. v. Credit Suisse*, [1982] A.C. 679 (H.L.) 702 (appeal taken from Eng.).

⁷³ As we shall see later, NSW did not retain explicit references to the roles of maintenance or champerty in relation to the illegality of contracts.

⁷⁴ *Roux v. Austl. Broad. Comm'n* [1992] 2 VR 577 (Austl.).

In 2006, the High Court in *Campbells Cash & Carry v. Fostif*⁷⁵ (*Fostif*) considered the effect of the NSW rule. In *Fostif*, the defendants as appellants in the High Court attacked the third-party funding arrangements used by the litigation funder. Specifically, they attacked how the funder actively sought out those who may have claims and offered terms which not only gave the funder control of the litigation, but also, if successful would have yielded a significant profit to the funder. The High Court noted that the appellants' submission could be understood as conflating two separate propositions:

First, that the funding arrangements constituted maintenance or champerty and, secondly, that for the maintainer to institute and continue proceedings, in the name of or on behalf of plaintiffs who were thus maintained, was an abuse of process which could be avoided only by ordering a stay of the proceedings.⁷⁶

As for the second proposition raised by the defendants, the High Court noted that “[t]he second of these propositions, about abuse of process, assumed that maintenance and champerty give rise to public policy questions beyond those that would be relevant when considering the enforceability of the agreement for maintenance of the proceedings as between the parties to the agreement.”⁷⁷

The Court held that “[i]n jurisdictions where legislation has been enacted to the same effect as the Abolition Act, the premise for the second proposition identified is not valid.”⁷⁸ As Judges Gummow, Hayne, and Crennan noted:

First, and foremost, [§] 6 of the Abolition Act preserved any rule of law as to the cases in which a contract is to be treated as contrary to public policy or as otherwise illegal. It preserved no wider rule of law. The Abolition Act abolished the crimes, and the torts, of maintenance and champerty. By abolishing those crimes, and those torts, any wider rule of public policy (wider, that is, than the particular rule or rules of law preserved by [§] 6) lost whatever narrow and insecure footing remained for such a rule.⁷⁹

As to how the funder actively sought out claimants and offered terms, the judges pointed out that in the instant case “none of these elements, alone or in combination, warrant condemnation as being contrary to public policy or leading to any abuse of process.”⁸⁰

In a narrow sense, the High Court in *Fostif* decided that TPLF arrangements of the kind at issue were not an abuse of process, and could not

⁷⁵ *Campbells Cash & Carry Pty. Ltd. v. Fostif Pty. Ltd.* [2006] 229 CLR 386 (Austl.).

⁷⁶ *Id.* at 432.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.* at 433.

⁸⁰ *Id.* at 433-34.

support a stay of proceedings. More generally, however, the judges disparaged maintenance and champerty as providing:

[N]o rule more certain than the patchwork of exceptions and qualifications that could be observed to exist in the law of maintenance and champerty at the start of the 20th century. As Fletcher Moulton L.J. had also said,⁸¹ it was then “far easier to say what is not maintenance than to say what is maintenance.” No certain rule would emerge because neither the content nor the basis of the asserted public policy is identified more closely than by the application of condemnatory expressions like “trafficking” or “intermeddling,” with or without the addition of epithets like “wanton” and “officious.”⁸²

Having said that, the High Court left open the point that under section 6 of the Abolition Act, “[i]t is necessary to bear steadily in mind that questions of illegality and public policy may arise when considering whether a funding agreement is enforceable. So much follows from s[ection] 6 of the Abolition Act.”⁸³

Given the judges’ and scholars’ disparaging remarks on maintenance and champerty offering a relevant rule of public policy it appears that, while interpreting the enforceability of funding contracts under section 6 of the Abolition Act may pose some difficulties, the traditional rules of maintenance and champerty are no longer relevant to that task.

d. Summary of the Nature and Effects of Maintenance and Champerty

In summary, NSW has abolished the torts and crimes of maintenance and champerty and the High Court in *Fostif* clarified that TPLF contracts are likely to be enforced in NSW—even though they involve maintenance or champerty—so long as they are in no other sense illegal or against public policy. Two other Australian states, Victoria and South Australia, and one territory, ACT, have also abolished the torts and crimes of maintenance and champerty but arguably left contracts that involve maintenance or champerty unenforceable by the words of their statutes. Finally, three other states, Queensland, Western Australia, and Tasmania, have not yet abolished the torts and crimes of maintenance and champerty and have also left contracts involving those doctrines unenforceable.

Table 1 below summarizes the law across Australia. For each jurisdiction by row, the second column provides the date of the state’s legislation abolishing maintenance and champerty, if any has been passed. The third

⁸¹ *British Cash & Parcel Conveyors, Ltd. v. Lamson Store Serv.*, [1908] 1 K.B. 1006, 1014 (U.K.).

⁸² *See Giles v. Thompson*, [1994] 1 A.C. 142, 161 (H.L.) (appeal taken from Eng.) (U.K.) (citing *British Cash & Parcel Conveyors, Ltd. v. Lamson Store Serv. Co.*, [1908] 1 K.B. 1006, 1014 (U.K.)).

⁸³ *Campbells Cash & Carry Pty. Ltd. v. Fostif Pty. Ltd.* (2006) 229 CLR 386, 434 (Austl.).

through fifth columns note any residual effect of the law of maintenance and champerty on crimes, torts, and contract enforceability in each jurisdiction. Ticks (\checkmark) indicate the historic effect of the law of maintenance and champerty on crimes, torts, and contract enforceability where it has been abolished in the relevant jurisdiction. A cross (X) indicates the historic effect of the law where it has not been abolished in the relevant jurisdiction. A question mark indicates uncertainty. The table shows that for Australia as a whole, the effect of the relevant law is both a patchwork quilt and at times uncertain. This no doubt hinders the development of TPLF in Australia overall, but may also encourage it in some jurisdictions and in some areas of law, in relative terms and all other things held constant.

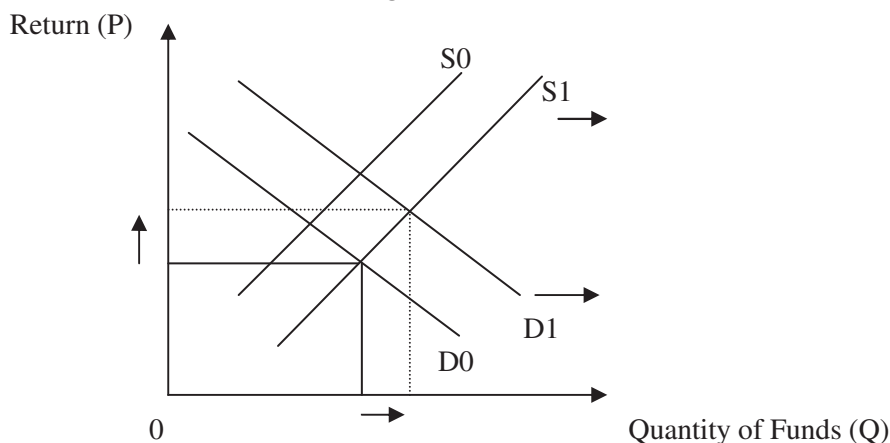
TABLE 1. STATE ABOLITION OF MAINTENANCE AND CHAMPERTY

State	Date	Crime	Tort	Contract
Victoria (Vic)	1969	\checkmark	\checkmark	?
South Australia (SA)	1992	\checkmark	\checkmark	?
New South Wales (NSW)	1993	\checkmark	\checkmark	\checkmark
Australia Capital Territory (ACT)	2002	\checkmark	\checkmark	?
Queensland	Not yet	X	X	X
Western Australia	Not yet	X	X	X
Tasmania	Not yet	X	X	X

Figure 2 below presents a possible representation of the effect on the market for litigation funding of the changes to the law on maintenance and champerty outlined above. Before states abolish the crimes and torts of maintenance and champerty, the demand for litigation funding in any state might initially be represented by the demand curve D_0 and supply by the curve S_0 . The exceptions to the old laws of maintenance and champerty, which we explored earlier, are likely in this setting, to have caused variation in the types of cases funded—by focusing funding on exceptions like insolvency. The statutes abolishing the crimes and torts of maintenance and champerty would then be expected to cause an increase in total demand and supply, shifting the demand curve shown below from D_0 to D_1 and shifting supply from S_0 to S_1 . This would also increase the range of cases being funded over time.

As shown in Figure 2, the abolition of the laws of maintenance and champerty will thus increase the prevalence of TPLF represented by the quantity of funds (Q) invested in equilibrium. Generally, however, although the amount of litigation funding (Q) would be predicted to increase under the statutes in the new equilibrium, the return to litigation funding (P) might have risen or fallen in equilibrium depending on the position and slope of the demand and supply curves. Given the assumed position and slope of the curves in the diagram above, this would likely increase both the amount of (Q) and return (P) to TPLF in equilibrium as shown below.

FIGURE 2. THE EFFECT OF STATE ABOLITION OF MAINTENANCE AND CHAMPERTY



2. Lawyers and Contingency Fees

Whether maintenance is considered a crime, only a civil wrong, or abolished completely, special considerations are applied to a solicitor. In a sense, it is the business of a solicitor to maintain litigation for his clients, perhaps by carrying the costs of the case “on account.” Thus, a solicitor in Australia is partially exempt from the laws of maintenance and champerty. There is, however, a key historic and evolving difference between Australia and the U.K. on one hand, and the U.S., on the other—Australia and the U.K. have not historically allowed lawyers to agree to contingency fees. This difference significantly differentiates their markets for TPLF.

The Full High Court of Australia in *Clyne v. NSW Bar Association*⁸⁴ made this difference clear when it stated the following:

[A] solicitor may with perfect propriety act for a client who has no means, and expend his own money in payment of counsel’s fees and other outgoings, although he has no prospect of being paid either fees or outgoings except by virtue of a judgment or order against the other party to the proceedings. This, however, is subject to two conditions. One is that he has considered the case and believes that his client has a reasonable cause of action or defence as the case may be. And the other is that he must not in any case bargain with his client for an interest in the subject-matter of litigation, or (what is in substance the same thing) for remuneration proportionate to the amount which may be recovered by his client in a proceeding:

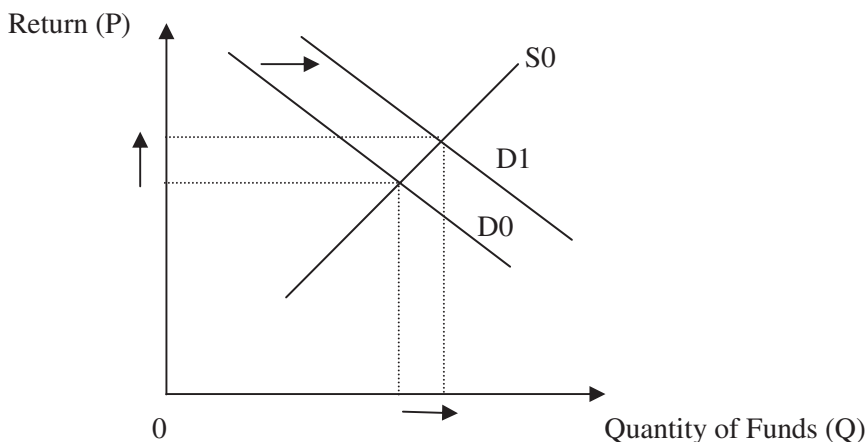
⁸⁴ *Clyne v. NSW Bar Assoc.* (1960) 104 CLR 186 (Austl.).

see Fleming, *The Law of Torts* (1957) p. 638, where it is pointed out that the position in the United States is different.⁸⁵

It is worth noting that because the law in Australia and the U.K. does *not* allow lawyers to offer contingency fees as a means of payment, the laws in both countries may also *indirectly* affect outcomes in the market for third-party litigation funding. To the extent solicitors “must not in any case bargain with his client for an interest in the subject-matter of litigation, or (what is in substance the same thing) for remuneration proportionate to the amount which may be recovered by his client in a proceeding,”⁸⁶ then this would tend to reduce the supply and increase the price of alternative sources of finance to TPLF (P') in equation (1) above. This, in turn, is likely to increase the demand for TPLF.

Figure 3 shows the possible effect of the regulation limiting contingency fees. It would tend to increase the demand for TPLF, shifting the demand curve outward. Accordingly, this would lead to an expected increase in the amount of TPLF in equilibrium in Australia and the U.K., all other things being equal.

FIGURE 3. THE INDIRECT EFFECT OF RESTRICTING LAWYERS USE OF CONTINGENCY FEES



3. Adverse Costs Orders

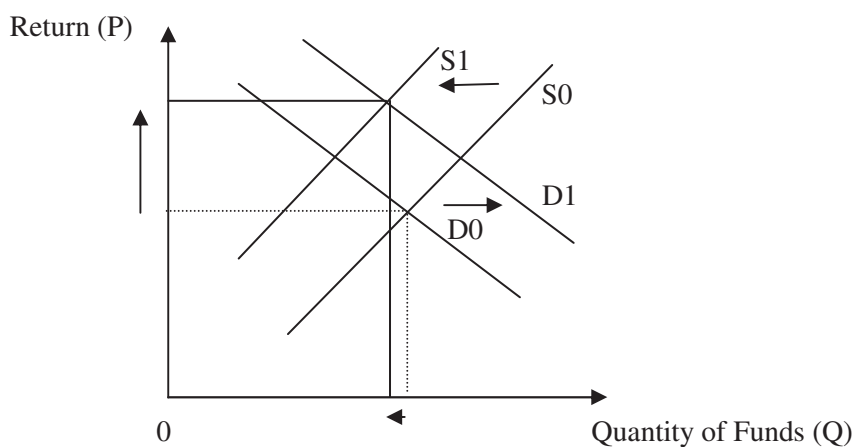
Laws on adverse costs in Australia and the U.K. may also *indirectly* affect outcomes for TPLF. Australia and the U.K. use the so-called loser pays, or English rule, for the allocation of court costs. This could increase

⁸⁵ *Id.* at 203.

⁸⁶ *Id.*

the costs and risks of litigation funding, which would reduce supply while possibly increasing demand. This is shown in the diagram below where the supply curve shifts from S_0 to S_1 and demand shifts from D_0 to D_1 . The effect of this on market equilibrium in such jurisdictions is shown at the intersection of the demand and supply curves. The outcome depends on the impact of the law on the position and elasticities of the relevant curves. In the case shown, it serves to increase returns to TPLF (P) but reduce the amount of TPLF in equilibrium (Q).

FIGURE 4. THE EFFECT OF ADVERSE COST ORDERS



One of the specific issues that has arisen under the English rule in Australia is the legal liability of the third-party funder for adverse costs orders. We discuss this first at the state level and then at the federal level in Australia. At the state level in NSW, in *Jeffery & Katauskas Pty. Ltd. v. SST Consulting Pty. Ltd.*⁸⁷ (*Katauskas*), the appellants argued that those who fund another's litigation for reward must agree to the following: to put the party who is funded in a position to meet any adverse costs orders and that a failure to do so amounts to an abuse of process. However, in a 4–1 decision, with Judge Heydon dissenting, the High Court held that the proposition was too broad, had no basis in legal principle, and that there was no abuse of process.⁸⁸

In the Federal Court, § 43(1) of the Federal Court Act vests statutory power in the Federal Court to award costs in proceedings.⁸⁹ It has been held that the Court's discretion in § 43(1) is unfettered besides for the fact that it must be exercised judicially. It has been unambiguously held that this broad discretion extends to the award of non-party orders to pay the costs of

⁸⁷ *Jeffery & Katauskas Pty Ltd. v. SST Consulting Pty Ltd.*, [2009] HCA 20, 43 (Austl.).

⁸⁸ *Id.* at 43–44.

⁸⁹ *Federal Courts of Australia Act 1976* (Cth) s 43(1) (Austl.).

one or all parties. The legal position in Australia then allows third-party litigation funders to either leave the risk of adverse cost orders with the party they fund or to assume it themselves.

4. Federal Regulation

In the last two years there have been significant legal developments on federal regulation of TPLF in Australia.

a. 2009: Funded Class Actions and Managed Investment Schemes

In *Brookfield Multiplex Ltd. v. Int'l Litig. Funding Partners*⁹⁰ (*Brookfield*), the full court of the Federal Court considered the question of whether, in relation to a class action, litigation funding arrangements between a law firm and litigation funders constituted a “managed investment scheme” under the Corporations Act, thus requiring registration with Australian Securities Investment Commission (ASIC). On appeal in the Federal Court, Judges Sundberg and Dowsett held that the section 9 requirements for a managed investment scheme were satisfied in the instant case.⁹¹ Judge Jacobson dissented, holding that the class members’ contributions were neither “pooled” nor a “common enterprise” for the purposes of section 9.⁹²

It is important to realize the obligations this decision entailed for firms running funded class actions at the time. Under the Corporations Act,⁹³ in order to obtain registration of a scheme, the scheme must have a constitution and compliance plan.⁹⁴ In addition, there must also be a responsible entity (RE),⁹⁵ who is the person who operates the scheme.⁹⁶

The constitution must adequately provide for “(a) the consideration that is to be paid to acquire an interest in the scheme, (b) the powers of the [RE] in relation to making investments of, or otherwise dealing with, scheme property, (c) the method by which complaints made by members in relation to the scheme are to be dealt with, and (d) the winding up [of] the scheme.”⁹⁷

⁹⁰ *Brookfield Multiplex Ltd. v. Int'l Litig. Funding Partners* [2009] FCAFC 147 ¶ 2 (Austl.).

⁹¹ *Id.* at 35.

⁹² *Id.* at 56-8.

⁹³ See *Brookfield Multiplex Ltd. v Int'l Litig. Funding Partners Pte. Ltd.* (No 3) [2009] FCA 450, ¶¶ 38-42 (Austl.) (summarizing the requirements of the Corporations Act of 2001).

⁹⁴ *Corporations Act 2001* (Cth) s 601EA(4) (Austl.).

⁹⁵ *Id.* s 601EA(2).

⁹⁶ *Id.* s 601FB(1).

⁹⁷ *Id.* s 601GA(1).

The compliance plan “must set out adequate measures [for] the [RE] to apply in operating the scheme to ensure compliance with [the Corporations Act] and the [] constitution.”⁹⁸ This includes arrangements for: (a) ensuring that all scheme property is clearly identified as scheme property and held separately from property of the RE and property of any other scheme; (b) ensuring that the compliance committee functions properly, if the scheme is required to have a compliance committee;⁹⁹ (c) ensuring that the scheme property is valued at regular intervals appropriate to the nature of the property; (d) ensuring that the compliance with the plan is audited under s 601GH; and (e) ensuring adequate records are kept.¹⁰⁰

Numerous obligations are imposed upon the RE. If less than half of the RE’s directors are “external,”¹⁰¹ the RE must establish a compliance committee¹⁰² and the RE must hold the assets of the scheme on trust for members.¹⁰³ In addition, on-going obligations are imposed on a RE. Specifically, the RE must: (a) act honestly; (b) act in the best interest of members; (c) treat members fairly; (d) ensure that the scheme constitution and compliance plan satisfy the specific content requirements of the Corporations Act; and (e) report breaches of the Corporations Act relating to the scheme to the Australian Securities and Investment Commission (ASIC).¹⁰⁴

Additionally, a RE “must be a public company that holds an Australian financial services licence authorising [sic] it to operate” the scheme.¹⁰⁵ A company must satisfy a range of requirements in order to hold an Australian Financial Services License (AFSL). First, the company must satisfy certain minimum financial requirements.¹⁰⁶ Specifically, it must have minimum net tangible assets (NTA) of 0.5% of the scheme assets with a minimum requirement of AUD50,000 and a maximum requirement of AUD5 million.¹⁰⁷ A custodian must be appointed to hold scheme property if the AFSL holder has less than AUD5 million of NTA.¹⁰⁸ Second, an AFSL holder must nominate a responsible manager that satisfies certain require-

⁹⁸ *Id.* s 601HA(1).

⁹⁹ To determine if a compliance committee is required, see *id.* s 601JA.

¹⁰⁰ *Corporations Act 2001* (Cth) s 601HA(1) (Austl.).

¹⁰¹ A director is external if they meet the six requirements laid out in § 601JA(2).

¹⁰² *Id.* s 601JA(1).

¹⁰³ *Id.* s 601FC(2).

¹⁰⁴ *Id.* s 601FC(1).

¹⁰⁵ *Id.* s 601FA.

¹⁰⁶ AUSTL. SEC. & INVS. COMM’N, REGULATORY GUIDE 166 LICENSING: FINANCIAL REQUIREMENTS (2010) [hereinafter REGULATORY GUIDE], available at [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/RG166a.pdf/\\$file/RG166a.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/RG166a.pdf/$file/RG166a.pdf).

¹⁰⁷ *Id.* reg 166.63.

¹⁰⁸ *Id.* reg 166.70.

ments with respect to education and experience.¹⁰⁹ Third, an AFSL holder must establish comprehensive compliance and risk management systems,¹¹⁰ remembering that a RE is subject to a separate requirement to maintain a scheme compliance plan.¹¹¹ Finally, there are a number of general obligations as well.¹¹²

There are additional obligations imposed on an AFSL holder when dealing with retail clients, which is a term defined in sections 761G and 761GA and includes investors who are not high net worth individuals or sophisticated investors.¹¹³ For example, an AFSL holder must, when dealing with retail investors, confirm certain transactions in writing or electronically¹¹⁴ and, in certain circumstances, provide periodic statements relating to investors' holdings.¹¹⁵ An AFSL holder is also required to have a dispute resolution system.¹¹⁶ Further, an AFSL holder may be required to issue a product disclosure statement (PDS) for a financial product, depending on how the financial product is acquired.¹¹⁷ For example, when the AFSL holder provides financial product advice to a retail client that includes a recommendation to acquire a financial product, an AFSL holder must provide the client with a PDS.¹¹⁸ A financial product generally means a facility—which includes intangible property or an arrangement¹¹⁹—“through which, or through the acquisition of which, a person . . . makes a financial investment, manages financial risk, [or] makes non-cash payments.”¹²⁰ This also includes an interest in a managed investment scheme.¹²¹ It is clear then that this decision imposes significant federal regulation of funded class actions. Following the *Brookfield* decision, the Minister for Financial Services, Superannuation and Corporate Law noted that, “there were serious concerns about impeding access to justice for small consumers.”¹²² Subsequently, the Commonwealth Government an-

¹⁰⁹ REGULATORY GUIDE 105: LICENSING: ORGANISATIONAL COMPETENCE (2007), available at [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg105-Published-13-May-2011.pdf/\\$file/rg105-Published-13-May-2011.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg105-Published-13-May-2011.pdf/$file/rg105-Published-13-May-2011.pdf).

¹¹⁰ REGULATORY GUIDE 104: LICENSING: MEETING THE GENERAL OBLIGATIONS 2 (2007), available at [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg104.pdf/\\$file/rg104.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg104.pdf/$file/rg104.pdf).

¹¹¹ See *Corporations Act 2001* (Cth) ss 601HA, 601JA (Austl.).

¹¹² *Id.* s 912A.

¹¹³ *Id.* ss 761G-761GA.

¹¹⁴ *Id.* ss 1017F(1)(a), (6)(a)(i)-(ii).

¹¹⁵ *Id.* s 1017D(1).

¹¹⁶ *Id.* s 912A(1)(g).

¹¹⁷ *Corporations Act 2001* (Cth) s 1012A.

¹¹⁸ *Id.* s 1012A(3)(a).

¹¹⁹ *Id.* s 762C.

¹²⁰ *Id.* s 763A(1).

¹²¹ *Id.* s 764A(1)(ba)(i).

¹²² Press Release, Chris Bowen, Austl. Gov't, the Treasury, Government Acts to Ensure Access to Justice for Class Action Member, (May 4, 2010), available at

nounced plans to draft regulations formally exempting litigation funders, when funding class actions, from registration as managed investment schemes under the Corporations Act. The Treasury has since written draft regulations that would expressly exclude litigation funding from the statutory definition of a Managed Investment Scheme under the Act.

In the meantime, ASIC has issued class orders enabling the temporary operation of funded representative proceedings and funded proof of debt arrangements without compliance with the requirements of the Act.

b. 2011: TPLF as Financial Products—Chameleon Mining

In *International Litigation Partners Pte Ltd. v. Chameleon Mining NL*, the court examined whether TPLF agreements constituted a financial product under the Corporations Act, in which case the funder must hold an Australian Financial Services Licence (AFSL).¹²³ A 2–1 majority of the NSW Court of Appeal held that the funding constituted a financial product according to the statutory criteria because it managed risk in relation to costs orders and claims and it therefore required an AFSL.¹²⁴

Based on this decision, a litigation funding agreement related to any sort of action—not just class actions—would also qualify as a “financial product” and could be rescinded because the funder did not hold an AFSL. This decision thus implied wholesale federal regulation of TPLF in Australia.

The requirement to hold an AFSL carries with it a number of obligations under the Corporations Act, which are outlined above. These include capital adequacy requirements¹²⁵ and risk management systems requirements.¹²⁶ Thus, unless the licensee is a body regulated by the Australian Prudential Authority (APA) under section 912A (d), the Act requires that they have available adequate resources—financial, technological and human resources—to provide the financial services covered by the license as well as to carry out supervisory arrangements. Section 912A (h) further requires that they have adequate risk management systems. Furthermore, section 912A requires that they must also do all things necessary to ensure that the financial services covered by the license are provided efficiently, honestly, and fairly, and that they have in place adequate arrangements for the management of conflicts of interest.¹²⁷ They also must ensure that they

<http://mfsscl.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/039.htm&pageID=003&min=eba&Year=&DocType=0>.

¹²³ *Int'l Litig. Partners Pte. Ltd. v Chameleon Mining NL* (2011) 276 ALR 138 (Austl.).

¹²⁴ REGULATORY GUIDE 166 LICENSING: FINANCIAL REQUIREMENTS (2010), available at [://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/RG166a.pdf/\\$file/RG166a.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/RG166a.pdf/$file/RG166a.pdf).

¹²⁵ *Corporations Act of 2001* s 912A (d).

¹²⁶ *Id.* s 912A (h).

¹²⁷ *Id.* s 912A(1)(aa).

comply with the conditions on the license and applicable financial services laws, along with taking reasonable steps to ensure that their representatives comply with these financial services laws as well.¹²⁸ In other words, this means maintaining the competence to provide those financial services by ensuring that their representatives are adequately trained and are themselves competent to provide those financial services.¹²⁹ They must also comply with any other obligations that are prescribed by applicable regulations.¹³⁰

For financial services that are provided to persons as retail clients, the licensee must also have a dispute resolution system complying with subsection (2).¹³¹ This subsection specifies that the system must consist of an internal dispute resolution procedure that (i) complies with standards, and requirements, made or approved by ASIC and (ii) covers complaints against the licensee made by retail clients.¹³² Subsection 2(b) requires membership of one or more external dispute resolution schemes that (i) is or are approved by ASIC in accordance with regulations made for the purposes and (ii) covers, or together cover, complaints—other than complaints that may be dealt with by the Superannuation Complaints Tribunal—against the licensee made by retail clients in connection with financial services covered by the license.¹³³ Regulations made for the purposes of subparagraph (2)(a)(i) or (2)(b)(i) may also deal with the variation or revocation of (a) standards or requirements made by ASIC or (b) approvals given by ASIC.¹³⁴

In terms of the demand and supply framework described earlier, the potentially onerous task of obtaining an AFSL would tend to increase costs and reduce supply of TPLF, thereby shifting the supply curve inward. This could also stifle competition.¹³⁵ There are, however, those who argue that regulation may also increase demand for TPLF, assuming the requirement that funders hold an AFSL leads to third-party funders remaining solvent while a particular matter is litigated. Then again, to some extent, this may be achieved already through security for costs orders.

In the context of *Chameleon Mining*, ASIC issued class order 11/555 on June 23, 2011, which exempted lawyers and funders from holding an AFSL in respect to providing a financial product. The order also extended

¹²⁸ *Id.* s 912A(1)(b).

¹²⁹ *Id.* s 912A(1)(e).

¹³⁰ *Id.* s 912A(1)(j).

¹³¹ *Corporations Act 2001* (Cth) s 912A(2).

¹³² *Id.* ss 912A(2)(a)(i)-(ii).

¹³³ *Id.* s 912A(2)(b)(i)-(ii).

¹³⁴ *Id.* s 912A(3)(a).

¹³⁵ Michael Legg et al., *Litigation Funding in Australia* 42 (Univ. of N.S.W. Faculty of Law Research Series, Working Paper No. 12, 2010), available at <http://law.bepress.com/cgi/viewcontent.cgi?article=1207&context=unswwps>.

the operation of the earlier class orders—which provided an AFSL exemption in relation to managed investment schemes—to September 30, 2011.¹³⁶

c. Formal Statutory Carve Out

In addition to these class orders, Australia's Treasury Department has written draft regulations that would expressly exclude litigation funding from the statutory definition of a Managed Investment Scheme under the Act. Excerpts of the draft regulations are outlined here:

(1) For paragraph (n) of the definition of *managed investment scheme* in section 9 of the Act, each of the following schemes is declared not to be a managed investment scheme:

(a) an approved benefit fund within the meaning given by section 16B of the *Life Insurance Act 1995*;

(b) a scheme that has all of the following features:

(i) the dominant purpose of the scheme is for each of its members (other than the lawyer mentioned in subparagraph (iii) and the funder mentioned in subparagraph (iv)) to seek remedies to which they may be legally entitled;

(ii) if there is more than one member seeking remedies — the possible entitlement of each of those members of the scheme to remedies:

(A) arises out of the same, similar or related transactions or circumstances; and

(B) relates to transactions or circumstances that occurred before any issue of interests in the scheme;

(iii) the steps taken to seek remedies for each of those members of the scheme include a lawyer providing services in relation to:

¹³⁶ The explanatory statement to CO 11/555 outlines its operative effect:

[CO 11/555] varies [CO 10/333] to exempt funders, lawyers and their representatives and other persons from the requirements to hold an AFSL or act as an authorised representative of a licensee to provide financial services associated with a litigation funding arrangement or a proof of debt funding arrangement to the extent the arrangement, or an interest in the arrangement, is a financial product.

[CO 11/555] also varies [CO 10/333] to exempt a person from the requirement to comply with the disclosure provisions in Pt 7.9 of the Act in relation to a litigation funding arrangement or a proof of debt funding arrangement to the extent the arrangement, or an interest in the arrangement, is a financial product.

Class order 11/555 also differs from class order 10/333 by replacing June 30, 2011, in paragraph 10 with September 30, 2011.

- (A) making a demand for payment in relation to a claim; or
 - (B) lodging a proof of debt; or
 - (C) commencing or undertaking legal proceedings; or
 - (D) investigating a potential or actual claim; or
 - (E) negotiating a settlement of a claim; or
 - (F) administering a deed of settlement or scheme of settlement relating to a claim;
- (iv) a person (the funder) provides funds under a funding agreement (including an agreement under which no fee is payable to the funder or lawyer if the scheme is not successful in seeking remedies) to enable those members of the scheme to seek remedies;
- (c) a scheme that has all of the following features:
- (i) the scheme relates to an externally-administered body corporate;
 - (ii) the creditors or members of the body corporate provide funds (including through a trust) or indemnities to the body corporate or external administrator;
 - (iii) the funds or indemnities enable the external administrator or the body corporate to:
 - (A) conduct investigations; or
 - (B) to seek or enforce a remedy against a third party; or
 - (C) to defend proceedings brought against the body corporate

There are a number of conditions attached to the proposed exemptions including identification and assessment of conflicts of interest, written procedures for managing conflict of interest, and compliance with the Competition and Consumer Act.

As ASIC can exempt funders from many of the requirements or exempt them entirely on a case by case basis, the regulations effectively propose two regimes: (1) funders to whom the AFSL and possibly managed investment scheme provisions will apply unless exempted on a case by case basis and subject to modification by ASIC, and (2) funders who are subject to the exemption regulations.

B. *Litigation Funders in Australia*

1. Funders

The Standing Committee of Attorneys-General's (SCAG) Litigation Funding Discussion Paper describes litigation funders as follows:

A litigation-funding company (LFC) is a commercial entity that contracts with one or more potential litigants. The LFC pays the cost of the litigation and accepts the risk of paying the other party's costs if the case fails. In return, if the case succeeds, the LFC is paid a share of the proceeds (usually after reimbursement of costs).¹³⁷

Variations are technically possible, including, for example, underwriting only a portion of solicitors' and barristers' costs, and in insolvency and other contexts, assigning claims either fully or partially to the litigation funding company.

In 2006, the Law Council of Australia's submissions in response to SCAG's Litigation Funding Discussion Paper identified five litigation funding companies operating in Australia. At the time, these five companies accounted "for approximately 95 percent of litigation funding in Australia."¹³⁸ In 2009, there were six or seven litigation funding companies in Australia "providing funding broadly on the basis that the funder agrees to pay the legal costs associated with the claim and agrees to pay the defendant's costs in the event the claim fails in return for a share of the proceeds of settlement or judgment, if any."¹³⁹

According to Legg et al., presently in Australia, litigation funders tend to use two distinct approaches to source funds:

The first is to be a company incorporated in Australia that obtains the funds to be invested in litigation from debt and equity sources. Under this model, the company is listed on a stock exchange and as such will comply with prospectus requirements in obtaining equity and the usual requirements for listed public corporations such as continuous disclosure obligations. The second model involves the funder sourcing funds from Australian and/or overseas high wealth individuals or corporations. The second model is more opaque and in some instances may operate off-shore so as to take advantage of favourable tax regimes.¹⁴⁰

¹³⁷ STANDING COMMITTEE OF ATTORNEYS-GENERAL, *Litigation funding in Australia* 4 (Discussion Paper, May 2006), available at http://www.imf.com.au/pdf/DiscussionPaperStandingCommitteeOfAttorneysGeneral_May2006.pdf.

¹³⁸ LAW COUNCIL OF AUSTRALIA, *Litigation Funding* 6 (Sept. 14, 2006), available at http://www.lawcouncil.asn.au/shadomx/apps/fms/fmsdownload.cfm?file_uid=8C744AB2-1C23-CACD-2297-5D181CEBB545&siteName=lca.

¹³⁹ Simon Dluzniak, *Litigation Funding and Insurance* 2 (2009), <http://www.imf.com.au/pdf/Paper%20-%20Dluzniak.pdf>.

¹⁴⁰ Legg et al., *supra* note 135, at 5-6.

Presently only IMF (Australia) Ltd. (IMF) and Hillcrest Litigation Services Ltd. (HLS) are listed on the Australian Securities Exchange.

2. Selection of Cases

Consistent with economic theory, IMF has indicated that they approach the cases as a typical investment manager would, with a focus on expected rates of return. Litigation funders are, as a result, more likely to fund certain categories of cases than others. SCAG, in their 2006 Discussion Paper, explained that:

The remainder of funded cases, outside the insolvency context, is usually limited to commercial litigation with large claims (over \$500,000, or for some [litigation funding companies], over \$2 million). An exception is for class actions, where a large number of smaller claims can be processed economically (e.g. petrol or tobacco tax refunds). [Litigation funding companies] are generally not involved in personal injury type matters or other smaller claims, as the associated costs and risks make them unviable.¹⁴¹

Funding commercial proceedings is considered less risky, as the award is more easily quantifiable by reference to the financial loss suffered by the claimant.¹⁴² However, “proceedings involving personal injury or recoveries that are assessed according to an ‘approximate’ loss are generally considered too risky for funders that engage in proper due diligence, particularly when success is less certain.”¹⁴³ Further, these latter types of claims tend to rely on evidence from individual applicants, usually presented orally, which “may give rise to a number of litigation risks and, in any event, are generally already well supported by lawyers acting on a ‘no win, no fee’ basis.”¹⁴⁴ Litigation funders are, however, moving into non-traditional areas, including family law.¹⁴⁵

The idea that litigation funders would consider an area of claims unattractive due to the existence of an alternate means of financing raises an interesting issue. Andrew Grech, on behalf of Slater & Gordon, maintains:

With respect, we believe that many of the proposals currently considered by SCAG [in respect of regulation in the emerging market for third-party litigation funding in Australia] fail to adequately address the greatest problem in the litigation funding market. That is, the fundamental lack of competition in the litigation funding market . . . that has led to: (a) [a] near

¹⁴¹ STANDING COMMITTEE OF ATTORNEYS-GENERAL, *supra* note 137.

¹⁴² LAW COUNCIL OF AUSTRALIA, *supra* note 138, at 12.

¹⁴³ *Id.*

¹⁴⁴ John Walker, Susanna Khouri, & Wayne Attrill, *Funding Criteria for Class Actions*, 32 U. NEW S. WALES L.J. 1036, 1037 (2009).

¹⁴⁵ QUANTUM FAMILY LAW FUNDING, <http://quantumfamily.com.au/> (last visited May 22, 2012); *Limited v. Chester* (2010) FamCAFC 251 (Austl.).

uniformity of available commercial terms; and (b) [a] narrowing in the types of matters in respect of which litigation funding is offered¹⁴⁶

Are these results truly indicators of a lack of competition? First, near uniformity may be indicative of the functionality of available commercial terms responding to market demands. Second, the “narrowing in the types of matters,” suggests that they were wide to begin with and negatively connotes what could simply be specialization. However, in Slater & Gordon’s opinion, active participation in the TPLF market in Australia carries substantial weight.

According to Grech:

It is [Slater & Gordon’s] strong position that the most appropriate method of reducing costs of litigation funding is to support measures that increased [sic] competition in the litigation funding market. Only through competition will [litigation funding company] commissions be reduced, whilst improving the quality of litigation funding services simultaneously. By way of example, the entry of CLF into the Australian market had an immediate impact on the cost of litigation funding services in Australia securities class actions. For the first time faced with competition, IMF’s commission was reduced from a range of 25 to 40% to a range of 15 to 30%, representing a substantial direct potential financial benefit to group members.¹⁴⁷

As a key element in their competitive strategy, particular litigation funders have clear policies on the selection of cases under which they either exclude categories of cases from funding outright or positively state that they usually only deal with certain claims. The historical approach of the five main funders is summarized below.

a. IMF

IMF is the largest litigation funder in Australia. The company started in 1989, when Hugh McLernon, now IMF’s Managing Director, “began funding a few large cases in Perth, using loans and savings from a twenty-five year career as a litigator. He then joined forces with John Walker, now one of IMF’s seven board members, who was funding a large number of small cases . . . in Sydney.”¹⁴⁸

In the financial year that ended June 30, 2010, IMF received a net income of \$18,718,276 from litigation funding.¹⁴⁹ This actually represents a significant decrease from the previous financial year’s net income from

¹⁴⁶ ANDREW GRECH, COMMERCIAL LITIGATION FUNDING IN AUSTRALIA ¶ 2.4, *available at* <http://www.ag.gov.au/Documents/Andrew+Gretch+Slater.pdf> (alteration in original).

¹⁴⁷ *Id.* ¶¶ 5.8-5.9.

¹⁴⁸ Anthony Lin, *Australia’s Litigation-Funding Giant Looks Abroad*, THE ASIAN LAWYER (July 6, 2011), <http://www.law.com/jsp/article.jsp?id=1202499382901>.

¹⁴⁹ IMF (AUSTRALIA) LTD, 2010 ANNUAL REPORT 4 (2010).

litigation funding, reported as \$35,246,957, a figure which represented a 21% increase in profitability from 2008.¹⁵⁰ The difference between 2009 and 2010 profits is attributed to the loss of the *Kingstream Steel* case;¹⁵¹ however, in late 2011, on appeal \$500,000 was awarded in damages and \$300,000 in interest.¹⁵² According to IMF's releases to the Australian Securities Exchange (ASX) IMF's estimated total current claim value went up from AUD1.65 billion as of September 30, 2010,¹⁵³ to AUD1.78 billion as of June 30, 2011,¹⁵⁴ then fell to AUD1.23 billion as of June 30 2012.¹⁵⁵

Originally, IMF limited its funding to insolvency cases.¹⁵⁶ Third-party funding has had a relatively long history in Australian insolvency cases. For instance, in 1996 *In Re Feasty's Family Restaurant Pty Ltd*,¹⁵⁷ the Supreme Court of NSW held that liquidators could properly enter into insured litigation finance arrangements.¹⁵⁸

It is difficult to argue against the utility of third-party funding as a liquidator's tool.¹⁵⁹ A liquidator may have a legitimate claim against a defendant, but the company in liquidation does not have the assets to pursue that claim. Further, decisions such as *Hall v. Poolman*¹⁶⁰ have reinforced the propriety of liquidators entering third-party arrangements. In that case, the Court noted:

[T]here is no per se objection in terms of legal policy to liquidators entering into litigation funding arrangements that will share the fruits of litigation with the funder, provided that any necessary approval of creditors or of the court is obtained under [§] 477(2B)/506(1A), [of the *Corporations Act*] and provided that the arrangements in fact made are consistent with the liquidator's statutory and other duties.¹⁶¹

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² IMF (AUSTRALIA) LTD, <http://www.imf.com.au/cases.asp?ID=64> (last visited May 22, 2012).

¹⁵³ Release from Diana Jones, COO of IMF (Australia) Ltd. to the Australian Securities and Exchange Commission (Oct. 11, 2010) (available at <http://www.asx.com.au/asxpdf/20101011/pdf/31t1jt53bxrjnk.pdf>).

¹⁵⁴ Release from Diana Jones, COO of IMF (Australia) Ltd. to the Australian Securities and Exchange Commission (July 26, 2011) (available at <http://www.asx.com.au/asxpdf/20110726/pdf/41zyzj1nx8cz7m.pdf>).

¹⁵⁵ Release from Diana Jones, COO of IMF (Australia) Ltd. to the Australian Securities and Exchange Commission (July 30, 2012) (available at <http://www.asx.com.au/asxpdf/20120730/pdf/427pcst3464z30.pdf>).

¹⁵⁶ Dluzniak, *supra* note 139, at 1.

¹⁵⁷ (1996) 14 ACLC 1058.

¹⁵⁸ See *Elfic Ltd v. Macks*, (2003) 162 FLR 41; see also generally Andrew Keay, MCPHERSONS'S LAW OF COMPANY LIQUIDATION.

¹⁵⁹ LAW COUNCIL OF AUSTRALIA, *supra* note 138.

¹⁶⁰ (2009) 228 FLR 164.

¹⁶¹ *Id.* ¶ 147.

However, in 2001, when IMF was first listed on the Australian Stock Exchange, it broadened its funding to include non-insolvency commercial litigation conducted solely in the Supreme Courts and Federal Court with claim values over \$2 million.¹⁶² It also began including multiparty commercial claims, usually involving breaches of the Corporations Act and Trade Practices Act.¹⁶³ As such, IMF currently categorizes its Litigation Funding Agreements as follows:

- a. Insolvency: covering agreements with insolvency practitioners;
- b. Non-Insolvency (or commercial): covering all recipients of funding who do not fall into either the insolvency category or multiparty category referred to below; and
- c. Multiparty: covering class actions and large group actions.¹⁶⁴

As a publicly listed company, IMF has been quite open and transparent with its information and case data. As a result, there are at least two studies now underway using IMF data. Daniel L. Chen and David S. Abrams obtained direct access to IMF data and have begun reporting on their analysis.¹⁶⁵ They report that from February 1999 to June 2007, IMF chose to fund ninety of the 763 cases it considered.¹⁶⁶

Malcolm Stewart¹⁶⁷ has also been collecting and analyzing IMF case data from public sources, and has kindly allowed use of the information in tables 1–3 below. Table 2 presents a breakdown of IMF cases by case category by year since 2000. In total, there is a reasonably even spread of cases by category, with group actions most common at 39%, commercial actions next at 33%, and insolvency actions at 28%.

TABLE 2. IMF CASES STARTED BY YEAR AND CATEGORY

Year	Insolvency	Commercial	Group	Total	Closed	Open
2000	1	1		2	2	0
2001	1		5	6	6	0
2002	3			3	3	0

¹⁶² John Walker, *Litigation Funding & Causally Connected Loss*, IMF (AUSTRALIA) LTD (Aug. 13, 2009), http://www.imf.com.au/pdf/173062_Forensic%20Accounting%20Conference.pdf.

¹⁶³ Dluzniak, *supra* note 139.

¹⁶⁴ See IMF (AUSTRALIA) LTD., *Apply for Funding*, IMF (AUSTRALIA) LTD (May 22, 2012), <http://www.imf.com.au/funding.asp>.

¹⁶⁵ See Daniel L. Chen, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes*, <http://www.duke.edu/~dlc28/papers/MktJustice.pdf> (June 2011); David S. Abrams, & Daniel L. Chen, *A Market for Justice: A First Empirical Look at Third Party Litigation Funding*, 14 J. Bus. L. (forthcoming 2012).

¹⁶⁶ *Id.* at 24.

¹⁶⁷ Fenn, Rickman & Stewart *supra* note 26.

2003	8	2	6	16	13	3
2004	4	5	2	11	10	1
2005	2	10	1	13	12	1
2006	3	5	2	10	6	4
2007	1	2	2	5	4	1
2008	1	2	10	13	4	9
2009	1	3	7	11	1	10
Total	25	30	35	90	61	29

Table 3 provides an analysis of IMF's closed cases by closure method. Commercial cases are least likely to go to judgement, at 9%, with both insolvency and group actions equally likely to go to judgement, at 17%.

TABLE 3. CLOSED CASES BY TYPE AND CLOSURE METHOD (POST MAY 2004)

Case Type\Ended by	Withdrawal	Settlement	Judgment	Unknown	Total
Group	2	8	2	0	12
Insolvency	1	13	3	1	18
Commercial	7	13	2	1	23
Total	10	34	7	2	53

Table 4 provides a breakdown of the outcome of IMF funded cases that have gone to trial. Of the six cases that went to trial, IMF has only won two after the appeal process has completed.

TABLE 4. OUTCOME OF TRIALS

Outcome for Funder's Client at First Instance		Outcome for Funder's Client on Appeal		
		Win	Lose	Outstanding
Win	4	2	2	0
Lose	3	0	2	1

Examining IMF's portfolio by value over the past decade reveals a trend towards multiparty litigation funding arrangements, which cover class

actions and large group actions, and a move away from insolvency and non-multiparty commercial matters. Commentary from Walker et al. and Legg et al. illustrate these developments:

Initially, IMF had no group actions¹⁶⁸ in its portfolio. By 30 June 2005, however, IMF reported that it was funding 10 group actions with an estimated total claim value of \$531 million and 24 commercial and insolvency claims with a combined estimated claim value of \$394 million.¹⁶⁹

In 2006, IMF (Australia) Ltd had a claim value of \$144 million in insolvency investments, \$274 million in commercial investments, and \$526 million in group actions, compared with the corresponding 2008 figures of \$132 million in insolvency investments, \$280 million in commercial investments and \$928 million in group actions.¹⁷⁰

By 30 June 2009, IMF was funding 19 group actions with an estimated claim value of \$875 million and 10 commercial and insolvency actions with a combined claim value of \$182 million. That is, the share (by value) of multi-party litigation in IMF's claims portfolio grew from nil in 2001 to just under 60 per cent in 2005, and subsequently to over 80 per cent by 2009, while the estimated value of these claims rose from nil to \$875 million in that time.¹⁷¹

IMF's current case investment portfolio as of June 30, 2011, includes four cases where the claim value is less than AUD10 million, fifteen cases where the claim value is between \$10 and \$50 million, and fourteen cases where the claim value is greater than \$50 million.¹⁷² In total, there are thirty-three cases with an estimated claim value of \$1.78 billion.¹⁷³ This portfolio only includes those investments where the budgeted fee to IMF is greater than \$500,000.¹⁷⁴

b. LCM Litigation Fund Pty Ltd (LCM)

LCM Litigation Fund Pty Ltd (LCM), previously known as the Australian Litigation Fund Pty Ltd, has been in business since 1998.¹⁷⁵ LCM primarily provides litigation funding to insolvency practitioners. However,

¹⁶⁸ Walker employs the term "group action" to cover both representative proceedings and other multi-plaintiff actions. Walker et al., *supra* note 144.

¹⁶⁹ *Id.*

¹⁷⁰ Legg et al., *supra* note 135, at 4.

¹⁷¹ Walker et al., *supra* note 144 (citation omitted).

¹⁷² Release from Diana Jones, COO of IMF (Australia) Ltd. to the Australian Securities and Exchange Commission (July 26, 2011) (available at <http://www.imf.com.au/announcements/Company%20Update%20-%2026%20Jul%202011.pdf>).

¹⁷³ *Id.*

¹⁷⁴ IMF (AUSTRALIA) LTD, *Case Overview*, IMF (May 30, 2012), <http://www.imf.com.au/caseoverview.asp>.

¹⁷⁵ LCM LITIGATION FUND PTY LTD., *Introduction*, LCM LITIGATION (May 30, 2012), <http://www.lcmlitigation.com.au/>.

they also provide funding to solvent companies and individuals with “worthwhile commercial legal claims.”¹⁷⁶ LCM explicitly states that it does not provide funding for “[n]on-commercial legal claims such as personal injuries claims or other claims involving physical harm; [m]atrimonial disputes; [and d]efamation [claims].”¹⁷⁷ According to their website, LCM also “prefers to undertake projects in which the relevant legal claim is for at least AUD2.5 million.”¹⁷⁸

c. Comprehensive Legal Funding LLC (CLF)

Comprehensive Legal Funding LLC (CLF) is a U.S.-based litigation funder that has recently entered the Australian market.¹⁷⁹ “[CLF] will consider any case that has legal merit but [its] projects fall into the following categories: class actions involving securities; product liability or employment law; intellectual property/patent infringement; commercial disputes; [and] civil litigation between individuals involving claims greater than AUD3 million.”¹⁸⁰

d. Quantum Litigation Funding Pty Ltd (Quantum)

Quantum Litigation Funding Pty Ltd (Quantum), a subsidiary to the Quantum Litigation Funding Group, was established in 2006 and provides litigation funding in both Australia and New Zealand.¹⁸¹ Quantum funds cases relate to contract disputes, insolvency, trade practices, intellectual property, general commercial disputes, family law, and personal injury.¹⁸² Quantum generally prefers to fund claims over AUD500,000 and only funds commercial claims over AUD2 million.¹⁸³

¹⁷⁶ *Id.*

¹⁷⁷ LCM LITIGATION FUND PTY LTD., *Funding for Solvent Companies and Individuals*, LCM LITIGATION (May 23, 2012), <http://lcmliigation.com.au/> (mouseover “How Does LCM Work” and follow the “Funding for Solvent Companies and Individuals” hyperlink).

¹⁷⁸ LCM LITIGATION FUND PTY LTD., *Introduction*, LCM LITIGATION (May 30, 2012), <http://www.lcmliigation.com.au/>.

¹⁷⁹ See press release by Comprehensive Legal Funding LLC regarding the Opening of the Melbourne Office (September 21, 2010), <http://www.comprehensivelegalfunding.com/news/press-release>.

¹⁸⁰ See Comprehensive Legal Funding LLC, *About the Company*, Comprehensive Legal Funding, <http://www.comprehensivelegalfunding.com/about-the-company/about-the-company>.

¹⁸¹ QUANTUM LITIGATION FUNDING, *About Us*, QUANTUM FUNDING (May 30, 2012), http://www.quantumlitigation.com.au/about_us.

¹⁸² QUANTUM LITIGATION FUNDING, *Our Services*, QUANTUM FUNDING (May 30, 2012), http://www.quantumlitigation.com.au/our_services.

¹⁸³ QUANTUM LITIGATION FUNDING, *Our Services*, QUANTUM FUNDING (May 30, 2012), http://www.quantumlitigation.com.au/our_services; QUANTUM LITIGATION FUNDING, *Litigation Fund-*

e. Litigation Lending Services Pty Ltd (LLS)

Litigation Lending Services Pty Ltd (LLS) has been operating since 1999, predominantly providing litigation funding for insolvency market actions typically ranging from claims between AUD200,000 and AUD10 million. However, in 2008, after a successful investment, changes in legislation, and recent court decisions, “the company has extended their services beyond insolvency to general commercial litigation, class actions and representative proceedings.”¹⁸⁴

3. Commissions & Other Relevant Criteria

In 2006, the Law Council of Australia was advised that litigation funding companies usually charge between 15% and 40% of an award or settlement.¹⁸⁵ In 2010, IMF, Quantum, and LLS all typically charged commissions that ranged between 25% and 40% of net litigation proceeds. IMF also charged additional project management fees “calculated as a 25% uplift on its actual out of pocket expenses.”¹⁸⁶ CLF typically charged a commission of 25% to 35% of net litigation proceeds, but it did not charge a project management fee.¹⁸⁷ Currently, commissions appear to range between 20% and 45%.¹⁸⁸

Litigation funders select cases based on case type and claim amount. There are also a number of other factors considered when determining what percentage of the settlement or award is charged as commission. IMF identifies the following as factors affecting the percentage charged: “the level of legal fees and disbursements expected to be incurred; the strength of the case; the likely capacity of the defendant to meet a judgment; and the time it will take for the case to be completed.”¹⁸⁹ IMF notes that “the commission normally reduces the earlier the litigation is resolved.”¹⁹⁰

ing, QUANTUM LITIGATION FUNDING, 4 available at http://www.quantumlitigation.com.au/files/QLF_A4_LitigationBrochure.pdf.

¹⁸⁴ LITIGATION LENDING SERVICES LTD., *The Company*, LITIGATION LENDING SERVICES (May 30, 2012), <http://www.litigationlending.com.au/about.html>.

¹⁸⁵ LAW COUNCIL OF AUSTRALIA, *supra* note 138.

¹⁸⁶ GRECH, *supra* note 146, ¶ 2-3.

¹⁸⁷ *Id.*

¹⁸⁸ Only IMF and HLS list their usual commission percentages on their website: 20% to 45% and 30% to 45%, respectively. IMF (AUSTRALIA) LTD, *Apply for Funding* IMF (AUSTRALIA) LTD (2009), <http://www.imf.com.au/funding.asp>; HILLCREST LITIGATION SERVICES LTD, *Funding Agreement* (2012), <http://www.hillcrestlitigation.com.au/profile/funding-agreement/>. IMF's website does not mention a project management fee.

¹⁸⁹ IMF (AUSTRALIA) LTD, *Apply for Funding*, IMF (May 23, 2012), <http://www.imf.com.au/funding.asp>.

¹⁹⁰ *Id.*

Ultimately the decision to fund litigation is a question of how profitable it will be to underwrite the risk. Legg et al. describe the process:

For a litigation funder to determine whether to fund an action he must calculate the risk associated with the litigation, that is, the prospects of success. He must also quantify the amount of a successful recovery and its potential liability for the costs of the proceedings (the expenses he incurs bringing the suit and the risk of having to pay the defendant's costs if the action fails). In simple terms, litigation funders will fund litigation when the probability of a successful outcome multiplied by the amount they stand to recover is greater than the probability of an unsuccessful outcome multiplied by the costs they are liable for. The percentage of the recovery going to the funder should reflect the risk inherent in the proceedings. The riskier the proceedings the greater the share of the proceeds that will need to be payable to the funder to make the investment attractive. However, the litigation funder is able to spread the risk associated with a particular proceeding by adopting a portfolio approach to its inventory of cases. If the funder is going to fund a claim involving novel theories of liability and therefore take a greater risk, it can offset the risk by also funding a low risk case where liability is clear.¹⁹¹

This appears to be IMF's approach, as demonstrated in their 2010 Annual Report:

IMF's profit was not as strong as 2009, reflecting the deferment of the resolution of major cases into subsequent years. However, IMF's portfolio of cases under management continued to improve. IMF is in a strong financial position moving forward and is capable of capitalising on opportunities to fund larger cases with larger potential returns.¹⁹²

So, despite the financial year-end loss in 2010 in the *Kingstream Steel* case and the impact of that loss on its net income from litigation funding, IMF reported a 33% increase in the value of its investment portfolio during 2010, from AUD1.06 to AUD1.4 billion.¹⁹³

4. Success Rates

Although there seem to be slight discrepancies between the statistics for wins-to-losses in IMF's Annual Reports,¹⁹⁴ these discrepancies can per-

¹⁹¹ Legg et al., *supra* note 135, at 4.

¹⁹² IMF (AUSTRALIA) LTD, *2010 Annual Report* 4 (2010), available at <http://www.imf.com.au/pdf/AnnualReport2010.pdf>.

¹⁹³ *Id.*

¹⁹⁴ IMF (AUSTRALIA) LTD, *2008 Annual Report* 18 (2008), available at <http://www.imf.com.au/pdf/AnnualReport2008.pdf> ("The extent of that risk can best be identified, from time to time, by reference to the fact that in the first six years of operation IMF has lost only four cases out of 127 matters funded since listing."); IMF (AUSTRALIA) LTD, *2009 Annual Report* 7 (2009), available at <http://www.imf.com.au/pdf/AnnualReport2007.pdf> (saying that despite losing "a small case on appeal" that year, "[t]his is our fourth loss in 140 cases over 8 years, hardly the basis for consternation.") IMF (AUSTRALIA) LTD, *2010 Annual Report* 18 (2010), available at <http://www.imf.com.au/pdf/AnnualReport2010.pdf> ("The extent of that risk can best be identified, from

haps be explained by how long it takes for complex litigation to be resolved. Successes on appeal further shift win-loss ratios. Ultimately, “between October 2001 and December 2010, the company funded 118 cases to completion. Of these, 79 resulted in settlements and nine were outright victories, while five cases were lost and 25 withdrawn.”¹⁹⁵ This netted approximately AUD187 million during the time period.¹⁹⁶

5. Case Management and Control

Litigation funders typically seek to manage risk through appropriate contractual arrangements that provide access to documents, litigation budget management, regular reporting from solicitors on record, and varying degrees of control over cases.

In *Fostif*, the majority found that the litigation funding agreement in question did not constitute an abuse of process despite that the lawyers were retained by the LFC, not the clients. The LFC was permitted to investigate the claims, instruct in the litigation and settle, without consultation with the clients. Despite the judgment, there has been some concern expressed about the depth of the LFC’s control over proceedings. For example, Grech notes that:

Slater & Gordon are strong proponents of litigation funding as a means of providing access to justice, and as a tool through which litigants can manage risk in litigation. We strongly agree that regulation is required in order to ensure that [litigation funding companies]: (a) do not provide legal advice; (b) do not otherwise hold themselves out as lawyers; and (c) [do not] act on behalf of clients as if they were lawyers.

IMF (Australia) Limited (IMF) strongly argues that they require such control in order to monitor risk associated with its investment, and threatens a reduction in funding offers (and therefore access to justice) if such scope is not provided.¹⁹⁷

In practice, where both Slater & Gordon and Maurice Blackburn are involved in a class action as the main players, both require that:

- (a) their conduct of the representative proceeding be on the instructions of the representative party to the proceeding (albeit in consultation with the LFC);
- (b) there be a separate retainer with the client, which outlines the terms on which the lawyer has agreed to act and defines the fiduciary relationship;

time to time, by reference to the fact that in the first eight years of operation IMF has lost only four cases out of 113 matters funded.”).

¹⁹⁵ Lin, *supra* note 148.

¹⁹⁶ *Id.*

¹⁹⁷ GRECH, *supra* note 146, ¶ 2.2-2.3 (alteration in original).

- (c) [] dispute resolution procedures and [] committee/consultation structures [must be used]; and
- (d) []LFC's [do not drive settlements] by requiring
 - (i) Senior Counsel's advice that the proposed settlement is reasonable; and
 - (ii) the approval of more than 50% of funded clients.¹⁹⁸

6. How Commonplace is TPLF?

Earlier, we proposed using the following ratio to measure the incidence of TPLF:

$$(3) \textit{TPLF Incidence} = \frac{\textit{Number of Cases with TPLF}}{\textit{Total Number of Cases}}$$

For the numerator, one can proxy the number of TPLF cases using the number of IMF cases collected from public sources by Malcolm Stewart presented in Table 2. On this basis, assuming IMF represents 50% of the TPLF market in Australia, then it appears that litigation funding is *not* that commonplace in Australia.

For the numerator, if IMF funds are half the TPLF market, then one could double IMF numbers as an estimate of the total number of cases with TPLF per year. To control for variation, one could also take the average number of cases IMF started over a two-year period. For example, for 2008-2009, the average was twelve cases per year.

One can then use the total number of civil cases in Australia around the same time for the denominator. The Australian Report of the Government (ROGS) can be used to determine the denominator.¹⁹⁹ It contains data on the supreme and federal courts for each Australian state, grouped by civil and criminal matters for the years 1994-2009. In 2009-2010 alone, ROGS shows that 595,200 civil cases were filed nationally in civil jurisdiction courts, excluding family courts, the Federal Magistrates Court, coroners', and probate courts.²⁰⁰ This included "591,600 cases in the State and Territory supreme, district/county and magistrates' courts, and 3,600 cases in the Federal Court."²⁰¹

Data from 2008-2009 show that, on average, IMF funded twelve cases per year over the past two years. This is divided by the 595,200 civil cases that were filed nationally in civil jurisdiction courts according to ROGS. This suggests that IMF's litigation funding is only 0.002% of the civil cases

¹⁹⁸ *Id.* ¶ 5.3.

¹⁹⁹ AUSTRALIAN GOVERNMENT, REPORT ON GOVERNMENT SERVICES (May 22, 2012), <http://www.pc.gov.au/gsp/reports/rogs>.

²⁰⁰ AUSTRALIAN GOVERNMENT, REPORT ON GOVERNMENT SERVICES: COURT ADMINISTRATION 7.17, available at http://www.pc.gov.au/_data/assets/pdf_file/0010/105310/028-chapter7.pdf. "In the states and territories, an additional 61,600 probate matters were lodged in the supreme courts." *Id.*

²⁰¹ *See id.*

that were filed in a year. Even if IMF is half the market, and we double the number to proxy total funded cases, the total incidence rate would be only 0.004%. Indeed, even multiplying it by fifty would only get to 0.1%, showing that third-party funded cases are far from commonplace.

This result weakens the empirical strength of Chen and Abrams's conclusions. They claim, based solely on IMF data, that litigation, court case-loads, and court expenditures increase with third-party funding in Australia.²⁰² It seems unlikely that something affecting much less than 0.1% of the civil caseload of courts in Australia could have a noticeable effect.

It is useful to reflect, however, on the degree to which TPLF cases may be a high percentage of total civil cases when measured by value rather than quantity. This reflection is especially useful since TPLF focuses on high value cases. It has been claimed that by June 30, 2005, IMF was "funding 10 group actions with an estimated total claim value of AUD531 million and 24 commercial and insolvency claims with a combined estimated claim value of \$394 million."²⁰³ By June 30, 2009, it was claimed that "IMF was funding 19 group actions with an estimated claim value of \$875 million and 10 commercial and insolvency actions with a combined claim value of \$182 million."²⁰⁴

This data is summarized in Table 5 below. The first two columns show the change in the total number and total value of funded cases. It shows that while the number of cases declined by 15%, the value of the cases increased by 14%. Therefore, compositional effects do cause the total value of cases to diverge from the number of cases funded. The fall in the number of cases seems to be linked to the increased emphasis on group actions; as shown in the last two columns, the number of group actions increased by 90%.²⁰⁵

TABLE 5. CHANGE IN IMF'S ESTIMATED TOTAL CLAIM VALUE

Year	Total Number of Funded Cases	Total Value of Funded Cases	Group Actions Number	Group Actions Value

²⁰² Chen & Abrams, *supra* note 165, at 1.

²⁰³ Walker et al., *supra* note 144.

²⁰⁴ *Id.*

²⁰⁵ For the results of recent research on the relationships between litigation funding and class actions in Australia see Vince Morabito, *An Empirical Study of Australia's Class Action Regimes: Class Action Facts and Figures* (2009), http://globalclassactions.stanford.edu/sites/default/files/documents/Australia_Empirical_Morabito_2009_Dec.pdf; Vince Morabito, *An Empirical Study of Australia's Class Action Regimes: Litigation Funders, Competing Class Actions, Opt Out Rates, Victorian Class Actions and Class Representatives* (2010), <http://globalclassactions.stanford.edu/sites/default/files/documents/Vince%20Morabito%202nd%20Report.pdf>; Vince Morabito & Vicki Wayne, *Reining in Litigation Entrepreneurs: A New Zealand Proposal*, 2011 NZ L. REV. 323 (2011).

2005	34	925	10	531
2009	29	1057	19	875
	-15%	14%	90%	65%

Thus, it appears TPLF was clearly growing during this period. Moreover, TPLF appears to be increasingly accepted by Australian judiciary, government and the market, with the potential to become even more so abroad. For example, Legg et al. state that:

The acceptance of litigation funding by the High Court in *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd*, its further endorsement in *Jeffrey & Katauskas Pty Ltd v SST Consulting Pty Ltd*, and the general acceptance by government that litigation funding can assist in securing access to justice suggests that litigation funding has a bright future in Australia.²⁰⁶

IMF's Managing Director Hugh McLernon claims that public awareness of litigation funding is "now approaching mainstream."²⁰⁷ He adds that, in "another decade, . . . it will be in the mainstream, not just in Australia but emanating out of here."²⁰⁸ In fact, in 2010, IMF's case portfolio had already been "augmented with [its] entry into offshore markets including the United States and United Kingdom markets."²⁰⁹ IMF seeks to continue this growth in the United States, Canada, the United Kingdom, South Africa, New Zealand, and Asia.²¹⁰

As noted, IMF approaches its cases as a typical investment manager would, with a focus on expected rates of return. In this regard, cases that are less costly to prove and manage may be more attractive, all other things being equal. Half of the cases IMF funds are class actions, with "the share (by value) of multiparty litigation in IMF's claims portfolio growing from nil in 2001 to just under 60 per cent in 2005, and subsequently to over 80 per cent by 2009, while the estimated value of these claims rose from nil to [AUD]875 million in that time."²¹¹ According to Walker et al., the trend demonstrated by IMF towards "multiparty" litigation noted above, "serves to highlight the critical role that multiparty case selection plays in the growth of IMF's business and in the litigation funding market in Australia generally."²¹²

²⁰⁶ Legg et al., *supra* note 135, at 41.

²⁰⁷ Lin, *supra* note 148.

²⁰⁸ *Id.*

²⁰⁹ IMF (AUSTRALIA) LTD, *2010 Annual Report* 4 (2010), available at <http://www.imf.com.au/pdf/AnnualReport2010.pdf>.

²¹⁰ IMF (AUSTRALIA) LTD., *See Our Services*, IMF (May 31, 2012), <http://www.imf.com.au/about.asp>.

²¹¹ Walker et al., *supra* note 144.

²¹² *Id.*

Within that subset, cases where the class are easier to define may be more financially viable—such as shareholder class actions that have a well-defined class. By comparison, competition law class actions—for example, against cartels—have proven difficult to fund, given the lack of certainty on the legal rules covering damages such as “pass through.” Pass through damages may not be recoverable by those harmed if the damages can be shown to have passed through any “cartel price,” for example, to their own customers.

Orion Litigation Intermediaries, according to its website, funds cases including product liability, patent infringements, class actions, commercial disputes, patent and trademark infringement, breach of contract, shareholder action, wrongful trading, construction adjudication, international arbitration, and professional indemnity, but not personal injury.²¹³ The firm claims that, “in asset terms, third party funding is uncomplicated. It is not affected by market conditions; in fact adverse market conditions have historically increased the amount of litigation activity. Case outcomes are not subject to, or correlated with, other market dynamics.”²¹⁴

This claim may be of interest to hedge funds internationally, but a key determinant of future growth in the market will be the nature of regulation that takes shape. Uncertainty in the legal environment is likely to adversely affect the incentive to invest.

III. LITIGATION FUNDING IN THE U.K. AND EUROPE

A. Introduction

This part of the paper discusses the prevalence and nature of litigation funding in the U.K. and Europe. Table 6 below presents the results of a survey on whether third-party funding of claims is available in twenty-six different European countries, as reported in February 2010 by the law firm Lovells.²¹⁵ Table 6 divides the countries into two categories depending on

²¹³ See ORION LITIGATION INTERMEDIARIES, *Case Criteria*, ORION LITIGATION (May 31, 2012), <http://www.orionlitigation.com/case-criteria>.

²¹⁴ See ORION LITIGATION INTERMEDIARIES, *Mitigate Risk*, ORION LITIGATION (May 31, 2012), <http://www.orionlitigation.com/mitigate-risk>.

²¹⁵ See generally HOGAN LOVELLS, *At What Cost? A Lovells Multi Jurisdictional Guide to Litigation Costs*, (Feb. 2010), available at <http://www.hoganlovells.com/files/Publication/c940bb4b-a67f-4e63-a5b8-ced6198b2125/Presentation/PublicationAttachment/fff33267-29d5-4230-a140-cf2eeb7d4a05/LitigationCostsReport.pdf>. Lovells surveyed over fifty jurisdictions and obtained answers to a list of standard questions on the legal and procedural regimes for funding and recovering costs from two sources: the Dispute Resolution practices in each of Lovells’ global offices and from other jurisdictions from leading and senior litigation practitioners in law firms with known Dispute Resolution capability.

TPLF availability²¹⁶ based on answers to Lovells' survey question, "Is third-party funding of claims available?" On the left side of the table, thirteen countries answered either that TPLF is not available, e.g., Greece and Portugal, is not common, is not customary, is limited, is rare, or is exceptional. On the right side of the table, the second group of thirteen countries answered that TPLF was available, not prohibited, or not regulated.

TABLE 6. ANSWERS TO SURVEY QUESTION—IS THIRD-PARTY FUNDING OF CLAIMS AVAILABLE?²¹⁷

Category One		Category Two	
TPLF Not Available, or not common, not customary, limited, rare or exceptional		TPLF Available, or not prohibited, or not regulated	
Country	Answer	Country	Answer
Belgium	Yes, but only in exceptional circumstances	Austria	Yes
Cyprus	No	Croatia	Not regulated
Denmark	Yes, but in limited circumstances	Czech Republic	Yes
Finland	Yes, but not common	England & Wales	Yes, but it is unregulated
France	Yes, but not customary	Germany	Yes
Greece	No	Italy	Not regulated, but not prohibited
Hungary	Yes, though it is rare for third party investors to finance claims	Luxembourg	Yes
Ireland	Yes, but not common	Romania	Yes, not prohibited
The Netherlands	No. Only non-for-profit organizations can fund cases.	Ukraine	Yes, Not prohibited in either Civil or Commercial Courts
Norway	Yes, not prohibited but usually by special interest groups	Slovak Republic	Yes, not prohibited
Poland	Yes, but uncommon	Slovenia	Yes, not prohibited
Portugal	No	Spain	Yes

²¹⁶ Table 6 includes twenty-four of the twenty-six E.U. member states, with results for Estonia and Malta—both EU member states—not available. We have, however, included results for Norway and Switzerland—not EU member states—to make a total of twenty-six.

²¹⁷ See generally HOGAN LOVELLS, *supra* note 215.

Sweden	Yes, in principle, though very rare	Switzerland	Yes, it is considered lawful but is not regulated
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It is thus clear from the left-hand side of Table 6 that half of the countries surveyed in Europe do not have a significant amount of TPLF. On the other hand, relatively little is known about the prevalence of TPLF in most of the thirteen countries on the right-hand side of table 6. Marco de Morpurgo²¹⁸ suggests that, while TPLF has been rapidly developing under the common law in England and Wales, its existence is very limited in the other twelve civil law jurisdictions on the right-hand side of the table, except in Germany, Austria, and Switzerland. Moreover, although independent companies are incorporated and offer litigation-funding services to claimants in Austria and Switzerland, it appears that outside of the U.K., most of the activity in TPLF—in the twelve civil law jurisdictions where TPLF is available—may be originating in Germany.

At the outset then, given the overall size of the market we are referring to here—including the twenty-six European countries outlined—we can conclude that TPLF in Europe appears to be far from commonplace.

The remainder of this part of the paper is divided into two major sections. The first part reviews the rules on litigation funding in Europe including England and Wales given the wide acknowledgement that England and Wales will be the most rapidly developing TPLF market in Europe. The second section examines the litigation funders and the selection of cases, again focusing on TPLF's prevalence in the U.K., with some comments about the broader situation in Europe. Our review is based on readily available public material. Another paper in this issue by Veljanovski complements this review of U.K. and European TPLF. The Veljanovski article is based on interviews with all the leading dedicated TPLF investors based in the U.K. as well as dedicated TPLF investors in group actions in Europe.

B. *The Legal Rules on Litigation Funders in England and Wales*

Part I's description of the early law of champerty and maintenance in Australia is equally apposite in the context of U.K. law. It clearly had the effect of outlawing TPLF in the U.K. Maintenance and champerty, however, were abolished as offenses in the U.K. by the Criminal Law Act 1967.²¹⁹ Section 13(1) of the Act provided that:

²¹⁸ See generally Marco de Morpurgo, *A Comparative Legal and Economic Approach to Third-Party Litigation Funding*, 19 CARDOZO J. INT'L & COMP. L. 343 (2011).

²¹⁹ Criminal Law Act, 1967, c. 58, § 13(1).

The following offences are hereby abolished, that is to say—(a) any distinct offence under the common law in England and Wales of maintenance (including champerty, but, not embracery), challenging to fight, eavesdropping or being a common barrator, a common scold or a common night walker.²²⁰

While the torts of champerty and maintenance were abolished under section 14 of the Act, the relevant provisions provided that:

(1) No person shall, under the law of England and Wales, be liable in tort for any conduct on account of its being maintenance or champerty as known to the common law, except in the case of a cause of action accruing before this section has effect.

(2) The abolition of criminal and civil liability under the law of England and Wales for maintenance and champerty shall not affect any rule of that law as to the cases in which a contract is to be treated as contrary to public policy or otherwise illegal.²²¹

It is clear that both the U.K. and Australian statutes share some common elements. Both jurisdictions abolished the torts and crimes of maintenance and champerty but preserved the public policy exception as a means of putatively rendering a contract unenforceable. In some instances, statutory abolition was temporally aligned.²²² A common feature that continues to hamper TPLF's evolution in both jurisdictions, however, may be residual uncertainty as to the ongoing role of the common law doctrines of maintenance and champerty, as well as the lack of certainty about what, if any, regulation may replace them. At the same time, certain glaring distinctions have emerged in the two jurisdictions that may explain their divergent experiences with TPLF, and these will be explained below—including the relative role of legal expenses insurance.²²³

1. Judicial Approaches: Champerty, Maintenance and Costs

a. Before Abolition

The prototypical descriptor of maintenance can be found within Lord Justice Lord Moulton's observations in *British Cash and Parcel Conveyors Ltd v. Lamson Store Services Co Ltd*.²²⁴ Lord Justice Lord Moulton observed that unlawful maintenance is “directed against *wanton and officious intermeddling* with the disputes of others in which the [maintainer] has no

²²⁰ *Id.*

²²¹ *Id.* § 14.

²²² The U.K. Statute gained assent in 1967, while the Australian provisions were enacted in 1958. *Wrongs Act 1958* (Vic) § 32; *Crimes Act 1958* (Vic) § 322.

²²³ See *Factortame*, [2002] EWCA (Civ) 932, [2003] Q.B. 381 (*cf. Fostif & Katauskas*).

²²⁴ [1908] 1 K.B. 1006 ('*Parcel Case*').

interest whatever, and where the assistance he renders to the one or the other party is without justification or excuse.”²²⁵ Furthermore, Lord Justice Mustill merely added to Lord Justice Lord Moulton’s observation above that “for champerty there must be added the notion of a division of the spoils.”²²⁶

b. *Hill v. Archbold*

In *Hill v. Archbold*,²²⁷ certain union officials were the subject of potentially defamatory letters. The appellant, a member of the same union, wrote the letters. The union supported the libel actions, but those actions were dismissed. The appellant sought to restrain the union’s treasurer from using the union’s funds to pay the costs of the two officials on the ground that their actions amounted to maintenance. The appellant added further that they were *ultra vires* in the sense of falling outside the treasurer’s powers under the union’s articles of association.

Master of the Rolls Denning—with whom Lord Justices Dankwerts and Winn agreed—reviewed the early origins and relevant authorities relating to maintenance.²²⁸ He then looked to the exceptions that emerged over time—where a master and servant relationship was in place²²⁹—and made the following observations:

(i) That the law of maintenance should not rest solely on ancient notions;²³⁰

(ii) a person is still guilty of maintenance if “he supports litigation in which he has no legitimate concern without just cause or excuse;”²³¹

(iii) the categories of just cause and legitimate concern are not fixed;²³² and

(iv) if an entity or person justifiably supports a suit, there is an expectation that they would pay the costs if the suit fails.²³³

In relation to the points above, Lord Justice Danckwerts added that “the law of maintenance depends upon the question of public policy, and public policy . . . is not a fixed and immutable matter. It is a conception

²²⁵ *Id.* at 1014 (emphasis added).

²²⁶ *Giles v Thompson*, [1994] 1 A.C. 142 (H.L.) (appeal taken from Eng.) (U.K.).

²²⁷ [1968] 1 Q.B. 686 (*Archbold*). Recall that § 14(1) of the *Criminal Law Act* preserved maintenance and champerty as offenses and torts where the cause of action arose before the Act came into effect. *Archbold* was delivered in June 1967, and the Act received royal assent in July 1967. In this context, *Archbold* can be seen as a statement of law in a period when the Act had no operation.

²²⁸ *Archbold*, [1968] 1 Q.B. 686 at 693.

²²⁹ *Id.* (citing *Bradlaugh v. Newdgate* [1883] 11 Q.B.D. 1 at 11).

²³⁰ *Id.* at 694.

²³¹ *Id.*

²³² *Id.*

²³³ *Id.* at 695.

which, if it has any sense at all, must be alterable by the passage of time.”²³⁴ Ultimately, the Court held that the union’s actions did not amount to maintenance. Notably, one commentator has observed that the doctrines of champerty and maintenance may be redundant to the extent that courts can oversee and disallow officious intermeddling when there is a risk that the judicial process will be “perverted.”²³⁵

c. *After Abolition*

There are three seminal U.K. cases dealing with the issues of champerty and maintenance following statutory abolition: (i) *Hamilton v. Al-Fayed (No 2)*,²³⁶ (ii) *R (Factortame) v. Secretary of State for Transport, Local Govt and the Regions (No 8)*,²³⁷ and (iii) *Arkin v. Borchland Lines Ltd & Ors.*²³⁸

i. *Hamilton v. Al Fayed*

In *Hamilton v. Al Fayed (No 2)*,²³⁹ the issue was whether the successful defendant in defamation proceedings should be entitled to recover from a group of funders the part of the defendant’s costs which he could not recover from the losing claimant. Lord Justice Simon Brown, with whom Lord Justices Chadwick and Hale, reluctantly, agreed, delivered the leading judgment for the Court of Appeal.

The claimant, an “impecunious” Member of Parliament (MP), brought a libel action against the well-known businessman, Mohamed Al-Fayed. Most of the MP’s legal expenses were paid for out of a “fighting fund” to which several hundred donors had contributed. The MP subsequently filed for bankruptcy. Al-Fayed sought an application for costs against nineteen of the largest contributors. Several of the contributors settled with Al-Fayed for costs, while others contested liability.

The judge at first instance, Justice Morland, rejected the defendant’s application and the defendant appealed. The rationale for that decision was that it would normally be just and reasonable to make a costs order against a non-party “professional funder”—save for exceptional circumstances—

²³⁴ *Archbold*, 1 Q.B. at 697.

²³⁵ Dr. Bill Long, *Champerty and Contingent Fees V*, (Dec. 15, 2005), <http://www.drbilllong.com/LegalHistoryII/ChampertyV.html>; see also Maria Steinitz, *Whose Claim Is It Anyway?* 95 MINN. L. REV. 1268, 1286 (2011).

²³⁶ 2002] EWCA (Civ) 665, [2003] Q.B. 1175 (*‘Hamilton’*).

²³⁷ *Factortame*, [2002] EWCA (Civ) 932, [2003] Q.B. 381.

²³⁸ [2005] EWCA (Civ) 655.

²³⁹ [2002] EWCA (Civ) 665, [2003] Q.B. 1175.

while the reverse is true of a “pure funder.”²⁴⁰ A pure funder stands not only to make no profit from his contribution,²⁴¹ but to have no control over how the funds are spent and takes no part in the management of the litigation.²⁴²

Lord Justice Simon Brown framed the central issue as whether the funding arrangement was to be considered “inequitable”—whether it “created an uneven . . . ‘playing field.’”²⁴³ Answering this question depended on looking at the competing public interests at play. Ultimately, Lord Justice Simon Brown, who concluded that those competing public interests may best be served by employing the extant costs structures, along with Justice Morland and Lord Justice Chadwick, noted that:

The starting point, as it seems to me, is to recognise that, where there is tension between the principle that a party who is successful in defending a claim made against him ought not to be required to bear the costs of his defence and the principle that a claimant should not be denied access to the courts on the grounds of impecuniosity, that tension has to be resolved in favour of the second of those principles[.]²⁴⁴

ii. *Factortame*

Factortame concerned the legality of a contingent fee agreement, whereby the funder contracted for an 8% success fee of the final settlement amount and agreed to pay for necessary expert witnesses. Master of the Rolls Lord Phillips handed down the Court of Appeal’s judgment.²⁴⁵

As to the law of champerty generally, the Court began by looking to the statutory abolition in the U.K. Criminal Law Act 1967, and particularly the preservation of the public policy exception contained within section 14(2). In the context of section 14(2), the Court noted that the exception’s presence meant “champerty survives as a rule of public policy capable of rendering a contract unenforceable.”²⁴⁶ Although the Court did not cite an authority for this observation, in *Trendtex*,²⁴⁷ Lord Wilberforce stated that the assignment of a bare right to litigate “manifestly ‘savours of champerty’ since it involves trafficking in litigation—a type of transaction which, under

²⁴⁰ See *Hamilton*, [2002] EWCA (Civ) 665, [2003] Q.B. 1775 at 1181 [6] (citing Morland, J.: at [69]-[70]).

²⁴¹ [2002] EWCA (Civ) 665, [2003] Q.B. 1175 at 1184 [14].

²⁴² [2002] EWCA (Civ) 665, [2003] Q.B. 1175 at 1181 [6] (citing Morland, J. in the original decision).

²⁴³ *Id.* at 1184 [15].

²⁴⁴ *Id.* at 1200 [63].

²⁴⁵ *Factortame*, [2003] Q.B. 381 at 390 [1].

²⁴⁶ *Id.* at 399 [31].

²⁴⁷ See generally *Trendtex Trading Corp. v. Credit Suisse*, [1982] A.C. 679 (H.L.) 702 (appeal taken from Eng.).

English law, is contrary to public policy,²⁴⁸ thereby drawing a direct nexus between champerty and public policy. It is beyond the scope of this discussion to examine the assignment of a bare right to litigate,²⁴⁹ but the quote nevertheless preserves champerty as a subsisting arm of the public policy exception.

The *Factorame* holding serves as an interesting counterpoint to the Australian approach. In the Australian case of *Fostif*, Judges Gummow, Hayne, and Crennan held that champerty and maintenance could *not* be used as independent concepts to found a challenge to a funding arrangement as contrary to public policy under the NSW legislation that abolished the relevant crimes and torts.²⁵⁰ Thus, in the U.K., maintenance and champerty survive as distinct public policy exceptions, while under the NSW legislation, litigants appear to be left with fewer options to argue that a TPLF contract is unenforceable.²⁵¹ It appears that TPLF contracts in the U.K. may thus be subject to greater legal uncertainty than applies under the NSW legislation. Consequently, all else being held constant, this may reduce TPLF's relative prevalence in the U.K., as compared to NSW.

As a general matter, and after reviewing the statutory wording and attendant judicial authority on the subject, the Court issued its holding. According to the Court, section 58 of the U.K. Courts and Legal Services Act 1990—as amended by section 27 of the U.K. Access to Justice Act 1999, which specifically permits conditional fees in certain circumstances and uplift quanta as prescribed by regulations—applied restrictions on fee arrangements *only* to the degree that they apply to those conducting litigation services or advocacy in respect to a particular matter, *not* third-party funders.²⁵²

More generally, the fact that Parliament enacted statutes permitting conditional fees was seen as evidence of a “radical shift” in public policy. This shift was from outright prohibition to the facilitation of access to justice, which ensures that “those who do not have resources to fund advocacy or litigation services should none the less be able to obtain these in support claims which appear to have merit.”²⁵³ Thus, the facilitation of access to justice became a viable driving factor in the Court's reckoning.

As to the quantum of the success fee, the Court held 8% was not extravagant or champertous. It also held that because the claimants continued to enjoy access to justice, public policy was not affronted.²⁵⁴

²⁴⁸ *Id.* at 694.

²⁴⁹ *See id.* at 679.

²⁵⁰ *Campbells Cash & Carry v Fostif* (2006) 229 CLR 386, 423 (Austl.).

²⁵¹ *Id.*

²⁵² *Factortame*, [2003] Q.B. at 407 [61].

²⁵³ *Factortame*, [2003] Q.B. at 408 [62].

²⁵⁴ *Factortame*, [2003] Q.B. at 413-15 [85]-[91].

iii. The *Arkin* Litigation

In *Arkin v. Borchland Lines Ltd & Ors*,²⁵⁵ the Court of Appeal considered the public policy objectives that attach to a successful party's claim for costs against an unsuccessful party's funder. In this context, the *Arkin* decision is similar to the High Court of Australia's *Jeffery* decision in terms of the pertinent issues. However, *Arkin*'s outcome was very different than *Jeffery*'s, as was the mode of reasoning of Master of the Rolls Phillips, with whom Lord Justices Brooke and Dyson agreed.

(1) Background

Arkin involved litigation initiated by Arkin, who was described as a "man without means."²⁵⁶ His lawyers acted for him on a conditional fee basis, and MPC, a third-party funder, supported the claim. The claim, although meritorious, failed because causation could not be proved, and the defendant was awarded costs. The defendants in the initial action sought to recover those costs from MPC. However, Justice Colman speaking for the High Court refused to issue the order on those terms²⁵⁷ given the presence of a cross-claim against the individual defendants for costs.²⁵⁸ Two issues therefore came before the Court of Appeal for consideration: first, an appeal against Justice Colman's order relating to costs sought from MPC; second, a review of the cross-claim amongst the defendants.²⁵⁹ The following discussion looks only at the first of these issues.

(2) Costs Rules

After reviewing Justice Colman's decision, the Court of Appeal began by looking to the relevant statutory and judicial authorities in relation to costs, specifically to provisions of the Supreme Court Act 1981 (U.K.), together with the relevant Civil Procedure Rules (CPRs).²⁶⁰ In this context, section 51(1) of the Supreme Court Act provides that subject to the provisions of this or any other Act and to rules of court, the costs of and incidental to all proceedings shall be in the *discretion of the court*; the court shall

²⁵⁵ [2005] EWCA (Civ) 655.

²⁵⁶ *Id.* at [1].

²⁵⁷ *Arkin v. Borchard Lines Ltd & Ors*, [2003] EWHC (Comm) 2844.

²⁵⁸ *Id.*

²⁵⁹ *Arkin*, [2005] EWCA (Civ), at [2]. For the outcome of the cross-claim, see *id.* at [46].

²⁶⁰ CPR § 48.2.44.3.

have full power to determine by whom and to what extent costs are to be paid.²⁶¹

The Court of Appeal also noted three aspects of the relevant CPRs: first, they require that when an order for putative costs is made against a non-party, that non-party must be formally added to the proceedings, but only for the costs proceedings;²⁶² second, as a general rule, the unsuccessful party must pay the costs of the successful party;²⁶³ and third, certain circumstances, such as a party's unreasonable conduct, permit a court to depart from the general rule, which is also termed the "costs exception."²⁶⁴

(3) Competing Policy

As a preliminary matter, and after reviewing the relevant authorities, Master of the Rolls Phillips noted:

I am *not* persuaded that, with regard to the order of priority of the public policy objectives as now formulated by *Hamilton v. Fayed* and *Factortame*, the fact that a professional funder fails to agree with the impecunious claimant to pay the defendant's costs if the claim fails should necessarily lead to a costs order being made against it.²⁶⁵

Instead, Phillips expressed the problem as one of balancing the benefit of litigation funding providing access to justice against the risk of litigation funding interfering in the due administration of justice. Thus, the implied test is whether, on the facts of the case, "the risk of interference in the due administration of justice displaces the public policy objective of such access."²⁶⁶ Phillips thus felt that whether a third-party costs order is appropriate against a professional funder does not depend simply on whether they stood to share in the proceeds of the litigation:

I am unable to accept that the mere fact of a contract for a share in the proceeds of the litigation necessarily involves such material prejudice. Whether it does will depend on the legal and practical relationship between the professional funder and the claimant. If that relationship by reason of the terms of the funding agreement is such as not to give rise to any material opportunity to the funder to influence the conduct of the litigation to serve his own interests as distinct from the proper running of the trial and the funder does not in the event inter-

²⁶¹ Supreme Court Act § 51(1) (emphasis added).

²⁶² CPR § 48.2.

²⁶³ CPR § 44.3(2)(a).

²⁶⁴ CPR §§ 44.4, 44.14; see *Arkin*, [2003] EWHC 2844 (Comm) ¶¶ 18-22.

²⁶⁵ *Arkin* [2003] EWHC 2844 (Comm) ¶ 74 (emphasis added).

²⁶⁶ *Id.* ¶ 70.

vene or attempt to do so, there will be strong grounds for declining to make an order for costs against him where, but for such funding, access to the court would have been impossible.²⁶⁷

Nevertheless, he commented:

The fact that the funder is to share in the proceeds of the claim and may thereby derive a large profit from its investment will normally justify an order for costs because the very fact of the funder's stake in recovery represents a risk of interference in the due administration of justice. Although in such a case access to the court may have been provided to the funded party the countervailing consideration of avoiding the risk of interference in the due administration of justice displaces the public policy objective of such access. Generally, as the authorities demonstrate, the greater the stake, the larger is that risk. Where, however, the funder is ring-fenced out of the area of control over the conduct of the proceedings, that risk is removed. True enough, the funder's stake may be considerable, but the objective of safeguarding the due administration of justice is achieved. The characteristic of the funder's relationship to the proceedings which offends public policy has been removed. In those circumstances access to the courts re-emerges as an objective of greater weight.²⁶⁸

Thus, although enunciating a statement of principle, the test of whether an agreement is champertous is factually-driven rather than rule-driven. Ultimately, the Court preserved the professional/pure distinction and concluded:

We consider that a professional funder, who finances part of a claimant's costs of litigation, should be potentially liable for the costs of the opposing party *to the extent of the funding provided*. The effect of this will, of course, be that, if the funding is provided on a contingency basis of recovery, the funder will require, as the price of the funding, a greater share of the recovery should the claim succeed. In the individual case, the net recovery of a successful claimant will be diminished. While this is unfortunate, it seems to us that it is a cost that the impecunious claimant can reasonably be expected to bear. Overall justice will be better served than leaving defendants in a position where they have no right to recover any costs from a professional funder whose intervention has permitted the continuation of a claim which has ultimately proved to be without merit.²⁶⁹

This contrasts markedly with the view expressed in the Australian NSW Supreme Court's *Jeffery* decision by Chief Justice French, and Justices Gummow, Hayne, and Crennan.²⁷⁰ In *Jeffery*, their Honors allowed third-party litigation funders to either leave the risk of adverse cost orders with the party they fund or to assume it themselves.²⁷¹ However, this could stem from the fact that *Fostif* may have largely removed maintenance and champerty as a means to render contracts unenforceable in NSW, unlike in the U.K. Once again, it seems that TPLF contracts in the U.K. may be subject to greater legal limits as well as uncertainty than they are under the

²⁶⁷ *Id.* ¶ 21.

²⁶⁸ *Id.* ¶ 70.

²⁶⁹ *Arkin*. [2005] EWCA (Civ) 655 ¶ 41.

²⁷⁰ *Jeffery & Katauskas Proprietary Ltd. v SST Consulting* (2009) 239 CLR 75.

²⁷¹ *Id.* at 97.

NSW legislation. This could potentially reduce the relative prevalence of TPLF in the U.K. compared to NSW in Australia, holding all other things constant.

d. The Jackson Review

The Review of Civil Litigation Costs led by Lord Justice Jackson in 2009 considered whether section 14(2) of the Criminal Law Act 1967 should be repealed. It provides that: “The abolition of criminal and civil liability under the law of England and Wales for maintenance and champerty *shall not affect any rule of that law as to the cases in which a contract is to be treated as contrary to public policy or otherwise illegal.*” Lord Justice Jackson noted the following in his preliminary report: “The point has been made that the doctrine of maintenance and champerty serves a useful purpose when individuals (e.g. fraudulent directors) hide behind companies, while controlling litigation.”²⁷² In his final report, Lord Justice Jackson concluded:

In my view, section 14(2) of the 1967 Act should not be repealed. It should, however, be made clear either by statute or by judicial decision that if third party funders comply with whatever system of regulation emerges from the current consultation process, then the funding agreements will not be overturned on grounds of maintenance and champerty. The law of maintenance and champerty has a wider impact, which goes beyond third party litigation funding of the kind discussed above. The abolition of this common law doctrine may have unforeseen and adverse consequences. Furthermore, such a drastic step is not necessary in order to protect the legitimate interests of third party funders.²⁷³

2. Issues with the Regulation of Third-Party Funding (TPF): Capital Requirements & Withdrawal

The Third Party Litigation Funders Association Draft Code of Conduct (Draft Code)²⁷⁴ was created in concert with the Jackson Preliminary Report (PR) and Final Report (FR). In June 2011, responses to the Draft Code were published. The following discussion addresses the primary question presented by the Draft Code.

²⁷² 1 LORD JUSTICE JACKSON, REVIEW OF CIVIL LITIGATION COSTS: PRELIMINARY REPORT 163 n.38 (Vol. I. 2009), available at http://www.judiciary.gov.uk/about_judiciary/cost-review/preliminary-report.htm.

²⁷³ LORD JUSTICE JACKSON, REVIEW OF CIVIL LITIGATION COSTS: FINAL REPORT 124 (2009), available at <http://www.judiciary.gov.uk/NR/rdonlyres/8EB9F3F3-9C4A-4139-8A93-56F09672EB6A/0/jacksonfinalreport140110.pdf>.

²⁷⁴ CIVIL JUSTICE COUNCIL, *Consultation on a Self-Regulatory Code of Third Party Funding: Summary of Responses* (2011), available at <http://www.judiciary.gov.uk/about-the-judiciary/advisory-bodies/cjc/third-party-funding>.

a. The Draft Code

The Draft Code included the capital adequacy requirements:

4.2.1 A Member complies with the capital adequacy requirements under this

Code, if the Member –

(a) (i) is able to pay all its debts as and when they become due and payable;

(ii) has total assets that exceed total liabilities as shown in the most recent balance sheet of the Member;

(iii) has no reason to believe that its total assets would not exceed its total liabilities on a current balance sheet;

(iv) reasonably expects that it will have adequate resources of cash or cash equivalent (when needed) to meet its liabilities for at least the next three months (including any additional liabilities it might incur during that period), taking into account all commercial contingencies for which the Member should reasonably plan;

....

b. Industry Responses to Draft Code

The first question presented was as follows:

1. Following the recommendations made in Lord Justice Jackson's Report, do you consider the "Code of Conduct for the Funding by Third Parties of Litigation in England and Wales" in its current form, should be endorsed by the CJC as best practice for commercial litigation funders? If not, what improvements should be made?

The response to the Draft in this context was lukewarm:

A majority of respondents argued that the Code should include stricter capital adequacy requirements to protect litigants. Funders should be required to demonstrate that they have sufficient resources to fund proceedings. Therium Capital Management argued that the current method of testing financial

adequacy was too crude, and may give litigants a false sense of security. They argued that funders should be required to keep funds in reserve equivalent to the aggregate amount of their commitments. The Law Society said funders should be required to provide a formal guarantee or undertaking from an independent source such as a bank which holds sufficient assets on deposit. Access to Justice, on the other hand, pointed out that certain funders already “ring-fence” money to meet obligations under LFAs.

c. Jackson Reports

This reflected sentiments present in the Jackson Report (FR):

2.10 Bearing in mind that litigation supported by a third party funder may last for years, section 4.2 of the draft code does not in my view afford adequate protection for the client.

Jackson continues:

3.1 My initial view was that capital adequacy was matter of such pre-eminent importance that it should be the subject of statutory regulation. The natural body to undertake such regulation is the Financial Services Authority (the “FSA”).

However, given the “nascent” character of third-party funding in the U.K., Jackson conceded that the cost of full regulation by the FSA would outweigh the benefit:

3.3 Given the low volume of third party funding at the moment and the fact that most clients are commercial parties with access to full legal and financial advice, I do not think it appropriate to recommend full regulation by the [FSA at the present time. Also, I doubt that any such recommendation (involving substantial costs) would be accepted.

The Civil Justice Council is considering the Draft Code for TPF regulation and will report soon.²⁷⁵ Some of Jackson’s reforms are being enacted

²⁷⁵ See CIVIL JUSTICE COUNSEL, *News Release: Civil Justice Council Working Group Agrees Code of Conduct on Litigation Funding* (Nov. 23, 2011), available at <http://www.judiciary.gov.uk/NR/rdonlyres/1C0104B4-4F70-4948-AB4A-8DBBE2889D68/0/CJCNewsReleaseCodeofConductforLitigantFunders.pdf>.

via the Legal Aid Sentencing and Punishment of Offenders Bill that is currently making its way through parliament,²⁷⁶ but many do not require primary legislation.²⁷⁷

C. TPLF in the U.K. and Europe

1. The Third-Party Litigation Funders and their Selection of Cases

The U.K. Law Society publishes a journal called *Litigation Funding* every two months, including a table of third-party litigation funders in the U.K. market. Its latest issue in August 2011 identified nineteen litigation funders.²⁷⁸ In addition, the journal ran a story that a new funder, Fullbrook Capital, was entering the market.

The table on the following pages includes the names of each of the nineteen litigation funders, some of whom are in fact only brokers, and information regarding the funds they have invested in litigation, the areas of litigation they cover, the minimum value of dispute, the funders percentage or how its calculated, whether solicitors and barristers must work on CFA, and proportion of own costs covered.

TABLE 7

	Funds already Invested in Litigation (approx)	Areas Covered	Minimum Value of dispute	Funders % or how its calculated	Must Solicitors/ Barrister/s work on CFA	Proportion of own costs covered
1. 1st Class Legal	£12m	Wide range of commercial litigation including property, construction, IP, professional negligence, insolvency, multi-party and wills and probate	£60,000	Set funding fee and simple interest charged that does not rise if award increases. The earlier the case settles, the lower the funding cost	No	Normally up to 50% of own costs not under CFA
2. Alliance Prozessfinance GMBH	£15.3m (not updated monthly)	Commercial cases	£100,000–£200,000	Individually indicated either a	No	Up to 100%

²⁷⁶ Legal Aid, Sentencing and Punishment of Offenders Act, 2012 c. 10 (Eng.).

²⁷⁷ See Herbert Smith, *Jackson reforms: taking stock*, Litigation e-Bulletin (Sept. 9, 2011), <http://www.herbertsmith.com/NR/rdonlyres/EFF8FF3D-9777-4466-9A6A-BC7EAC0FC242/0/JacksonreformstakingstockSep2011.html>.

²⁷⁸ 74 LITIG. FUNDING (Aug. 2011) (Published by U.K. Law Society Publishing).

	Funds already Invested in Litigation (approx)	Areas Covered	Minimum Value of dispute	Funders % or how its calculated	Must Solicitors/ Barrister/s work on CFA	Proportion of own costs covered
				percentage of proceeds, or a multiple of the committed investment		
3. Argentum Litigation	£15m	Commercial disputes: common law jurisdictions	£2m	Greater of multiple of funding invested or percentage of proceeds	No	100%
4. Burford Capital	\$140m	Commercial disputes in U.S. including cross border disputes litigated in U.S.; International arbitration in any jurisdiction; foreign litigation in some circumstances; plaintiff claims; and also defendants in appropriate cases	Typically over \$50m	Varies depending entirely on circumstances of case, and return may be based on or include other factors relating to, for example, to investment made	No	Up to 100%
5. Calunius Capital LLP	Many millions	All commercial disputes	£5m	Pricing varies from case to case and might include a fixed sum, or multiple of outlay and/or percentages that vary depending on nature of risk and stage at which successful resolution occurs	Not absolutely but like interests aligned	All
6. Claims Funding International Plc	Currently a European cargo recovery	Corporate misconduct cases: including shareholder	£20m	Usually a range of 25%–40% depending on when the	Yes Usually lower hourly rate with an uplift	100%

	Funds already Invested in Litigation (approx)	Areas Covered	Minimum Value of dispute	Funders % or how its calculated	Must Solicitors/Barrister/s work on CFA	Proportion of own costs covered
		actions, cartels, breach of competition law, conduct adversely affecting investors		matter resolves, degree of risk and complexity		
7. Commercial Litigation Services Ltd.	Not disclosed	Commercial and private cases including group and class actions organised in association with litigation management Ltd. (member of A2J Group)	Likely to be >£2m Depends on funding	Either a multiple of funding provided or percentage of damages where appropriate	Normally Yes	100%
8. Global Arbitration Ltd.	Not disclosed	International claims; cross border litigation, and international arbitration, particularly involving sovereigns) loss of investment, distressed and non-performed debt agreements	\$5m	Bespoke to funding arrangement	Varies from deal to deal	Varies from deal to deal
9. Harbour Litigation Funding Ltd.	Not disclosed	All commercial disputes including arbitration	£3m	Greater multiple of funding provided (at time matter concludes) or percentage of proceeds	No	All
10. IMF (Australia) Ltd.	As at 30 June 2011 IMF estimated total claim value was AUD1.78Bn	Commercial litigations brought by liquidators and administrators, group actions (such as cartel claims and	£5m – higher for group action	Percentage usually 25-45%. Factors include claim size, risks and expected duration	At least a partial CFA. CFA's may affect the availability of funding	All

	Funds already Invested in Litigation (approx)	Areas Covered	Minimum Value of dispute	Funders % or how its calculated	Must Solicitors/ Barrister/s work on CFA	Proportion of own costs covered
		claims by shareholders and investors) and domestic and international arbitrations				
11. IM Litigation Ltd.	Not disclosed	Commercial litigation—no personal injury, most construction cases, criminal or family matters or cases that depend solely on oral evidence	£3m	25-50% of net proceeds depending on duration, subject to achieving minimum return based on multiple of the funding. No upfront costs	No but preferred	All
12. Juridica Investments Ltd.	\$134m (as of 6 May 2011)	Commercial claims excluding personal injury, mass tort, product liability, or shareholder class action matters, typical investment size exceeds £500,000	Typical claim size exceeds £15	Rated by various factors, including risk profile, security of the capital investment, expected capital outlay and time to return	No but preferred	Varies form case to case, but can be considered
13. Litigata	Not disclosed	All commercial corporate litigation including IP, arbitration litigation brought by liquidators and Administrators, U.S. and Canada jurisdictions considered	£100,000 but typically at least £250,000	Bespoke based on multiples of investment or on a percentage basis, in exceptional circumstances percentage can be as low as 5% of net proceeds or as high as 50%	Usually a partial CFA with a minimum 50% discount	100%
14. Maxima LLP	N/A	Independent advice on all types of litigation	£100,000	We negotiate with the funder the level of their percentage on your	No	Case specific

	Funds already Invested in Litigation (approx)	Areas Covered	Minimum Value of dispute	Funders % or how its calculated	Must Solicitors/Barrister/s work on CFA	Proportion of own costs covered
				behalf, given we have access to the whole market of providers		
15. Redress Solutions LLP	Significant	Commercial litigation of all kinds including multi-party actions	None—as justified by damages	Percentage of claim, multiple of funding or combination	Solicitors on a part CFA also prefer counsel	100%
16. TheJudge Ltd	Not disclosed	Accept all areas except personal injury, clinical negligence and defamation	Damages claim with a realistic value in excess of £500,000 no maximum	N/a all funding calculation models considered	No	All own fees and funding disbursement requirements considered
17. Therium	Not Disclosed	All forms of litigation in the U.K. and international arbitration	No minimum with damages in excess of £1m	A multiple of funding, percentage of the claim (usually between 20-45%) or a combination	No	100%
18. Vannin Capital	Well Capitalized following significant private equity investment	All forms of commercial litigation subject to the jurisdiction of the Courts of EW, U.S. and all of the Caribbean jurisdictions; litigation brought by liquidators and administrators and all domestic and international arbitrations	£5m but exceptionally will consider lower value cases	Bespoke to each investment but normally the greater of a multiple of funding provided, and an agreed percentage of damages recovered	No but preferred so that all parties interests are aligned	Up to 100%
19. Woodsford Litigation Funding	Not disclosed	Commercial U.K./ international litigation arbitration and expert determined claims, preferably	£3m	25-49% of net proceeds, depending on case duration, or a minimum return based on a multiple of the fund-	No	All

	Funds already Invested in Litigation (approx)	Areas Covered	Minimum Value of dispute	Funders % or how its calculated	Must Solicitors/ Barrister/s work on CFA	Proportion of own costs covered
		governed by English law		ing		

Table 7 suggests that TPLF has been developing steadily under the common law in England and Wales. However, as noted previously, de Morpurgo²⁷⁹ suggests that by comparison, TPLF is very limited in the civil law jurisdictions of continental Europe, except in Germany.

De Morpurgo thus notes that:

Allianz Prozessfinanzierung²⁸⁰ in Germany has funded litigation costs to plaintiffs in Germany, Austria, and Switzerland, holding claims of at least €100,000, with a high probability of success and with a potentially divisible award that the company can share, in exchange for 20 to 30% of the proceeds (if any).²⁸¹

Allianz also entered the U.K. market in 2007.²⁸² In Germany, de Morpurgo²⁸³ further notes that:

[A]part from subsidiaries of insurance companies like Allianz Prozessfinanzierung or Roland Prozessfinanz,²⁸⁴ independent companies like FORIS Finanziert Prozesse,²⁸⁵ the first German company operating in TPLF and recently incorporated, offer to advance court costs and fees necessary to initiate an action, as well as to assume the risk of a cost award if the plaintiff loses.²⁸⁶ In Germany, there are a number of independent competing companies that offer similar services, including FORIS, DAS Prozessfinanzierung AG,²⁸⁷ Juragent²⁸⁸ and Exactor AG.²⁸⁹

²⁷⁹ See generally de Morpurgo, *supra* note 218, at 343.

²⁸⁰ ALLIANZ PROZESSFINANZIERUNG, <http://www.allianz-profi.com> (last visited May 22, 2012).

²⁸¹ De Morpurgo, *supra* note 218, at 365.

²⁸² See ALLIANZ LITIGATION FUNDING, <http://www.allianz-litigationfunding.co.uk> (last visited May 22, 2012).

²⁸³ De Morpurgo, *supra* note 218, at 365-66.

²⁸⁴ ROLAND PROZESSFINANZIERUNG, <http://www.roland-prozessfinanz.de/de/roland-prozessfinanz> (last visited May 22, 2012).

²⁸⁵ FORIS AG, <http://www.foris.de> (last visited May 22, 2012).

²⁸⁶ See Roland Kirstein & Neil Rickman, *FORIS Contracts: Litigation Cost Shifting and Contingent Fees in Germany*, CSLE Discussion Paper 2001-04 (2001), available at <http://econpapers.repec.org/paper/zbwcsledp/200104.htm>; Michael Coester & Dagobert Nitzsche, *Alternative Ways to Finance a Lawsuit in Germany*, 24 CIV. JUST. Q. 83, 84 (2005).

²⁸⁷ D.A.S. PROZESSFINANZIERUNG AG, <http://www.das-profi.de> (last visited May 22, 2012).

²⁸⁸ JURAGENT PROZESSFINANZIERUNG, <http://www.juragent.de> (last visited May 22, 2012).

²⁸⁹ EXACTOR, <http://www.exactor.de> (last visited May 22, 2012).

De Morpurgo further suggests that two common features of TPLF are that “(1) the asserted claim must be of a certain value (the minimum amounts required vary among the different financing companies ranging between €500 and €50,000); and (2) the percentage of the claim to be paid to the financier is inversely proportional to the value of the claim.”²⁹⁰

As the market has developed, competition appears to be driving down returns. As Kirstein & Rickman²⁹¹ note, while FORIS initially demanded 50% of the client’s return from settlement or trial, nowadays—with more competition in the market—it only claims 30%. Below, we provide further qualitative information on selected specific litigation funders in the U.K. and Europe generally, and their selection of cases.

a. IM Litigation Funding (IMLF)

IM Litigation Funding (IMLF) was established in 2002.²⁹² It typically funds cases of £3 million or more that have a 70% or “better chance of success where the prospective defendant has the means to pay the amount sought.”²⁹³ Although IMLF deals almost exclusively in insolvency matters,²⁹⁴ they “will also consider non-insolvent, i.e., general commercial litigation which is lacking the funds to pursue a good claim.”²⁹⁵ Nevertheless, “such claims will be subject to the same assessment process as insolvent litigation.”²⁹⁶

b. Harbour Litigation Funding (HLF)

Harbour Litigation Funding (HLF) was established by Brett Carron, Susan Dunn, and Martin Tonnby in 2007.²⁹⁷ In fact, Susan Dunn was one of the founders of IMLF.²⁹⁸ According to their website, HLF provides funding for all types of claimants—corporate, insolvency practitioners, and in-

²⁹⁰ De Morpurgo, *supra* note 218, at 366.

²⁹¹ See Kirstein & Rickman, *supra* note 11.

²⁹² Jon Robins, *The new, new thing: A study of the emerging market in third-party litigation funding*, JURES 5 (2010), available at http://www.jures.co.uk/whitepapers/QkLK6oHO_TPF%20report.pdf.

²⁹³ Application Process, IM LITIGATION FUNDING, <http://www.insolvencymanagement.co.uk/ApplicationProcess.htm> (last visited May 22, 2012).

²⁹⁴ IM LITIGATION FUNDING, *Who is IMLF for?*, INSOLVENCY MANAGEMENT, <http://www.insolvencymanagement.co.uk/WhatWeDo.htm> (last visited May 22, 2012).

²⁹⁵ *Id.*

²⁹⁶ *Id.*

²⁹⁷ Robins, *supra* note 292, at 5.

²⁹⁸ *Id.*

dividuals²⁹⁹—in various litigation, arbitration, and tribunal claims, so long as the matter has a minimum claim value of £3 million.³⁰⁰

While HLF predominantly funds claims in England and Wales, they have also funded cases in the Channel Islands, USA, Caribbean, and New Zealand.³⁰¹ Further, HLF claims that they are one of the first litigation funders in the U.K.³⁰² Since 2002, HLF has reviewed over 1200 cases and funded over 100.³⁰³

c. Therium Capital plc (Therium)

Therium Capital plc (Therium) is a recent entrant to the TPLF market.³⁰⁴ Its focus is on large commercial litigation and arbitration claims.³⁰⁵ Although it does not stipulate a minimum claim size, and looks instead at the viability of the claim relative to the funding required,³⁰⁶ claims are usually in excess of £1 million.³⁰⁷ As for their commission, Therium expects costs to be reimbursed in full and will usually seek between 20% and 45% of the case proceeds, a multiple of the funding, or a combination of the two, depending upon factors like the claim size, the costs, and the case duration.³⁰⁸

d. Calunius Capital LLP (Calunius)

Calunius Capital LLP (Calunius) “has been authorised and regulated by the Financial Services Authority as an Investment Adviser since June

²⁹⁹ HARBOUR LITIGATION FUNDING LTD, *About You*, HARBOUR LITIGATION FUNDING (May 22, 2012), <http://www.harbourlitigationfunding.com/about-you>.

³⁰⁰ HARBOUR LITIGATION FUNDING LTD, *Welcome to Harbour Litigation Funding*, HARBOUR LITIGATION FUNDING (May 22, 2012), <http://www.harbourlitigationfunding.com>.

³⁰¹ HARBOUR LITIGATION FUNDING LTD, *Is what you do legal?*, HARBOUR LITIGATION FUNDING (May 22, 2012), <http://www.harbourlitigationfunding.com/faqs>.

³⁰² *Id.*

³⁰³ HARBOUR LITIGATION FUNDING LTD, *About Us*, HARBOUR LITIGATION FUNDING (May 22, 2012), <http://www.harbourlitigationfunding.com/about-us>.

³⁰⁴ THERIUM CAPITAL MANAGEMENT LTD, *Who We Are*, THERIUM (May 22, 2012), <http://www.therium.com/howeare.htm>.

³⁰⁵ *Id.*

³⁰⁶ THERIUM CAPITAL MANAGEMENT LTD, *Frequently Asked Questions*, THERIUM (May 22, 2012), <http://www.therium.com/faqs.htm>.

³⁰⁷ THERIUM CAPITAL MANAGEMENT LTD, *Who We Are*, THERIUM (May 22, 2012), <http://www.therium.com/howeare.htm>.

³⁰⁸ THERIUM CAPITAL MANAGEMENT LTD, *The Funding Process*, THERIUM (May 22, 2012), <http://www.therium.com/the-funding-process.htm>.

2007, during which time Calunius has become globally recognised as a leading brand in large scale Commercial Litigation Finance.”³⁰⁹

Calunius only provides funding for commercial claims, both in litigation and arbitration; it “does not finance consumer disputes, divorce, libel, slander, or personal injury.”³¹⁰ “Cases of particular interest include breaches of contract such as breaches of confidentiality agreements, breaches of trade agreements, distribution disputes, breaches of fiduciary duty and professional negligence.”³¹¹ Calunius provides funding “under several different national laws and jurisdictions, including: the UK; Germany, Austria and Switzerland; Australia, New Zealand and Canada; Bermuda, British Virgin Islands and Cayman Islands; and the Channel Islands.”³¹²

According to Calunius’s website, there are two basic parameters that first need to be met: (1) the claim must have good prospects of success against a solvent defendant and (2) the claim value must be for “a sufficient multiple of the likely costs,” which “as a rule of thumb” requires a minimum claim value of at least £3 million “in order to be fundable.”³¹³

Further, Calunius primarily assesses “potentially investable cases” on the following factors: Merits—what are the strengths and weaknesses of the legal arguments and of the supporting evidence?; Quantum—what level of damages is likely to be achieved on success at trial or on settlement?; Recoverability—is the defendant good for the money?; Time—how long will it take to achieve resolution including the risk of appeal?; Costs—how much will the claimant’s costs turn out to be; what is the risk of over-run; how will the adverse costs risk be dealt with?; and, Variability—how likely are each of the above factors to change?³¹⁴ These factors are comparable to the ones considered by IMF when determining the percentage commission chargeable,³¹⁵ with the exception of the variability component, which has not been explicitly listed as a consideration by any other litigation funder mentioned in this paper.

³⁰⁹ CALUNIUS CAPITAL, <http://www.calunius.com> (last visited May 22, 2012).

³¹⁰ CALUNIUS CAPITAL LLP, *The Calunius Mandate*, CALUNIUS (May 22, 2012), <http://www.calunius.com/litigation-funding/calunius-mandate.aspx>.

³¹¹ CALUNIUS CAPITAL LLP, *Litigation*, CALUNIUS (May 22, 2012), <http://www.calunius.com/litigation-financefunding/litigation.aspx>.

³¹² *Id.*

³¹³ CALUNIUS CAPITAL LLP, *Litigation Funding Assessment*, CALUNIUS (May 22, 2012), <http://www.calunius.com/assessment.aspx>.

³¹⁴ *Id.*

³¹⁵ *See* IMF (AUSTRALIA) LTD, *Apply for Funding*, IMF (May 22, 2012), <http://www.imf.com.au/funding.asp>.

e. Juridica Investments Limited (Juridica)

Juridica Investments Limited (Juridica), launched in 2007 and registered in Guernsey,³¹⁶ “focuses exclusively on business-to-business related claim investments” where the claim value exceeds USD25 million.³¹⁷ Juridica’s investments “are predominantly in the U.S., the U.K. and in international arbitration cases and are identified by [its] Investment Manager, Juridica Capital Management Limited (Juridica Capital Management), from direct and indirect marketing to major corporations and an established network of leading lawyers and world-class law firms.”³¹⁸

Juridica provides funding for large commercial litigation including, among other things, “intellectual property, antitrust, insurance, contract disputes, and shareholder disputes,”³¹⁹ but explicitly states that “it does not invest in personal injury, product liability, mass tort, or class action claims.”³²⁰

f. Commercial Litigation Funding Limited (CLFL)

Commercial Litigation Funding Limited (CLFL) was established in 2006³²¹ by the principals of Access to Justice Group (A2J), whose experience in the field of providing legal expenses insurance dates back to 1992.³²²

CLFL provides both litigation and arbitration funding for insolvency, commercial, intellectual property, group action, defamation, breach of contract, and family law matters.³²³ CLFL stipulates that “the minimum amount of fees and other costs funded (including the ATE insurance premium) in litigation cases is £150,000,” although the main requirement is that the value of damages claimed must exceed £2 million.³²⁴ However, the

³¹⁶ JURIDICA INVESTMENTS LTD, *About Juridica*, JURIDICA INVESTMENTS (May 22, 2012), <http://www.juridicainvestments.com/about-juridica.aspx>.

³¹⁷ JURIDICA INVESTMENTS LTD, *Investment Policy*, JURIDICA INVESTMENTS (May 22, 2012), <http://www.juridicainvestments.com/about-juridica/investment-policy.aspx>.

³¹⁸ *Id.*

³¹⁹ JURIDICA CAPITAL MANAGEMENT LTD, *Juridica Investments Limited*, JURIDICA (May 22, 2012), <http://www.juridica.co.uk/investments.php>.

³²⁰ JURIDICA INVESTMENTS LTD, *Investment Policy*, JURIDICA INVESTMENTS (May 22, 2012), <http://www.juridicainvestments.com/about-juridica/investment-policy.aspx>.

³²¹ *Id.*

³²² *See* COMMERCIAL LITIGATION FUNDING LTD, *Information for Solicitors*, LITFUNDING (May 28, 2012), <http://www.litfunding.co.uk/how-we-can-help-you/information-for-solicitors>.

³²³ *See* COMMERCIAL LITIGATION FUNDING LTD, *Litigation Funding*, LITFUNDING (May 28, 2012), <http://www.litfunding.co.uk/types-of-funding/what-is-litigation-funding>.

³²⁴ *See id.*

amount in respect to arbitration cases is £8 million.³²⁵ Since its establishment in 2006, CLFL has reviewed more than 230 cases and arranged funding for cases worth over £10 million.³²⁶

g. Allianz ProzessFinanz GmbH (APF)

Allianz ProzessFinanz (APF) is an affiliate of the international insurer Allianz Deutschland AG, which first established a litigation funding venture in Germany in 1997 before later moving into the Austrian and Swiss markets.³²⁷ In 2007, APF was lauded as “Europe’s No. 1 litigation financier.”³²⁸ It was in that same year that APF entered the U.K. litigation funding market³²⁹ and opened their London office.³³⁰

While APF tends to fund “medium and large commercial law cases—for example, “contractual disputes where the claimant company feels overpowered by a larger opponent or intimidated by the prohibitive costs of legal proceedings in the U.K. . . . suitable claims of individuals will also be considered for funding.”³³¹

At present, for APF to provide funding in England, the claim value must be at least £100,000, and the matter itself must have very good prospects of success.³³² The following percentage commissions are charged:

1. 20% of a settlement reached before court proceedings are issued (“[APF does not] only finance “regular” lawsuits, but also international arbitration and mediation proceedings”³³³);
2. 30% of a settlement or award, where the amount is £350,000 or less;
3. 20% of a settlement or award, where the amount is in excess of £350,000.³³⁴

³²⁵ *Id.*

³²⁶ *Id.*

³²⁷ Robins, *supra* note 292, at 5.

³²⁸ ALLIANZ PROZESSFINANZ, *Risk-free litigation financing* (2007), https://www.allianz.com/en/press/news/business_news/insurance/news_2007-08-17.html.

³²⁹ Robins, *supra* note 292, at 5.

³³⁰ See ALLIANZ PROZESSFINANZ, *Allianz ProzessFinanz GmbH Opens London Office*, ALLIANZ, https://www.allianz.com/en/press/news/business_news/insurance/news_2007-11-12.html (Nov. 12, 2007).

³³¹ *Id.*

³³² See ALLIANZ PROZESSFINANZ, *Risk Free Litigation Funding*, ALLIANZ, https://www.allianz.com/en/press/news/business_news/insurance/news_2007-08-17.html (Aug. 17, 2007).

³³³ ALLIANZ PROZESSFINANZ, *Allianz ProzessFinanz GmbH Opens London Office*, ALLIANZ, https://www.allianz.com/en/press/news/business_news/insurance/news_2007-11-12.html (Nov. 12, 2007).

³³⁴ See *Whatever You Want*, LAW SOC’Y GAZETTE (Jan. 17, 2008), <http://www.lawgazette.co.uk/features/whatever-you-want>.

The same conditions apply for APF to provide funding in Germany and Austria, except the minimum claim values are €100,000³³⁵ and €80,000,³³⁶ respectively, and the percentage charged changes from 30% to 20% when a settlement or award exceeds €500,000.

Over the span of five years, from mid-2002 to mid-2007, APF reported having received “around 3,000 financing requests representing some five billion euros in claims.”³³⁷ Further, according to Arndt Eversberg, one of the two managing directors, “We have been profitable since our third year of business, and have a success rate of 80% for the proceedings we have financed.”³³⁸ It should be noted, however, that by the end of 2007, many new litigation funders were entering the European litigation funding market.

J. *Claims Funding International plc (CFI)*

Claims Funding International plc (CFI) is “a litigation funding company incorporated in the Republic of Ireland” that started as “a joint venture between IMF, a publicly listed litigation funding company in Australia, and interests associated with Maurice Blackburn Lawyers, one of Australia’s leading plaintiff law firms.”³³⁹ In 2008, IMF withdrew from the CFI venture and Maurice Blackburn has since been seeking new investors.³⁴⁰ IMF cited two reasons for withdrawing from CFI: (1) the global economic downturn and (2) the risk-reward calculus of litigating in the U.K., citing among other things, the risks under the British “loser pays” fee-shifting rule.³⁴¹

According to CFI, “CFI’s principal business is to identify, organise and fund multi-party legal actions in the EU and elsewhere in the world, other than Australia. This will include actions arising out of anti-competitive European and global cartels.”³⁴² For the provision of funding

³³⁵ ALLIANZ PROZESSFINANZ, *Swiss Precision, Austrian Charm and British Humor*, ALLIANZ (July 15, 2008), https://www.allianz.com/en/press/news/business_news/insurance/news_2008-07-15.html.

³³⁶ *See id.*

³³⁷ ALLIANZ PROZESSFINANZ, *Allianz ProzessFinanz GmbH Opens London Office*, ALLIANZ (Nov. 12, 2007), https://www.allianz.com/en/press/news/business_news/insurance/news_2007-11-12.html.

³³⁸ *Id.*

³³⁹ CLAIMS FUNDING INT’L, SUBMISSION TO THE COMMISSION FOR THE EUROPEAN COMMUNITIES’ WHITE PAPER ON DAMAGES ACTIONS FOR BREACH OF THE EC ANTI-TRUST RULES 1 (2008); Wayne Attrill, *Claims Funding Int’l plc, Ethical Issues in Litigation Funding* 1 (2008), http://www.claims-funding.eu/fileadmin/Documents/Ethical_Issues_Paper.pdf.

³⁴⁰ Richard Lloyd, *Some Plaintiffs in U.K. Courts are Turning to Third-Party Funders to Pay Their Lawyers*, AM. LAW. (June 1, 2009), http://www.americanlawyer.com/PubArticleTAL.jsp?id=1202430855594&Litigation_Support.

³⁴¹ *See id.*

³⁴² CLAIMS FUNDING INT’L, *supra* note 339; Attrill, *supra* note 339.

CFI requires that there be a 70% prospect of success as assessed by CFI and that the minimum claim value not be for less than €5 million—although they also note that they prefer cases with a minimum claim value of at least €25 million.³⁴³ Further, they liken themselves to “private ‘legal aid.’”³⁴⁴

2. Insurance and Funding

As indicated in the earlier economic model, the extent of TPLF might be understood to depend on the availability of alternative source of finance for litigation. In this regard, the greater availability of insurance in the U.K. and Europe may be affecting differences in the extent and growth of the TPLF market.

Before the event (BTE) insurance, also known as LEI, functions like most insurance policies: the insurer provides a guarantee of compensation, in this case for losses associated with litigation, in return for payment of a premium. After the event (ATE) insurance is similar in that a premium is paid for a guarantee of compensation, but costs associated with litigation *after* the event potentially giving rise to a cause of action have already been incurred.

BTE is far more common in civil law jurisdictions due to the predictability of litigation costs, as exemplified by Germany, where 43% of the population have BTE.³⁴⁵ Without such predictability, the insurer would have great difficulty quantifying the risk it seeks to underwrite.

Beyond the concern of predictability, Lord Justice Jackson notes that “[for] historical and cultural reasons LEI has never been as widely taken up by private individuals in the UK as it has been in Germany.”³⁴⁶ According to Arag plc, a company that has provided LEI in Germany since 1935 and in the U.K. since 2006, “LEI became popular in Germany after the Second World War when there was no legal aid available.”³⁴⁷ Lord Justice Jackson draws a basic distinction between BTE coverage where insurers pay solicitors to act for the insured when a claim arises (BTE₁) and BTE coverage where insurers will “sell” claims to solicitors in return for referral fees, and the solicitors will thereafter act on a CFA (BTE₂).³⁴⁸

FIGURE 5

³⁴³ See CLAIMS FUNDING INT’L PLC, *Apply for Funding*, CLAIMS FUNDING (May 28, 2012), <http://www.claims-funding.eu/apply-for-claims-funding.html>.

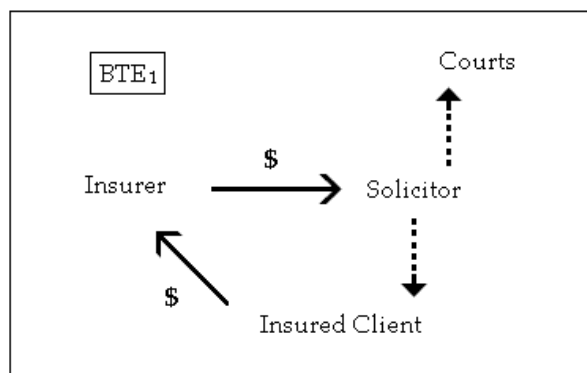
³⁴⁴ See CLAIMS FUNDING INT’L PLC, *Our Objectives*, CLAIMS FUNDING (May 28, 2012), <http://www.claims-funding.eu/19.html>.

³⁴⁵ Christopher Hodges, Stefan Vogenauer & Magdalena Tulibacka, *Costs and Funding of Civil Litigation: A Comparative Study* 30 (Oxford Legal Studies Research Paper No. 55-2009, 2009).

³⁴⁶ JACKSON, *supra* note 272, at 151.

³⁴⁷ *Id.*

³⁴⁸ *Id.* at 153.

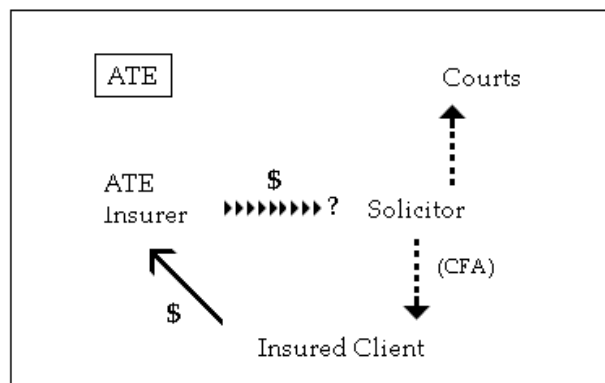


At its most basic, BTE in the U.K. resembles the figure above. An insured individual pays a premium to their insurer, who, in the event of litigation, acquires the services of a solicitor, to whom the *insurer* pays the costs of litigation. The solicitor owes fiduciary obligations to their insured client while acting as an officer of the Court.

Lord Justice Jackson identifies the following benefits of such a system:

BTE₁ insurance brings a number of benefits and serves the public interest. First and foremost, IN[which denotes the person or company insured under a BTE policy,] is able to bring or defend claims, which may otherwise be beyond his means. Secondly, insurers provide a stream of work to their panel solicitors. Insurers have an interest in keeping down costs. Accordingly, they will use their bargaining power to hold down hourly rates or to negotiate alternative fee structures, in the same way that liability insurers have done for many years.³⁴⁹

FIGURE 6

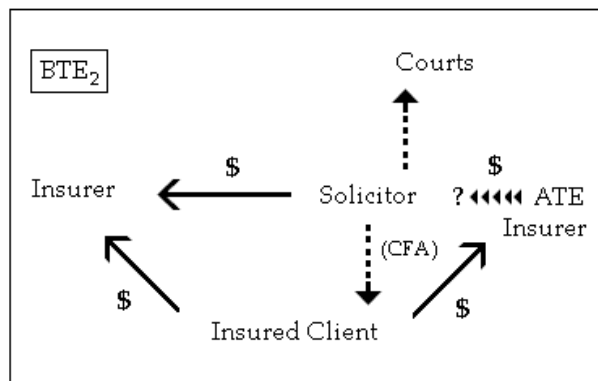


On the other hand, ATE functions as shown above. A client obtains the services of a solicitor on a CFA basis and is able to proceed, with the

³⁴⁹ *Id.*

solicitor only charging for services if the suit is successful. This, however, does not protect the client from an adverse costs order, and *that* is the risk ATE covers. The client thus pays a premium to the ATE insurer who guarantees compensation in the event of an adverse costs order. As of April 2000, the use of ATE became widespread in the U.K., as the winning party was then able to recoup the ATE premium as a disbursement.³⁵⁰

FIGURE 7



As noted by Lord Justice Jackson, and as demonstrated above, BTE₂ increases the cost of litigation; the insured individual pays a premium to their insurer, who, in the event of litigation, refers them to a solicitor, who pays the insurer a referral fee. The solicitor enters into a CFA with the insured individual, only charging for services if the suit is successful. However, the insured individual must further pay the ATE premium to cover any possible adverse costs orders, as the CFA would not guard against that risk. That being said, “BTE₂ insurers do provide free legal advice by telephone. This is a valuable service, particularly in relation to consumer claims.”³⁵¹

In terms of the spread of BTE in the U.K., “BTE insurers state that (after deducting for duplication) about 10–15 million separate households in the UK have BTE cover.”³⁵² Small and medium sized enterprises do not tend to take out BTE insurance.³⁵³ It is even more unpopular with larger enterprises which “prefer to meet the costs of such disputes and the consequential litigation as and when they arise.”³⁵⁴

³⁵⁰ *Id.* at 156. See also Callery v. Gray, [2002] UKHL 28, [2002] (appeal taken from Eng.); Michael Zander, *Where are We Now on Conditional Fees? – Or Why this Emperor is Wearing Few, if any, Clothes*, 65 MOD. L. REV. 919, 923 (2002).

³⁵¹ JACKSON, *supra* note 272, at 153.

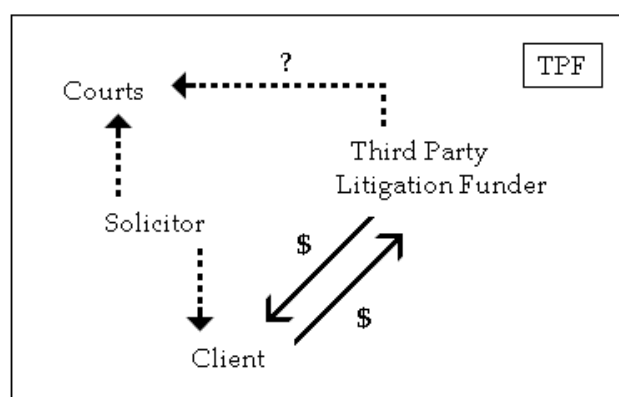
³⁵² *Id.* at 152.

³⁵³ *Id.* at 152-53.

³⁵⁴ *Id.* at 152.

ATE appears far more widespread than BTE due to its almost symbiotic relationship with CFAs and its subsumption into TPLF in the U.K. ATE coupled with a CFA is available in personal injury cases, cases of libel, small business disputes, environmental claims, group actions, clinical negligence, and, to a lesser extent, in large commercial cases. However, the premium charged varies significantly between the categories of claims, and in some categories, even between the cases.³⁵⁵ Further, many of these categories of claims are ones generally not covered by TPLF.

FIGURE 8



The basic funder–client relationship as seen in Australia is depicted above. When a client wishes to pursue a large commercial claim that they cannot afford, the client instructs their solicitor to seek out a third-party litigation funder. The third-party litigation funder generally undertakes independent assessments and due diligence procedures before agreeing to fund the litigation.

If the claim meets the specific funder’s requirements, funding is provided to cover all the costs of the litigation in exchange for a percentage commission. The amount of percentage commission charged corresponds with the estimated level of risk. The legal relationships remain distinct—by contract, the solicitor owes fiduciary obligations to their client and the third-party litigation funder. The extent of control that should be afforded to a third-party litigation funder was addressed above. However, questions remain regarding the standing of third-party litigation funders. Unlike solicitors acting as officers of the court, third-party litigation funders have yet to be held as falling within the court’s inherent jurisdiction.

According to Lord Justice Jackson:

³⁵⁵ *Id.* at 157-58.

Funders do not provide ATE cover, although they require that ATE insurance is taken out in any litigation which they support. The funder is potentially liable for the other side's costs, at least to the extent of the funding which it has provided. A number of brokers specialise in litigation funding and put together packages comprising litigation funding and ATE insurance.³⁵⁶

As such, TPLF and ATE appear to be bundled products in the U.K. For example, Litigation Protection Ltd, CLFL's sister company, labels CLFL on its website as an independent broker specialising in "innovative insurance solutions for solicitors and their clients."³⁵⁷

3. How commonplace is TPLF in the U.K. and Europe?

As noted at the outset, given the twenty-six European countries discussed in this report, TPLF in Europe appears to be far from commonplace. TPLF appears more prevalent in the common law of EW. Outside of that, it can be found in certain civil law jurisdictions, particularly Germany.

Sam Eastwood, a partner in Norton Rose's dispute resolution team, commenting on the state of the TPLF market in the U.K. in 2007, noted that "[a]t the time, there was a lack of awareness of the potential for third-party funding—and considerable scepticism."³⁵⁸ However, there was potential for development. Freshfields Bruckhaus Deringer's 2008 report commented that with respect to EW that:

A recent high-level market survey concluded that the UK market is immature but most market participants believe there is a significant opportunity for [TPLF]. The key drivers of the market are thought to be changing legal precedent, increasing legal costs and improving levels of awareness of such funding. Competition within the market is evolving, with a range of players and business models apparent. The London litigation market is said to be attractive to funders because of its sophistication and the relative speed with which cases are brought to a conclusion (thereby reducing the pay-back period for funders).³⁵⁹

By 2009, Austria, Germany, Ireland, and the Netherlands were also seen as jurisdictions in which TPLF was developing.³⁶⁰ Third-party litiga-

³⁵⁶ JACKSON, *supra* note 272, at 161.

³⁵⁷ LAWSURE DIRECT LTD, *Third Party Funding of Commercial Litigation*, LITIGATION PROTECTION (May 21, 2012), <http://www.litigationprotection.co.uk/who-we-are/78-moonlight-classics-summer-viewing>.

³⁵⁸ Grania Langdon-Down, *Litigation funding: an overview of a contentious area of growth*, LAW SOC'Y GAZETTE (May 21, 2009), <http://www.lawgazette.co.uk/features/litigation-funding-an-overview-of-a-contentious-area-of-growth>.

³⁵⁹ *Recent developments in class actions and third party funding of litigation: A rapidly evolving landscape*, FRESHFIELDS BRUCKHAUS DERINGER 8-9 (2008), available at www.freshfields.com/publications/pdfs/2008/feb20/21722.pdf.

³⁶⁰ Hodges et al., *supra* note 345.

tion funders in these countries cited a recovery fee of 25–40%,³⁶¹ which is similar to Australian litigation funders' typical commissions.³⁶² And yet, in that same year, costs specialist Tony Guise maintained that awareness of TPLF among the legal profession remained "pretty poor."³⁶³ This appears to be a common motif. As Selvyn Seidel, Chairman of the U.S. funder Burford Group, put it: "The industry's biggest enemy is the lack of awareness."³⁶⁴

Similarly, even as of February 2012, Gavin Foggo and Molly Ahmed of Fox Williams reiterated that "awareness on the part of lawyers and the business community is vital for third-party funding to take off in the UK and US, as it has done in Australia."³⁶⁵ The litigation funder Calunius made the following claims in a July 2011 memorandum for a Roundtable on Third-Party Funding of International Arbitration:

The UK and certainly continental Europe can be considered more grown up about funding of large commercial disputes than the US. Germany, Europe's largest economy, has enjoyed an active and mature funding market for more than 10 years, which makes it – together with Australia – one of the world's early movers in this respect. Since about 2007 the UK has embraced litigation funding for commercial disputes also outside the insolvency arena, where the early activities in the market took place. Politically litigation funding is considered to be a "good thing" in these jurisdictions through which access to justice is improved. The hostilities that appear to have taken place in the US towards litigation funding have not occurred in Europe.

A key difference between the common law countries and the civil law countries is that the ancient doctrine of champerty and maintenance that occasionally still plagues the industry in the common law world does not exist in the civil law countries, which is one of the reasons why a balanced market was able to grow in Europe before this happened in the US. There are of course other limitations to what a funder can and cannot do, but these are largely to do with commercial terms in the context of protecting consumers; consumers are almost certainly never going to be party to an arbitration.³⁶⁶

IMF's Wayne Attrill also made some interesting remarks regarding the TPLF market in the U.K., as compared to in the U.S. and Australia:

³⁶¹ *Id.*

³⁶² *Id.*

³⁶³ Langdon-Down, *supra* note 358.

³⁶⁴ Robins, *supra* note 292.

³⁶⁵ Gavin Foggo & Molly Ahmed, *Third-party funding: the awareness barrier*, CDR NEWS (Feb. 24, 2011), available at <http://www.foxwilliams.com/news/2>.

³⁶⁶ Memorandum from Calunius Capital LLP on A European Perspective to the Roundtable on Third Party Funding of Int'l Arbitration Claims: The Newest "New New Thing", Fordham Univ. School of Law (June 15, 2011) (available at <http://www.calunius.com/media/1549/tpf%20of%20international%20arbitration%20claims%20the%20newest%20new%20new%20thing.pdf>).

There's a surprising amount of interest coming out of the US for litigation funding given that they have such a well-developed contingency fees system and lawyers are quite happy to run cases on a contingency basis," reports Attrill. He compares this to the UK where he detects "a degree of conservatism in the market. UK industry itself is small and there is a limit to how much the relatively small number of funders can achieve in terms of publicising their products and increasing general awareness." Funded litigation "rarely makes the headlines in England," he says. "Here in Australia almost every week you will find multiple references to our funded cases in the Australian media."³⁶⁷

In early 2010, there was media speculation that "Europe, and particularly the UK, is gaining credibility as a [third-party funding] market"³⁶⁸ with Juridica announcing that it "is getting serious about the UK and earmarked \$50 million for local projects."³⁶⁹ On the other hand, the Burford Group, despite having attracted £35 million from U.K. institutional investors when it successfully floated on the London Stock Exchange's Alternative Investment in October 2009, declared that "it had no immediate plans to fund domestic UK cases, [for] now, [as] the US is simply a far more dynamic and lucrative market."³⁷⁰ Burford Group's Chairman Seidel went on to note that, "The UK and Europe are very focused on trying to resolve things outside the courts whereas the US is a very court-orientated country with far more litigation than any country in the world, with cases that are much vaster and complex than anywhere else, [and] with much larger damages."³⁷¹ This seems to be particularly true of Germany:

The German model has predictable costs for virtually *all cost items* (court costs, lawyers' fees, and to a great extent for witness and expert costs). It works particularly well for simple, lower value claims. It is, however, significant that it is less effective for more complex cases, and it is notable that larger commercial cases tend to use arbitration, within which greater access to documentary evidence can apply or be ordered by the arbitrator.³⁷²

This might be because "a recent German reform requires mandatory mediation in some cases before court proceedings can be triggered."³⁷³ However, European third-party "litigation" funders appear to have responded to these market demands by providing funding not just for litigation, but also for arbitration and mediation. For example, HLF, Therium, Calunius, and CLFL fund arbitration, Juridica funds international arbitration only, and APF funds both arbitration and mediation.

³⁶⁷ Robins, *supra* note 292, at 11.

³⁶⁸ Greg Bousfield., *Third-Party Funders Eye Up Europe*, CDR NEWS (Feb. 17, 2010), <http://www.fulbrookmanagement.com/news/100217.html>.

³⁶⁹ *Id.*

³⁷⁰ *Id.*

³⁷¹ *Id.*

³⁷² Hodges et al., *supra* note 345, at 41.

³⁷³ *Id.* at 43.

Another area in which TPLF has the potential to grow is in the arena of regulating anti-competitive behavior in Europe. “The European Commission encourages individuals to pursue damages for breaches of competition law, as demonstrated in its white paper on compensating consumer and business victims for breaches of competition rules.”³⁷⁴ Siemens AG observes that “investors have discovered the ‘European market’ and are working autonomously across the national borders of the Member States, especially in the field of antitrust law.”³⁷⁵ As noted above, this category of case falls directly within the purview of CFI’s principal business.

Australia has led the world in terms of being the first jurisdiction to develop a robust TPLF market, with a history dating back some twenty years.³⁷⁶ However, it is still too early to say it is commonplace because it constitutes less than 0.1% of the annual volume of civil litigation in Australia. In the U.K., it seems inappropriate to describe TPLF as commonplace for the same reason.³⁷⁷ The European market for TPLF appears to be still in its infancy. We have outlined a number of reasons why there are differences between countries in TPLF, focusing on the evolution of legal rules. However, more work is required to both measure TPLF and assess its determinants. A key feature holding back the further growth and evolution in common law countries may be uncertainty as to the ongoing residual role of the common law doctrines of maintenance and champerty, and what, if any, regulation may replace them.

³⁷⁴ Aileen Murtagh, *Other People’s Money*, LAW SOC’Y GAZETTE (Phillips Lee Solicitors, Dublin, Brussels) (Nov. 2009), available at <http://www.lawsociety.ie/Documents/Gazette/Gazette%202009/March2009.pdf>.

³⁷⁵ SIEMENS AG, Translation of POSITION PAPER FOR THE PUBLIC CONSULTATION OF THE EUROPEAN COMMISSION: “TOWARDS A COHERENT EUROPEAN APPROACH TO COLLECTIVE REDRESS” 8 (April 12, 2011), http://ec.europa.eu/competition/consultations/2011_collective_redress/siemens_en.pdf.

³⁷⁶ MCGOVERN ET AL., *supra* note 5, app. B, at 69.

³⁷⁷ *Id.*

THIRD-PARTY FINANCING IN THE PERSPECTIVE OF GERMAN
LAW—USEFUL INSTRUMENT FOR IMPROVEMENT OF THE CIVIL
JUSTICE SYSTEM OR SPECULATIVE IMMORAL INVESTMENT?

*Professor Dr. Alexander Bruns**

I. THE GERMAN SYSTEM OF MUTUAL LITIGATION COST SHIFTING,
ATTORNEYS' COMPENSATION, AND THIRD-PARTY FINANCING

A. *Basic Idea of Mutual Cost Shifting and Equality of Procedural Powers*

Legal analysis of third-party financing of civil litigation generally should be based on the legal system of cost allocation. Unlike its American counterpart, contingent fees are generally not available under German civil procedure law. Litigation cost is a rather intensely regulated sector. The German rule concerning parties' litigation costs is quite different from the American rule that each party bears its own costs. German civil procedure requires the loser to pay court fees, his own expenses, and the winner's attorney's fees.¹

The basic idea underlying the "loser pays" rule is that a court's judgment in a case is based on the application of substantive law and, as such, is deemed to be crystallized truth and substantial justice. If the plaintiff wins the case, he bears no cost because the judgment gives him what he is entitled to under substantive law and what the loser unlawfully refused to deliver or pay. If the defendant prevails, he justifiably burdens the plaintiff with both parties' litigation costs because substantive law, as applied by the court, has deemed the plaintiff's suit to be groundless.

This loser pays rule is more justifiable in a procedural system that primarily aims to enforce substantive law rather than merely resolve disputes. Its cost shifting approach necessitates limiting the amount that may be shifted to the losing party, so as to avoid unjust inequality and abuse. Otherwise, the losing party could be liable for a higher amount if the winning party paid more money to his attorney. Moreover, a cost shifting model is preferable if it is designed to ensure the predictability of potential cost risks. The German cost shifting law is governed by the principle that there is equality of cost risk to the litigating parties and, in a broader sense,

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¹ ZIVILPROZESSORDNUNG [ZPO] [CODE OF CIVIL PROCEDURE], § 91.

can be seen as a basic element of a procedural system that is designed to promote equal procedural powers among the litigating parties.

B. *Basic Legal Framework of Attorneys' Compensation*

Against this background, it is understandable that German civil procedure law lays a rather sophisticated legal framework governing lawyers' fees and compensation.² Due to negative experiences with unreasonably high honoraria for lawyers and widespread abuses, legislative reforms intended to remedy frequent disgrace through detailed regulations that governed the adequacy of attorneys' compensation for their legal services. The governing Attorneys' Fee Law provides: "The compensation (fees and expenses) of an attorney for his professional activity shall be measured according to this law."³ The law sets forth in detail both the circumstances under which attorneys are to be compensated and the amount of compensation for each kind of professional service rendered.

The basic unit for remuneration of a professional service is a "fee" (*Gebühr*), and the law describes how many fees correspond to a given legal service. For example, the preparation and filing of an ordinary civil case is associated with 1.3 fee units plus another 0.15 fee units for a preparatory letter to the defendant. If the case reaches the hearing stage in court (*Hauptverhandlung*), another 1.2 fee units will be added, permitting counsel to charge a total of 2.5 fee units. To encourage settlement, the attorney will be entitled to an extra 1.5 fee units if the case is settled in court. Additionally, according to the Attorneys' Fee Law, certain disbursements incurred by counsel such as travel expenses, telephone charges, photocopies, etc. are to be reimbursed.

The amount associated with each fee unit depends on the value of the subject matter of the rendered service (*Gegenstandswert*), which in litigated cases generally equals the amount in controversy as determined under the Court Costs Law (*Streitwert*). For example, if a plaintiff seeks €500,000 in damages, the value of the subject matter and the amount in controversy is €500,000. The Attorneys' Fee Law determines the amount chargeable per fee unit at each level of the subject matter. The amount chargeable per fee unit is €2,996 for an amount in controversy of €500,000, €4,496 for an amount in controversy of €1,000,000, €7,496 for an amount in controversy of €2,000,000, and €31,496 for an amount in controversy of €10,000,000. To illustrate, in an ordinary personal injury case where the plaintiff asks for €500,000 in damages, his attorney will be entitled to roughly €12,000 in

² For an outline in English of the German law, see PETER L. MURRAY & ROLF STÜRNER, GERMAN CIVIL JUSTICE 112-15 (2004).

³ Rechtsanwaltsvergütungsgesetz [RVG] [Act on the Remuneration of Lawyers], May 5, 2004, Bundesgesetzblatt [BGBl] at I pp.718, 788, as amended, § 1, para. 1 (Ger.).

compensation, or approximately 2.4% of the amount in controversy, plus taxes, regardless of the case's outcome. The same calculation applies to the defendant's attorney. The winning party will be entitled to the reimbursement of his attorney's fees for that same amount. So, if the plaintiff wins, the defendant will have to pay the plaintiff €500,000 in damages and €12,000 for the plaintiff's attorney's fees⁴ plus €12,000 to his own attorney.

In case of a partial success, the cost-shifting will be partial too. Assuming the plaintiff seeking €500,000 is awarded €100,000 and the rest of his claim is dismissed, he will only be reimbursed for 20% of his attorney's fees, whereas the defendant may recover 80% of his attorney's fees from the plaintiff. Notably, the amount chargeable per fee unit rises degeneratively. The underlying idea is that smaller claims generate reasonable attorney compensation and contribute substantially to an attorney's income and independence. Thus, cases with higher amounts in controversy may effectively subsidize, to a degree, the less valuable cases in a given lawyer's portfolio of cases.

C. *Limited Admissibility and Enforceability of Contingent Fees*

The Attorneys' Fee Law permits lawyers and clients to enter into agreements that deviate from the legal cost regime to some extent.⁵ Such an agreement must meet formal requirements.⁶ Interestingly, the fee agreement may provide for lower attorney compensation than would be due under the legal compensation scheme, but only if the amount is reasonably related to the service rendered by the attorney, his responsibility, and his risk of civil liability.⁷

In the aftermath of a 2006 decision of the German Constitutional Court, the legislature enacted a new provision in the Attorneys' Fee Law concerning the limited admissibility of contingent fee agreements.⁸ According to § 4a subs. 1 sentence 1 RVG and § 4b RVG, a contingent fee agreement is admissible and enforceable only if made in an individual case and if the client, motivated by a reasonable analysis of his economic situation, would be prevented from the procedural pursuit of his rights without the agreement. In litigated cases, an agreement providing for a no-win-no-fee arrangement is admissible only in so far as the victorious attorney recovers an *adequate* extra charge in addition to the legally prescribed compensation.⁹ What constitutes an adequate extra charge is not

⁴ ZIVILPROZESSORDNUNG [ZPO] [CODE OF CIVIL PROCEDURE], § 91.

⁵ RVG §§ 3a-4b.

⁶ RVG § 3a.

⁷ RVG § 4(1).

⁸ BVerfG NJW 2007, 979. RVG § 4a.

⁹ RVG § 4a(1).

entirely clear and remains in dispute among scholars.¹⁰ The dispute is centered on extra charges of up to 100% of the legal compensation.¹¹ However, German legislators are cautious not to adopt wide-ranging admissibility of the contingent fee agreements prevalent in the United States.

D. *Access to Civil Litigation and Legal Aid by State*

As access to civil litigation is a constitutional right in Germany,¹² its Civil Procedure Code provides for substantial state support of litigants who cannot afford to pay court fees and compensate their attorneys.¹³ Since 1879, Germany has had a “poor persons law” (*Armenrecht*) providing for the appointment of lawyers to represent poor litigants in court. The New York Legal Aid Society, originally organized by German-Americans in 1876 as the German Legal Aid Society (*Der Deutsche Rechtsschutz Verein*), was formed to provide free legal assistance to indigent German-American immigrants.¹⁴ This can be seen as an export of the German tradition of legal aid for the indigent to the New World.¹⁵

An indigent German who wants to bring or defend a civil case can either apply directly to the court or, as is more often the case, ask a lawyer to help with the application process.¹⁶ All lawyers are eligible to assist an indigent litigant in applying, and many of them will agree to do so. Legal aid will be granted only if the applicant is financially eligible, and if the case is both non-capricious and has a prospect of success.¹⁷ A litigant’s financial eligibility depends on a detailed income and property test¹⁸ that may require the individual to pay modest instalments toward litigation costs. To protect the lawyer, the state treasury will pay the full legal aid fee directly to the party’s attorney and seek reimbursement from the indigent litigant.

¹⁰ See, e.g., Teubel in Mayer/Kroiß (ed.), *Rechtsanwaltsvergütungsgesetz*, 5th ed. 2012, § 4a Rn. 42 f.

¹¹ See, e.g., Mayer in Gerold/Schmidt, *Rechtsanwaltsvergütungsgesetz*, 19. Aufl. 2010, § 4a Rn. 11-21.

¹² See, e.g., the following decisions of the German Constitutional Court: Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] July 3, 1973, 35 ENTSCHEIDUNGEN DES BUNDESVERFASSUNGSGERICHTS [BVERFGE] 348 (361), (Ger.); BVerfG DATE, 79 BVERFGE 80 (84); BVerfG DATE, 85 BVERFGE 337 (345); BVerfG DATE, 88 BVERFGE 118 (123); BVerfG DATE, 93 BVERFGE 99 (107); BVerfG Jan. 27, 1988, 97 BVERFGE 169 (185); see also Bruns ZZZ 124 (2011), 29, 33.

¹³ For an overview in English, see MURRAY & STÜRNER, *supra* note 2, at 116-23. ZPO §§ 114-27.

¹⁴ REGINALD HEBER SMITH, *JUSTICE AND THE POOR* 135 (1919).

¹⁵ See MURRAY & STÜRNER, *supra* note 2, at 116.

¹⁶ MURRAY & STÜRNER, *supra* note 2, at 117.

¹⁷ ZPO § 119(1).

¹⁸ ZPO § 115.

The fee schedule in legal aid cases is roughly equivalent to the aforementioned standard fee schedule as long as the amount in controversy does not exceed €3,000. Above this threshold, the fees under the legal aid schedule do not rise as quickly as those under the non-indigent schedule. Also, the maximum amount in controversy used for the calculation of compensation is capped at €30,000 under the legal aid schedule.¹⁹ Therefore, in a lawsuit with an average amount in controversy, the attorney's compensation under the legal aid scheme will be somewhat less than it would be in a commensurable ordinary case. Moreover, if the amount in controversy is much greater than €30,000, the indigent party's lawyer will receive far less compensation than he would in non-indigent litigation.

E. *Legal Cost Insurance*

An overview of the basic financial structure of civil litigation should mention the availability of legal cost insurance.²⁰ Besides ordinary liability insurance covering the cost of defending a case, including the mandatory car-owner liability insurance,²¹ a litigant may be protected against exposure to the cost of litigation if he or she has secured legal cost insurance offered by private insurance companies.²² The ordinary legal cost insurance policy covers the policyholder's cost for his or her own attorney and any obligation to pay the opponent's cost for legal representation if the policyholder loses at trial. The exact scope of coverage varies with the respective contractual stipulations.

A considerable number of German citizens hold some kind of legal cost insurance. Gross payments of annual premiums nearly doubled in the last twenty years from roughly €1.6 billion in 1990 to more than €3.2 billion in 2010.²³ The availability of legal cost insurance has been criticized by judges and commentators as the cause of a "litigation explosion" in non-meritorious claims.²⁴ However, statistical data does not seem to support this notion on a general scale.²⁵ The proposition of mandatory legal cost insurance has not been implemented in Germany.²⁶

¹⁹ RVG § 49.

²⁰ See MURRAY & STÜRNER, *supra* note 2, at 123-25.

²¹ VERSICHERUNGSVERTRAGSGESETZ [VVG] [INSURANCE CONTRACT LAW], § 101.

²² VVG §§ 125-29.

²³ See Gesamtverband der Deutschen Versicherungswirtschaft e.V. (ed.), *Statistisches Taschenbuch der Versicherungswirtschaft*, 2011, p. 71.

²⁴ See, e.g., van Büren *Anwaltsblatt* [AnwBl] 1991, 501.

²⁵ See Jagodzinski et al. *Neue Juristische Wochenschrift* [NJW] 1993, 2769, 2771.

²⁶ Baur *Juristenzeitung* 1972, 75; for an overview, see Hedderich, *Pflichtversicherung*, 2011, pp. 454-456.

II. THE NEW MODEL OF THIRD-PARTY FINANCING

Some years ago, commercial finance firms entered the market offering third-party financing of litigation.²⁷ If a plaintiff is not eligible for legal aid and does not hold an adequate legal cost insurance policy, the cost of civil litigation may act as a barrier preventing access to the litigation system, even for well-to-do citizens.²⁸ Under an ordinary third-party finance agreement, the finance firm is obliged to pay all of the plaintiff's costs, plus the defendant's costs and legal fees if the defendant wins or the judgment cannot be enforced. In return, the firm will be entitled to a share of the recovery if the plaintiff wins, usually expressed as a percentage. The percentages vary with the contractual schedule deployed by the finance firm and range between 15% and 75%. Normally, 20% to 50% will be due, depending on the amount of recovery or the procedural stage at which the case was finally decided or settled.²⁹

The prospective litigant will have to assign his underlying substantive claim to the finance firm as security on his contractual obligations. Provided that the assignee empowers the assignor to sue on the assigned claim in his own name via a declaration of will, German civil procedural law basically leaves the litigant's standing to sue untouched, whether or not the assignment is revealed to the adversary and the court.³⁰ A plaintiff who signs on to this type of finance agreement is normally free to choose his own attorney. The litigant will be bound by the finance contract to abide by certain standards of diligent litigation, keep the finance firm properly informed, and maintain secrecy with regard to the finance agreement and its contents. The contract will require that important litigation decisions, such as settlements, be consented to by the third-party finance firm. The plaintiff may be obliged to settle the case on certain conditions. The third-party financing firm may be entitled to terminate the finance contract if it determines that further litigation does not make sense. For example, evidence could surface that significantly diminishes the merits of the plaintiff's case, or the defendant could become insolvent. An ordinary third-party finance contract refers all disputes in connection with the agreement to arbitration.

²⁷ For a short account in English, see MURRAY & STÜRNER, *supra* note 2, at 124-25. For detailed critical legal analysis, see *Bruns Juristenzeitung* 2000, 232-241.

²⁸ MURRAY & STÜRNER, *supra* note 2, at 124.

²⁹ For a tabular overview, see *Kallenbach* 5 ANWALTSBLATT [AnwBl] 352 (353), 2010 (Ger.).

³⁰ See, e.g., Bundesgerichtshof [BGH] [Federal Court of Justice] DATE, ENTSCHEIDUNGEN DES BUNDESGERICHTSHOFES IN ZIVILSACHEN [BGHZ] 161, 161 (165) (Ger.).

III. HISTORICAL BACKGROUND AND STATUS OF DISCUSSION

A. *History of the German Ban on Contingent Fees*

The historical roots of the ban on contingent fee agreements can be traced back to Roman law.³¹ Neither the procedural representative nor the *advocatus* were allowed to contract to take a share in the recovery.³² The Germanic *Vorsprecher* who was vested with public authority in the ninth and tenth centuries apparently was not allowed to take any kind of pay. The *Schwabenspiegel*, which already provided for a form of legal aid for indigent litigants ordered by the court,³³ authorized the reimbursement of travel costs and expenses but not compensation or fees.³⁴ Medieval town laws set forth fee schedules, such as the law of Lübeck of 1240, the laws of Hamburg of 1270 (barring contractual deviation) and of 1294, the law of Regensburg of 1320, and the law of Prague of 1354.³⁵ The Council of Lyon laid down, among other things, a mandatory fee schedule for *advocati* and *procuratores* that excluded the admissibility of contractual modifications and sanctioned offences with exclusion from the legal profession.³⁶

In 1274, King Phillip of France transferred this rule for ecclesiastical cases to civil procedure. In proceedings in the *Reichskammergericht*, attorneys' compensation originally was fully amenable to contractual arrangement, but after complaints by the Estates of the Empire in 1556 about excessive fees, the *Reichsabschied* (resolution) of 1557 forbade attorneys from contracting for compensation (*Dienst- und Wartgeld*).³⁷ In 1713, the first fee schedule for proceedings in the *Reichskammergericht* was enacted regulating compensation of the *procurator*, while the fees of advocates were being taxed by the judge.³⁸ That same year, Friedrich Wilhelm I issued a fee schedule that reduced the size of fees to roughly one quarter of those that had been available before the reform.³⁹ The first uniform comprehensive fee schedule for Prussia dates back to August 23, 1815.⁴⁰ In the Rhineland, however, the "tax order" of 1807 applied, which allowed for

³¹ See Bruns *Juristenzeitung* 2000, 232-33.

³² See MAX KASER & KARL HACKL, *DAS RÖMISCHE ZIVILPROZESSRECHT* 209 (Walter Otto & Hermann Bengtson eds., 2d ed. 1996).

³³ cap. 72 § 4.

³⁴ See ADOLF WEIBLER, *GESCHICHTE DER RECHTSANWALTSCHAFT* 96-97 (1905).

³⁵ *Id.* at 56-57.

³⁶ *Id.* at 113.

³⁷ *Id.* at 131.

³⁸ *Id.* at 132.

³⁹ *Id.* at 298.

⁴⁰ WEIBLER, *supra* note 34, at 363.

negotiated compensation subject to revision by the Disciplinary Council in cases of controversies.⁴¹

In the preparatory discussion of the Draft Reich Fee Law (*Reichsgebührenordnung*), there was a clash between the model of a strictly preemptive fee schedule and the countervailing approach of negotiated attorney compensation. The Reich Fee Law of October 1, 1879, implemented a compromise by laying down a basic fee schedule with the possibility for a complementary written fee agreement.⁴² The Reich Fee Law of 1879 did not explicitly ban contingent fee arrangements, but the Reich Supreme Court (*Reichsgericht*) considered such agreements to be unethical for lawyers, immoral, and null and void.⁴³ In 1944, an explicit ban on contingent fee agreements was enacted in § 92 subs. 2 of the Reich Attorneys' Fee Law.⁴⁴ Upon the enactment of the post-war Federal Attorneys' Fee Law, the legislature decided not to adopt an explicit ban, so as to leave the issue of the enforceability of contingent fee agreements for further discussion in the courts. The draftsmen of the new Attorneys' Fee Law were convinced, however, that contingent fee agreements would be endorsed by the courts only in rare cases.⁴⁵ The professional directives for lawyers, declared unconstitutional by the Constitutional Court for lack of jurisdiction to prescribe, largely forbade contingent fees with certain exceptions.⁴⁶ The Council of Bars and Law Societies of Europe (CCBE) Code of Conduct for Lawyers in the European Union of 1988, which applies to European cross-border litigation under § 29 subs. 1 of the German Professional Conduct Law, prohibits *quota litis*-agreements, i.e., regular contingent fee arrangements, in principle but provides for exceptions if the honorarium is calculated on the basis of the amount in controversy and conforms to a formally authorized tariff (No. 3.3). The Federal Attorneys Law (*Bundesrechtsanwaltsordnung*) of 1994 had explicitly declared contingent fees inadmissible,⁴⁷ but since the Constitutional Court has decided that a general ban on contingent fees is unconstitutional, the present version refers to the limited enforceability of such agreements under the Attorneys' Fee Law.⁴⁸

⁴¹ *Id.* at 410.

⁴² *Id.* at 603.

⁴³ Reichsgericht [RG] [Federal Court of Justice] Entscheidungen des Reichsgerichts in Zivilsachen [RGZ] 115, 141-142 (graduated additional *quota litis*-honorarium); RGZ 142(70, 72) (additional 10 % *quota litis*-honorarium).

⁴⁴ [Reich Attorney's Fee Law] Apr. 21, 1944 Reichsgesetzblatt, Teil I [RGL. I] at 104, § 92, no. 2 1944.

⁴⁵ See DEUTSCHER BUNDESTAG: DRUCKSACHEN UND PROTOKOLLE [BT-Drucks.] 2/2545, at 226-27 (Ger.).

⁴⁶ See Hummel in: LINGENBERG/HUMMEL (ED.), KOMMENTAR ZU DEN GRUNDSÄTZEN DES ANWÄLTlichen STANDESRECHTS, § 52 (2d. ed. 1988).

⁴⁷ BUNDESRECHTSANWÄLTsORDNUNG [BRAO] [THE FEDERAL LAWYERS' ACT], § 49b.

⁴⁸ See *supra* Part I.C.

The historical overview reveals a tendency to subject attorney compensation to fee schedules in order to limit the amount of fees and restrict the enforceability of contingent fee agreements to circumstances where access to justice requires an exception. Interestingly, continental European attorney fee regulation law and the traditional common law doctrines prohibiting maintenance and champerty have common historical roots and are legal concepts based on the same ideas. The fourfold rationale underlying these legal policies includes excluding inappropriate economic influence on civil procedure, safeguarding the attorney's independence, balancing procedural powers, and providing access to the justice system at reasonable cost.

B. *Status of Discussion*

The Supreme Court (*Bundesgerichtshof*) basically adheres to the jurisprudence of the Reich Supreme Court (*Reichsgericht*), which declares contingent fee agreements void for immorality.⁴⁹ The main rationale behind this ban is to protect the independence of the German attorney as an “independent organ of the administration of justice,” as defined by § 1 of the Federal Attorneys Law. The independence and freedom of the legal profession is considered a material element in the effort to set boundaries on the power of the state.⁵⁰ The overwhelming majority of academic authors concur in this opinion, although there is some criticism.⁵¹ Proposals for reform have not received substantial support.⁵² The legislature has been reluctant to give leeway to the enforceability of contingent fee agreements on a broader scale. Third-party financing that transfers the contingent fee model to a situation involving three people has not yet been judicially scrutinized in court decisions. The substantial body of monographic analyses of third-party financing of civil litigation is basically supportive of the new financ-

⁴⁹ Bundesgerichtshof [BGH] [Federal Court of Justice] 22 Entscheidungen Des Bundesgerichtshofes in Zivilsachen [BGHZ]162(163)(contingency fee of an attorney from Washington D.C. admissible); 34 BGHZ 64 (71); 39 BGHZ142 (145); 51 BGHZ 290 (293f); Bundesgerichtshof [BGH] 1981 Neue Juristische Wochenschrift [NJW] 998; 1987 NJW 3203 (3204); 1990 Neue Juristische Wochenschrift – Rechtsprechungsreport 948 (949); 133 BGHZ 90 (93); 1996 NJW 2499, 2500. For decisions which have been more generous with regard to the recognition of foreign judgments enforcing contingent fee agreements see 118 BGHZ 312 (340).

⁵⁰ See MURRAY & STÜRNER, *supra* note 2, at 88.

⁵¹ See Alexander Bruns, *Das Verbot der quota litis und die erfolgshonorierte Prozessfinanzierung*, 2000 JURISTENZEITUNG 232, 234 (citations omitted).

⁵² See WOLFGANG GRUNSKY, *Empfehlen sich im Interesse einer effektiven Rechtsverwirklichung für alle Bürger Änderungen des Systems des Kosten-und Gebührenrechts?*, Gutachten A, Verhandlungen des 51. Deutschen Juristentages 5, 77 ss. (1976).

ing model on the whole.⁵³ Some scholars, however, criticize third-party financing shaped by the contingent fee model as inadmissible and void because it is immoral or illegal.⁵⁴ The main reason this minority notion exists is because of the manifest disturbance in the balance of procedural powers in German civil procedure.

IV. IMMORALITY AND NULLITY OF THIRD-PARTY FINANCING AGREEMENTS

Third-party financing agreements are unenforceable because they are immoral and against public policy as provided by § 138 subs. 1 of the German Civil Code. This is evident for three main reasons: (A) their infringement of the independence of the attorney, (B) the excessive compensation they give to attorneys, and (C) their disturbance of equal procedural powers in the German system. This section also discusses the legal consequences of nullifying third-party financing agreements and how the arbitration clauses in these agreements should be handled.

A. *Infringement on the Independence of the Plaintiff's Attorney*

A third-party financing agreement could be considered unenforceable according to § 138 subs. 1 Civil Code because it infringes on the independence of the plaintiff's attorney. As explained earlier, the Supreme Court and nearly all academic literature argue that *quota litis* attorney compensation agreements are effectively immoral because they tend to jeopardize the independence of the plaintiff's attorney as an independent organ of the administration of justice.⁵⁵ The independence of an attorney crystallizes in his duty to counsel independently and objectively,⁵⁶ and to observe the truth.⁵⁷ It appears to be a truism that the requisite critical distance of the attorney from the matter in dispute and the plaintiff may diminish with an attorney's increased economic interest in the case's outcome. From this point of view, a widespread use of contingent fee arrangements would lead to a change in the classic role allocation between the court, the attorneys, and the parties, which, depending on one's standpoint, may be welcome or rejected. However, the factual consequences of contingent fees can hardly be denied.

⁵³ See, e.g., MATTHIAS HOMBERG, ERFOLGSHONORIERTE PROZESSFINANZIERUNG 142-198 (2006); NORBERT MAUBACH, GEWERBLICHE PROZESSFINANZIERUNG GEGEN ERFOLGSBETEILIGUNG 31-68 (2002); KARSTEN STURM, ZIVILRECHTLICHE, PROZESSUALE UND ANWALTSRECHTLICHE PROBLEME DER GEWERBLICHEN PROZESSFINANZIERUNG 85-196 (2005).

⁵⁴ See Bruns, *supra* note 51, at 232, 236-38.

⁵⁵ See *supra* Part III.B.

⁵⁶ BRAO §§ 3(1), 49a(1).

⁵⁷ BRAO § 49a(3).

Clients' positive experiences with the traditional structure of German civil procedure do not suggest any need for future reform toward a contingent fee system in this area of civil procedural law.

The new model of third parties financing litigation costs, although devised as a circumvention of the German ban on *quota litis* agreements, essentially avoids balancing the plaintiff's and attorney's interests. Under an ordinary third-party financing arrangement, the lawyer will be paid what is due according to the legal compensation scheme regardless of the litigation's outcome. If, however, the plaintiff's attorney is a major shareholder in the financing corporation, ethical standards could be contravened. Especially where the plaintiff's attorney is a majority or the sole shareholder of the third-party financing firm, the attorney's independence, as envisaged by the Federal Attorneys Law and the Federal Attorneys' Fee Law, is endangered in a way that justifies the conclusion that third-party financing is immoral and unenforceable. Moreover, the independence of the plaintiff's attorney will be restricted indirectly where the plaintiff's freedom to settle the case is bound by the financing contract in that the financier's consent is made a condition precedent—settlement without the third-party financier's consent will result in a recovery claim for advanced costs from the plaintiff. The attorney's duty to give reasonable objective legal advice will then collide with strong economic considerations, making it clear that the plaintiff's attorney is influenced when a third-party financier bears the cost of litigation.

B. *Excessive Compensation*

The prohibition of *quota litis* agreements has always also served to protect the plaintiff against excessive attorney honoraria.⁵⁸ In a legal system that basically adheres to the freedom of contract, such as Germany's, the excessiveness of attorney compensation can be an argument against enforcing a contract only in exceptional circumstances.⁵⁹ In Germany, contingent fee agreements are met with considerable reservation because the attorney is typically much better qualified to assess the risks and outcomes of litigation than his client. The lawyer's superior professional skills cause unequal bargaining power between the lawyer and his client. This consideration is not at all dispelled in the case of third-party financing of litigation. This is especially questionable because of how large attorney's fees are if the plaintiff is successful.

Even in the U.S., where contingent fee arrangements have become generally accepted, the legitimacy of the attorney's contingency fee is being

⁵⁸ See *supra* Part III.A for a historical overview.

⁵⁹ Cf. Alexander Bruns, *Die Vertragsfreiheit und ihre Grenzen in Europa und den USA - Movement from Contract to Status?*, 62 *Juristenzeitung* 385, 385-93 (2007).

questioned. Contingency fees of 30%–40% are customary in civil cases in the U.S., the rates in German third-party financing agreements are even higher (50% or more), and are met with substantial doubt. Not only are contingent fee agreements much lower in the U.S., but the risk assessment in German civil cases appears to be easier because outcomes in German civil litigation are much more predictable because judges make the final decisions rather than juries. With regards to settlements, it must be taken into account that German laws on attorney compensation and allocation of litigation costs have much less influence on the litigating parties' bargaining positions. In German civil procedure, a settlement is far more likely to be negotiated in the shadow of substantive law than in the U.S., where the rules of attorney compensation, procedural cost allocation, and an imminent jury trial has a significant impact on the settlement negotiations.

Moreover, in the U.S., the plaintiff's attorney working on contingency is required to advance the costs of pretrial discovery, experts, and sometimes even the trial itself. At the beginning of the discovery process, it is often unforeseeable how much effort and cost must be invested in the plaintiff's case and how promising the case is on the merits. The monetary risk borne by a plaintiff's attorney in U.S. civil litigation is substantially higher than those borne by his or her German colleagues under German civil procedure laws. Under the German Federal Attorneys' Fee Law, the monetary risk borne by the attorney is limited and clearly predictable at the outset of litigation. Under German civil procedure, no costs of pretrial discovery accrue, which makes even 30% rates in German third-party litigation finance agreements appear excessive.

Finally, it is important to note that the plaintiff's attorney may be responsible to the plaintiff for mistakes in case management under the rules of professional liability. There is not a comparable liability risk for third-party financiers; this supports the notion that the contingent fees under German third-party financing agreements are excessive and unenforceable on grounds of immorality. The immorality of such agreements is particularly apparent when there are high contingency fees that apply to both recovery at the end of trial and settlement at an early stage of litigation.

A possible counterargument arises from the admissibility of factoring agreements. In factoring contracts, which are common and enforceable, the factor takes a certain percentage discount on a claim's nominal value as compensation for collection expenditures, financing cost, or the risk that the debtor is insolvent, all of which shift the risk of loss onto the factor. The amount which compensates for collecting the debt and financing the face value ranges between 0.2% and 1.2%. However, if the factor takes the debtor's risk of insolvency as well—so-called "echtes Factoring"—the compensation normally ranges between 10% and 20% of the claim's nomi-

nal value.⁶⁰ Thus, a third-party financing agreement is different from a factoring contract because the third-party financier does not assume the risk of loss of the claim's face value, but only the risk of losing the advanced litigation costs, which are comparably low in German civil procedure. A factor receiving compensation of 10%–20% of the litigation cost could appear reasonable. However, 10%–20% of the amount in controversy does not appear reasonable. Considering that the third-party financier normally is entitled to a thorough screening of the case's merits and the debtor's financial status, the adequate compensation for such a financier should be even lower than the 10%–20% received by a factor. Hence, comparing third-party financing agreements with factoring agreements strongly supports the notion that third-party contingent fee agreements providing for a higher compensation than 10%–20% of the litigation cost are immoral and should not be enforced. The excessiveness of the contingent fee is only one argument that supports the view that third-party financing contracts are null and void. More modest percentages could be reconcilable with a policy that protects plaintiffs' access to the litigation system unless such third-party financing arrangements are unenforceable on other grounds.

C. *Disturbance of Equal Procedural Powers*

The central argument against enforcing third-party financing contracts flows from the equal procedural powers in the German system. The rule of mutual cost shifting to the losing party⁶¹ is a basic way to make certain that the parties in litigation have equal procedural powers. In German civil procedure, the plaintiff and defendant bear roughly equivalent cost risks at the outset, unlike the American rules concerning costs and possible insurance coverage. At its core, equal procedural power embodies the German constitutional guarantee of equal protection.⁶² This equilibrium of procedural economy and procedural psychology is severely disturbed by third-party litigation cost financing arrangements because they free the plaintiff from the intrinsic cost risk of civil litigation while leaving the defendant with no chance to secure comparable third-party financing support.⁶³ If the defendant wants to litigate without cost risk, he or she needs insurance coverage,

⁶⁰ See, e.g., MICHAEL MARTINEK, *MODERNE VERTRAGSTYPEN: BAND I: LEASING UND FACTORING* § 9, at 225-26 (1991).

⁶¹ ZPO § 91.

⁶² See Alexander Bruns, *Der Zivilprozess zwischen Rechtsschutzgewährleistung und Effizienz*, 124 *ZEITSCHRIFT FÜR ZIVILPROZESS* 29, 36-37 (2011); see also Art. III subs. 1 Constitution.

⁶³ A similar observation can be made with regard to civil litigation in the U.S., cf. Shepherd Bailey, draft at D., pp. 25-27. But see JÜRGEN JASKOLLA, *PROZESSFINANZIERUNG GEGEN ERFOLGSBETEILIGUNG* 132, 135 (2004); NORBERT MAUBACH, *GEWERBLICHE PROZESSFINANZIERUNG GEGEN ERFOLGSBETEILIGUNG* 65-68 (2002); KARSTEN STURM, *ZIVILRECHTLICHE, PROZESSUALE UND ANWALTSRECHTLICHE PROBLEME DER GEWERBLICHEN PROZESSFINANZIERUNG* 87, 94 (2005).

which he or she cannot contract for after the dispute emerges. If the plaintiff is afforded the possibility to use a third-party financier after a controversy has developed, the uninsured defendant will be without similar protection. Thus, third-party financing tends to push individuals toward purchasing legal cost insurance. This result does not seem to be at all desirable.

Interestingly, the English Law Society instituted After-the-Event Insurance (AEI) that covers the opposing party's expenses and attorney's fees, but not the contracting party's own litigation costs.⁶⁴ If it were available for the defendant, AEI could reduce but not completely remedy the imbalance of procedural powers that would be created by third-party litigation cost agreements. However, AEI is practically unavailable in the German insurance market. Even in the U.S., AEI does not seem to be used on a broad scale.⁶⁵ One reason could be a dearth of individuals interested in AEI, which caused unaffordable insurance premiums. Insurability is often an adequate test for reasonableness and basic justice, and the unavailability of affordable insurance coverage can be perceived as an indicator of unreasonableness and injustice.

Thinking about a cure for the defendant's serious difficulties leads to a cross-check: what if third-party financing of the defendant's litigation costs was analogous to that available to the plaintiff? Such a contract would unburden the defendant from all litigation costs in the event of defeat if he pays 30%–50% of the amount in controversy to the third-party financier. Therefore, a defendant either pays everything to the plaintiff or up to 50% to the financier. Such an arrangement not only appears to be quite unattractive to a defendant, but could even be considered outrageous because the defendant seems bound to pay half of the amount in controversy regardless of the merits of the plaintiff's claim. This cross-check reveals a basic shortcoming of third-party financing of civil litigation that cannot be overcome. Because the enforceability of third-party financing agreements depends on which side of the litigation is being scrutinized, the entire third-party financing regime is questionable. Based on the assumption that both parties are effectively given the same procedural rights and held to the same procedural standards, a third-party financing contract under German law is considered unenforceable.

It is unlikely that the negative consequences of the contingent fee model and third-party financing could be outweighed by advantages inherent to the U.S. contingent fee and third-party financing model. Some authors see the high settlement rates in American civil cases as significant

⁶⁴ See Petra Schaaff, *Das Conditional Fee – Einführung des Erfolgshonorars im englischen Prozeßrecht*, *Anwaltsblatt* 1997, at 169-70.

⁶⁵ See CHARLES W. WOLFRAM, *MODERN LEGAL ETHICS* § 9.4.1, at 527 (1986).

advantage of the U.S. model of litigation cost allocation.⁶⁶ However, one should be aware that many problems in American civil litigation are also connected to the system's rules of cost allocation. The American plaintiff may litigate on a contingent fee basis without any cost risk, whereas the defendant must pay his attorney by the hour from the commencement of proceedings. As a consequence, especially at the disclosure and pretrial discovery phases of litigation, the defendant is faced with the disadvantageous and painful alternatives of either giving way to the plaintiff and settling regardless of the merits of the plaintiff's case or paying his attorney on an hourly basis.⁶⁷ This reality casts a shadow on the high settlement rates of litigation in American federal and state courts. Notably, incentives resulting in high settlement rates are not only technical instruments that relieve the judiciary from a substantial portion of the caseload, but also alter the nature and purpose of civil procedure.⁶⁸ Against this background, the German legislature would not be well advised to introduce third-party financing of civil litigation to the system of civil procedural law.

D. *Legal Consequences of the Nullity of the Third-Party Financing Contract*

Since third-party financing contracts are null,⁶⁹ the contractual stipulations in such an agreement are unenforceable. There will be no automatic reduction of the fee to a reasonable percentage⁷⁰ because the attorneys' compensation fee scheme does not apply to the third-party financing of civil litigation.⁷¹ A reduced percentage would allow the plaintiff to disturb the equality of procedural powers at a lower price and thus would not be an adequate remedy. Payments made by the financier under the third-party financing agreement are not recoverable as unjust enrichment because the financier has acted immorally and therefore will be barred from recovery.⁷² Under the law of unjust enrichment, a payment made by the defendant directly to the financier could be recovered by the plaintiff, as well as a payment made by the plaintiff.⁷³

⁶⁶ See, e.g., Samuel Gross, *The American Advantage: The Value of Inefficient Litigation*, 85 MICH. L. REV., 734, 752 ss. (1987).

⁶⁷ For a German perspective, see Rolf Stürmer, *Modellregeln für den internationalen Zivilprozeß? – Zum Stand eines gemeinsamen Vorhabens des American Law Institute und des Institut International pour l'Unification du Droit Privé (Unidroit)*, 112 ZEITSCHRIFT FÜR ZIVILPROZESS 185, 188 ss. (1999).

⁶⁸ See also *infra* Part VII.A.

⁶⁹ BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], § 138(1).

⁷⁰ 44 BGHZ 158, 162 (Ger.); 68 BGHZ 204, 207 (Ger.).

⁷¹ See Alexander Bruns, *Das Verbot der quota litis und die erfolgshonorierte Prozessfinanzierung*, 2000 JURISTENZEITUNG 232, 238 (citations omitted).

⁷² BGB, § 817(2).

⁷³ See Bruns, *supra* note 71.

E. *Unenforceability of Arbitration Clauses in Third-Party Financing Contracts*

Referring controversies connected to third-party financing contracts to arbitration raises the issue of whether such arbitration clauses are enforceable. The prevailing opinion among the courts and the academic literature is that an arbitration clause can be unenforceable on grounds of immorality.⁷⁴ The same reasons underlying the notion that third-party financing contracts are immoral and unenforceable also support the view that corresponding arbitration clauses are immoral and unenforceable. If third-party financing agreements manifestly disturb the equality of the parties' procedural powers in civil litigation, it would not be justifiable to bar the plaintiff from seeking recovery in court proceedings. Likewise, the third-party financier should not be allowed to resort to arbitration regarding his purported claim for compensation. Otherwise, the strong public policies protecting plaintiffs against excessive attorney compensation and unequal procedural powers could be undermined. Refusing to enforce arbitration clauses in third-party financing contracts conforms to public policy and appears to be the appropriate remedy.

V. LAW GOVERNING PROFESSIONAL CONDUCT AND LIABILITY

A. *Professional Conduct*

An attorney is obliged under the Federal Attorneys Law to practice conscientious professional conduct and prove himself or herself to be worthy of the respect and confidence that are required by his or her position as an independent organ of the administration of justice.⁷⁵ An attorney's breach of a retainer agreement usually results in damages, not in sanctions for professional misconduct. However, the prevailing view is that the attorney infringes standards of professional conduct if, for example, he or she enters into immoral contracts or harms others in an immoral way, because such behaviour is detrimental to the legal profession's reputation.⁷⁶ The pivotal question is whether an attorney violates standards of professional conduct when he or she advises his or her client to enter into an immoral third-party litigation cost financing agreement that will cover his or her own

⁷⁴ See, e.g., BGH Zeitschrift für Schiedsverfahren 2009, 247; Hartmann in: ADOLF BAUMBACH ET AL., ZIVILPROZESSORDNUNG § 1029 No. 17 (69th ed. 2011); Voit in: HANS-JOACHIM MUSIELAK, KOMMENTAR ZUR ZIVILPROZESSORDNUNG § 1029 No. 10 (6th ed. 2008).

⁷⁵ BRAO § 43(1).

⁷⁶ See, e.g., PRÜTTING IN: PRÜTTING/HENSLER (ED.), BUNDESRECHTSANWALTSORDNUNG § 43 No. 29 (3d ed. 2010); FEUERICH IN: FEURICH/WEILAND/VOSSEBUERGER, BUNDESRECHTSANWALTSORDNUNG § 43 No. 19 (7th ed. 2008).

claim for compensation. If the immorality of the agreement is evident, as will normally be the case, a convincing argument can be made that the attorney's behavior is impermissible under the law of professional conduct. Moreover, such behavior can be seen as a violation of the legal standards of professional conduct if the attorney who is paid with a third-party financier's money is a partner or shareholder of the financing company, as he or she participates in the excessive compensation that will be paid by the plaintiff. The attorney's economic interest in the outcome of litigation is irreconcilable with the rationale underlying the § 43b subs. 2 Federal Attorneys Law prohibiting contingent fees.

B. *Professional Liability*

A plaintiff's attorney who advised his or her client to enter into a third-party financing agreement may be liable for any damages incurred by his or her client for either a committed tort⁷⁷ or breached contract.⁷⁸ The loss could be seen in the money paid to the financier, especially if the amount is not recoverable from him or her, and, depending on the individual circumstances, could also be the cost of arbitral proceedings against the financier. If the attorney's advice caused the client to negligently enter into the third-party financing contract, the client may have a meritorious damages case against his or her attorney. Causation will depend on whether the law finds that the financing contract was formed because of the client's free and independent decision. In earlier days, courts found causation only if the decision of the contracting party was provoked by the defendant.⁷⁹ This causation requirement will rarely be met with respect to third-party financing agreements. More recently, however, the courts have become less strict, and it may suffice if the plaintiff's assent to the financing agreement was "justified" by considering his attorney's advice,⁸⁰ or if it was "no extraordinary or entirely inappropriate reaction" to the advice.⁸¹ It is not unlikely that courts will find that the more lenient standard of causation is met in the third-party financing context. Depending on the circumstances, the attorney's professional liability could, but need not, be mitigated on grounds of the plaintiff's comparative negligence.⁸²

⁷⁷ BGB § 826.

⁷⁸ BGB § 280.

⁷⁹ *E.g.*, BGH Neue Juristische Wochenschrift 1990, 2885; 1987, 2925 s.

⁸⁰ *Cf.* BGHZ 101, 215, 219 ss.; BGH Neue Juristische Wochenschrift 1988, 1262, 1263; 1990, 2882, 2883.

⁸¹ *Cf.* BGH Neue Juristische Wochenschrift 1993, 1139, 1141; 1997, 250, 253.

⁸² BGB § 254(1).

VI. UNFAIR COMPETITION LAW

Moreover, third-party financing of civil litigation could be challenged under §§ 1 and 3 Unfair Competition Law.⁸³ Courts and academic authors agree that immoral business conduct qualifies as “unfair” within the meaning of German unfair competition law.⁸⁴ If third-party financing were considered immoral in the sense of § 138 subs. 1 Civil Code, unfairness under competition law is obvious. A business entity that offers a third-party financing model based on immoral and unenforceable financing contracts runs the risk of being liable for unfair competition. Standing to bring an action for a permanent injunction prohibiting unfair business conduct is given not only to competitors, but also to societies that foster fair competition, chambers of commerce, and other qualified entities.⁸⁵ Such societies, entities, and chambers of commerce may significantly contribute to the effectiveness of the ban on unfair third-party financing, although no published court decision currently enjoins a third-party financier from conducting his or her business.

VII. CONSUMER CREDIT AND BANKING LAW

A. *Third-Party Financing Contracts and Consumer Credit Law*

A third-party litigation cost financing agreement is similar to a credit transaction. The financier advances the cost of litigation, and if the plaintiff is successful, the financier gets his or her money back plus substantial additional compensation. If the third-party financing contract qualifies as a loan, it would be subject to a consumer credit law⁸⁶ that implements Directive 2008/48/EC of the European Parliament and the Council of April 23, 2008, on credit agreements for consumers and repeals Council Directive 87/102/EEC,⁸⁷ provided the plaintiff acts as a consumer. The majority of

⁸³ GESETZ GEGEN DEN UNLAUTEREN WETTBEWERB [UWG] [LAW AGAINST UNFAIR COMPETITION], BGBl. I 2010, p. 254.

⁸⁴ RGZ 115, 319, 325 f.; 166, 315, 319 s.; BGHZ 109, 153, 162 s.; 110, 278, 289 ss.; 120, 320, 324; Schönemann in: HENNING HARTE-BAVENDAMM ET AL. (ED.), GESETZ GEGEN DEN UNLAUTEREN WETTBEWERB § 3 No. 114 (2d ed. 2009); Sosnitza in: HENNING PIPER ET AL. (ED.), GESETZ GEGEN DEN UNLAUTEREN WETTBEWERB § 3 No. 10, 13 (5th ed. 2010); Köhler in: HELMUT KÖHLER & JOACHIM BORNKAMM (ED.), UWG § 3 No. 100, 43 ss. (29th ed. 2011).

⁸⁵ UWG § 8(3).

⁸⁶ BGB §§ 491–509.

⁸⁷ 2008 O.J. (L 133) 66.

authors tend to reject the notion that third-party financing is a loan.⁸⁸ Their view is, to some extent, supported by a 1999 decision of the Banking Regulatory Authority that declared a banking licence unnecessary for a third-party financier.⁸⁹ The main argument for denying that a third-party financing contract is a loan is that the plaintiff is not obliged to pay back the litigation costs advanced by the financier in case of defeat. This argument, however, is not very persuasive.

In medieval Italy, a special kind of loan arrangement was used to finance extremely risky merchant shipping. A financier advanced the costs of goods and the ship's equipment and in return was repaid the capital plus a substantial compensation that was higher than the ordinary interest rate. However, the capital and compensation were due only if the cruise was successful—if the ship sank, the merchant borrower was under no obligation to repay anything.⁹⁰ A special form of such maritime loan agreements is called bottomry (*Bodmerei*), which Black's Law Dictionary describes as:

[A] contract by which the owner of a ship borrows for the use, equipment, or repair of the vessel, and for a definite term, and pledges the ship (or the keel or bottom of the ship, *pars pro toto*) as security; it being stipulated that if the ship be lost in the specific voyage, or during the limited time, by any of the perils enumerated, the lender shall lose his money.⁹¹

It is generally accepted among legal historians that bottomry and the described maritime loans were loan agreements in nature, and maritime loans conflicted with medieval canonical usury laws that forbade taking interest in excess of certain rates. The similarity of third-party financing agreements and bottomry is striking—civil litigation as a maritime cruise. This is not to say that a German proverb that likens risks in courts to risks on the high seas is true.⁹² However, the different purposes of third-party financing contracts neither necessitate nor justify a different legal qualification of the business transaction. Hence, it is plausible that a third-party financing contract can be viewed as nothing but a special kind of loan agreement.⁹³

Accordingly, if the plaintiff acts as a consumer, consumer credit law applies to the third-party financing agreement. This is all the more correct because the applicability of consumer credit law in full compliance with EC Consumer Credit Directive 2008 is not strictly limited to loans in a techni-

⁸⁸ See, e.g., STURM, *supra* note 63, at 64, 65; MAUBACH, *supra* note 53, at 76-79; JASKOLLA, *supra* note 63, at 47-50; MATTHIAS HOMBERG, ERFOLGSHONORIERTE PROZESSFINANZIERUNG 61-64 (2006).

⁸⁹ Cf. Ströbel, 1999 BRAK-MITTEILUNGEN 205 ss.

⁹⁰ See ALEXANDER BRUNS, HAFTUNGSBESCHRÄNKUNG UND MINDESTHAFTUNG 31-32 (2003).

⁹¹ BLACK'S LAW DICTIONARY, 186 (6th ed. 1990).

⁹² The proverb says: "Vor Gericht und auf hoher See ist man in Gottes Hand."

⁹³ E.g., STEPHAN ANDREAS ROCHON, DIE ERFOLGSHONORIERTE PROZESSFINANZIERUNG UND IHRE AUSWIRKUNGEN FÜR DEN RECHTSANWALT 68-92 (2003).

cal sense, but also extends to other similar financial accommodations.⁹⁴ As a consequence, the third-party financing agreement is null and void if, as is nearly always the case, the information required by consumer credit law is not passed on to the consumer-plaintiff.⁹⁵ The contract becomes enforceable if, and to the extent that, the borrower—or his or her attorney—has received the money from the financier,⁹⁶ but the interest will be reduced to the legal interest rate, i.e., 4% per year.⁹⁷ Moreover, the consumer-plaintiff will be entitled to a right of withdrawal.⁹⁸ The applicability of consumer credit law has serious consequences for the enforceability of third-party financing agreements and the corresponding high compensation rates that are especially attractive to financial investors.

B. *Divergence of Aims of Civil Procedural Law and Economic Analysis*

At the outset, it should be noted that there is a significant divergence between the aims of civil procedure law and economic analysis.⁹⁹ Civil procedure law sets the legal framework for litigating claims and the rights litigants are entitled to under substantive law. Civil procedure law is a set of legal rules that serve the end of implementing substantive law. Thus, German civil procedure law differs to some extent from American civil procedure law in that German procedure law's primary purpose is the enforcement of claims and rights under substantive law. However, in the U.S., the litigation system can be perceived primarily as a dispute resolution mechanism because, in practice, the judicial decision of a case is the exception and settlement is the rule. This difference in civil procedure culture becomes even more visible if the ratio of jury verdicts and overall caseload in the system is considered. Regardless of the exact purposes of civil procedure law in the respective litigation systems, it cannot be overlooked that the economic analysis of civil procedure law has quite different standards and aims.

Economic analysis seeks to maximize wealth and efficiently allocate resources. Economic analysis may afford valuable insights and contribute substantially to the analysis of the effects of third-party litigation financing.

⁹⁴ See, e.g., BGB § 506 Art. 3(c); Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on Credit Agreements for Consumers and Repealing Council Directive 87/102/EEC, 2008 O.J. (L 133) 66.

⁹⁵ BGB § 494(1).

⁹⁶ BGB § 494(2).

⁹⁷ BGB § 246.

⁹⁸ BGB §§ 495, 506; Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on Credit Agreements for Consumers and Repealing Council Directive 87/102/EEC, 2008 O.J. (L 133) 66, 79, Art. 14.

⁹⁹ For a recent general analysis in German, see Alexander Bruns, *Der Zivilprozess zwischen Rechtsschutzgewährleistung und Effizienz*, 124 *Zeitschrift für Zivilprozess*, 29-44 (2011).

However, such analysis cannot independently answer the question of whether third-party financing should be admissible in a given legal system or define how the legal standards for third-party financing should be properly set. Legal analysis should account for economic analysis, but ultimately an independent legal judgment will be necessary to assess the admissibility of third-party financing in a procedural system.

C. *Facilitating Access to Justice by Third-Party Financing?*

Especially in Europe, it is often said that third-party financing facilitates access to justice.¹⁰⁰ The access to justice debate must be seen against the background of Art. 6(1) of the European Convention on Human Rights which provides, as does the German Constitution, a right of access to civil litigation.¹⁰¹ At first glance, one could think that third-party financing facilitates access to justice because it makes it easier or even affordable for the plaintiff to litigate his or her case. This consideration motivated the German Constitutional Court to hold that an outright ban on contingency fees is unconstitutional.¹⁰² However, the American argument that third-party financing facilitates access to justice is questionable when high settlement rates in civil matters are considered: a settlement is not justice. In the German civil procedure system, third-party financing is one of many sources for funding civil litigation, so the access to justice argument is valid, if at all, only in exceptional circumstances.

Moreover, a third-party financier will be entitled to much of a winning plaintiff's claim. This immediate loss, which ranges from 15%–75% of the claim's face value, is so substantial that it manifestly interferes with the plaintiff's access to justice. A civil procedural system that endorses U.S.-style contingency fees on a broader scale will probably be more prone to accepting similar third-party financing of civil litigation than a regime of basic equality of cost risk, which is prevalent in German civil procedure law.

¹⁰⁰ Cf. Michael Faure & Jef De Mot, *Comparing Third Party Financing of Litigation and Legal Expenses Insurance*, 8 J.L. ECON. & POL'Y 743, 769-77 (2012); Joanna M. Shepherd, *Idea Versus Reality in Third-Party Litigation Financing*, 8 J.L. ECON. & POL'Y 593, 596-99 (2012).

¹⁰¹ Council of Europe, *The European Convention on Human Rights*, Art. 6(1) ("In the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. Judgement shall be pronounced publicly by the press and public may be excluded from all or part of the trial in the interest of morals, public order or national security in a democratic society, where the interests of juveniles or the protection of the private life of the parties so require, or the extent strictly necessary in the opinion of the court in special circumstances where publicity would prejudice the interests of justice.").

¹⁰² See *supra* Part I.C.

The argument that without third-party financing there could be no access to the litigation system falls short if the German Constitution or the European Convention on Human Rights demands access at a lower cost. The fact that the cost of civil litigation in Europe is relatively low supports the notion that both constitutional and human rights law call for access to the judiciary at lower cost than under normal third-party financing contracts. High third-party financing compensation rates of 30%–50% are particularly questionable for indigent litigants who are in desperate need of funds. It is not convincing that the constitutional right to access justice means third-party financing is required when these financiers take 30%–50% of an indigent person's meritorious award.

Finally, regarding the third-party financing of commercial litigation, the access to justice argument has little or no merit.¹⁰³ Under German law, it is quite questionable whether it is sound business judgment for a corporation's board of directors to use third-party financing when the decision to do so may result in liability for the directors. The argument that third-party financing of civil litigation facilitates access to justice is not persuasive.

D. *Curing Shortcomings of Civil Procedural Law by Financial Market Instruments?*

A central question to be answered is whether it is advisable to try to cure the shortcomings of civil procedure law with financial market instruments. Why should third-party financing not be used as a cure of prohibitive legal cost? Is it preferable to put more money in the litigation system to strengthen the plaintiff's bargaining power if the legislature is unwilling or unable to provide an effective remedy? First, it seems reasonable to assume that any problems caused by civil procedure law can best be solved by a change of civil procedure law. Second, as can be inferred from the conflict between the purpose of civil procedure law and economic analysis of the litigation system, the aims and purposes of civil procedure and financial investment are different, so the assumption that the instruments deployed in the financial market are compatible with the needs of a well-designed civil justice system is not plausible. Third, bearing in mind the world financial crisis that has focused attention on the shortcomings and problems of the financial market, it is difficult to assume that the financial market is better suited to remedy a deficient civil justice system. Overall, it is unlikely that the instruments of the financial markets are apt to cure the weaknesses and shortcomings of civil procedure law. If the high costs of litigation make the pursuit of individual rights unaffordable, then why not cut costs? If litigation costs cannot be reduced, why not consider legal aid schemes that provide for affordable loans? And, if pre-trial discovery is too

¹⁰³ See Shepherd, *supra* note 100, at 599-610.

expensive, then why not restrict it to facts relevant for the adjudication of the controversy? These questions need to be answered with substantive reforms instead of trying to cure the shortcomings of civil procedure law with unsuitable measures. Third-party financing of litigation is certainly not the answer to the flaws and dissatisfaction with contemporary civil procedure law.

SUMMARY

1. The historical genesis of German litigation costs shows a clear tendency to subject attorney compensation to fee schedules that limit attorney's fees and restrict the enforceability of contingent fee agreements to circumstances where access to the litigation system requires an exception. English and U.S. laws on maintenance and champerty are rooted in Roman law (*champ parti*"—*campi partitio*) and are supported by a fourfold rationale: the security of an attorney's independence, the equality of the litigating parties' procedural powers, the accessibility of the justice system at reasonable cost, and the exclusion of inappropriate economic influence on civil procedure. In this regard, German litigation cost law and common law are grounded on the same basic ideas.

2. Third-party financing contracts are unenforceable under German law because they are immoral despite leaving the independence of the plaintiff's attorney intact. Such agreements contravene the public policy of equal allocation of cost risk in civil litigation and manifestly disturb the equality of procedural powers because only the plaintiff has a means to shift the cost risk to a third party. The plaintiff and the defendant should bear equal cost risks; everybody has basically the same chance to buy legal cost insurance before a controversy originates.

3. The compensation of 30%–50% normally due under typical third-party financing contracts in Germany is clearly excessive. This excessiveness is an additional reason why third-party financing agreements are immoral and unenforceable under German law.

4. German professional conduct law prohibits attorneys from encouraging their clients to enter into an immoral and unenforceable third-party financing contract. It is also inadmissible for an attorney to become a partner or a shareholder of a third-party financier that is funding a client that he represents. Moreover, the attorney may be exposed to professional liability if he or she encouraged his or her client to use third-party financing to cover his or her litigation costs.

5. Third-party financing contracts are like medieval maritime loans and bottomry agreements and should be qualified as a special kind of loan. Therefore, they have to comport with German Consumer Credit Law and the EC Directive on Credit Agreements, which obliges EC members to enact legislation that implements the European standard of consumer protec-

tion. Furthermore, the nature of third-party financing as a credit transaction should subject third-party financiers to banking regulatory law.

6. Despite differences between civil procedure systems, there is common ground for discussion and evaluation of third-party financing of litigation cost. The legal analysis should avail itself of the findings of economic analysis of civil procedure law, but ultimately an independent legal judgment on third-party financing should be made. The argument that third-party financing facilitates access to justice is not convincing. In Germany, constitutional law demands affordable access to litigation and the rates of compensation in third-party financing agreements are excessive. In the U.S., corporate plaintiffs do not have a problem with access to justice but seek to outsource the risk of litigation. Consequently, in the U.S., individual, non-corporate plaintiffs will most likely settle and not proceed to trial.

7. Shortcomings and flaws in civil procedure law cannot and should not be cured by financial markets, but rather should be remedied through civil procedure reform. The influence of financial markets on civil litigation systems should not increase because these financial institutions caused the world financial crisis that originated in the U.S. Third-party financing of civil litigation is not an appropriate remedy for defective civil procedure laws, should not be seen as an improvement of the civil justice system, and at least in Germany, must be qualified as an immoral investment.

FUNDING OF MASS DISPUTES: LESSONS FROM THE NETHERLANDS

*Professor Dr. Ianika N. Tzankova**

For a long time, the topic of costs and financing of litigation has had a second-rung status in civil law (continental) academic literature, at least in the Netherlands. Although in academic legal writing it has been acknowledged that financing is an essential precondition for the proper functioning of any legal system and one of the pillars of access to justice, most academic studies have focused on the material aspects of the functioning of civil law. In contrast, common law legal systems have traditionally and consistently integrated the influence of financial incentives on the functioning of the law into academic writing. This seems to be a difference not just in academic styles and traditions, but also in legislation and in the attitude of the judiciary in day-to-day legal practice.

This paper will focus on (1) the funding of mass claim disputes in the Dutch legal system as an aspect of the civil law family and (2) will seek to explore whether the Dutch legal system has adequate mechanisms in place to secure access to litigation funding in mass claim disputes. To address the research question, the functioning of the main litigation funding options in the Netherlands will be assessed in the context of the *Dexia* case. The main litigation funding options in the Netherlands include Legal Aid funding, before-the-event legal expense insurance (LEI), and a relatively new development in the funding of mass disputes: after-the-event third-party funding (TPF).

This paper aims to enhance awareness of the functioning of Legal Aid funding and LEI in mass disputes in a European (Dutch) context and the implications of the development of third-party funding of mass claim disputes in the Netherlands.

The function and significance of litigation funding in the context of mass disputes is being influenced by the principle of party autonomy and its

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This paper partly builds on the results of case studies conducted in an international collaborative empirical project led by Professors Deborah R. Hensler (Stanford University/Tilburg University), Christopher Hodges (Oxford Center for Socio Legal Studies/Erasmus University), and Ianika N. Tzankova (Tilburg University), examining the functioning of class or group litigation schemes in various countries. Final results of the case studies were presented at the annual Law and Society Conference in Honolulu, Hawaii, in June 2012.

exponents—the free choice of legal counsel and the right to determine one’s litigation strategy. The *Dexia* case study illustrates that applying those principles mechanically serves as an obstacle for the adequate funding of mass disputes through Legal Aid. Case law out of the European Court of Justice which builds on the principle of free choice of legal counsel could have a similar impact on LEI and be disadvantageous for the business model of LEI providers, but to date, that possibility has not been the case in the Netherlands because of the institutional environment in which Dutch LEI providers operate.

Redefining the meaning of party autonomy and free choice of legal counsel, or simply limiting the impact of those concepts in the context of mass disputes will provide only a partial improvement in the funding of mass disputes under the currently available funding mechanisms. Even when they are properly framed, Legal Aid schemes and LEI can function as a funding option primarily in national consumer related matters as a result of institutional and market restraints. Without additional coordination of efforts at the national and supranational level, there will be a deficit in the funding of mass disputes in the remaining types of cases: international consumer and non-consumer mass disputes.

To secure access to justice in these two categories of mass disputes, alternative funding options such as third-party financing will remain necessary and will become increasingly available. The Dutch legal tradition and litigation landscape is advantageous for the business model of third-party litigation financiers. The emerging practice in Europe already proves that there is a need and a market for that type of funding, despite dogmatic and ethical objections that some legal scholars have put forward in surrounding jurisdictions. Although the practices and business models of third-party financiers vary considerably, there seems to be a general consensus between opponents and proponents of third-party financing that it should be regulated; however, their opinions on the scale and intensity of regulation vary. Regulation has even greater significance in legal systems, like the Dutch system, where the legislature and the judiciary traditionally have been less focused on the influence of financial incentives on litigation dynamics. However, regulation of third-party funding should be carefully considered and should take into account the differences in practices and business models of third-party financiers. The nature and intensity of regulation might also differ depending on the type of client—whether the client is a business or consumer.

I. LEGAL WRITING ON COSTS AND FINANCING OF LITIGATION

A. *Background*

For a long time the topic of costs and financing of litigation has had second-rung status in civil law continental academic literature, at least in the Netherlands. Many legal scholars still view the law of civil procedure as subordinate to material civil law,¹ and somehow of lesser importance. This might explain why academic writing about costs of financing litigation, as part of civil procedure, has been limited and underdeveloped for a long time, although it has been acknowledged that financing is an essential precondition for the proper functioning of any legal system and one of the pillars of access to justice.² Academic studies on the influence of finance on litigation dynamics was limited to dogmatic studies of cost-shifting rules and discussions about the need for more resources to be made available through Legal Aid funding to meet the needs of those with lower incomes. Costs and funding issues were mainly interesting to the legal profession but not legal scholars because this topic was considered practical and less intellectually challenging than other legal issues.³ Comprehensive and sophisticated analyses about the influence of financial incentives on the behavior of litigants and their agents or the courts were generally lacking, at least in the Netherlands until recently. Whereas it became more and more evident that the legal profession is no longer exclusively an *officium nobile*, but also a profit-driven business like many others. It is generally still considered inappropriate to suggest that economic models apply to judicial matters or that the courts are managerial entities suffering from systemic risks and operating under the influence of financial incentives like any other agent or economic actor. A recent empirical study confirms what has been sus-

¹ For an overview of contemporary legal research about the purpose and role of civil procedure see Ianika Tzankova & Martin Gramatikov, *A Critical Note on Two EU Principles: Proceduralist View on the Draft Common Frame of Reference*, in *THE FOUNDATION OF EUROPEAN PRIVATE LAW* 421 (Roger Brownsword et al. eds., Hart Publishing 2011).

² MAURO CAPPELLETTI & BRYANT GARTH, *ACCESS TO JUSTICE: A WORLD SURVEY* 1 (1978); Roderick Macdonald, *Access to Justice in 2003-Scope, Scale, Ambitions*, in *ACCESS TO JUSTICE FOR A NEW CENTURY: THE WAY FORWARD* 2, 11-17 (Julia Bass et al. eds., 2005); CHRISTINE PARKER, *JUST LAWYERS: REGULATION AND ACCESS TO JUSTICE* 32-35 (1999).

³ For example, the Dutch Association for Procedural Law was founded in 1979 and its purpose “is the study and dissemination of knowledge on issues of civil and administrative litigation and judicial organization of national or international context both in practice and in theory.” *Over* (About), NEDERLANDSE VERENIGING VOOR PROCESRECHT (THE DUTCH ASSOCIATION FOR PROCEDURAL LAW), <http://www.nvvprocesrecht.nl/over/> (last visited June 4, 2012). The Dutch Association for Procedural Law also initiated two publications about the costs of civil procedure in 1992 and 2007. *Publicaties* (Publications), THE DUTCH ASSOCIATION FOR PROCEDURAL LAW, <http://www.nvvprocesrecht.nl/publicaties/> (last visited June 4, 2012). See also Mark Tuil, *The Netherlands*, in *THE COSTS AND FUNDING OF CIVIL LITIGATION* 401 (Christopher Hodges et al. eds., 2010).

pected for years; Dutch courts appear not to experience significant difficulties when they rule on liability and damages, nor when they rule on matters laying far beyond their expertise.⁴ Overall Dutch judges seem to feel uncomfortable and hesitate when they must invoke financial incentives and sanction parties for their conduct in the course of the litigation.⁵ Presumably, this is not an example of Dutch exceptionalism, but rather a feature of the judiciary system in civil law jurisdictions. The first Dutch studies that took a broader perspective on the influence of financial incentives on civil litigation and the behavior of litigants are relatively recent and oriented to law and economics.⁶

In contrast, common law legal systems seem to have traditionally and more consistently integrated the influence of financial incentives on civil procedure in academic writing and case law.⁷ One could summarize the different attitudes towards costs and funding as *civil law legal idealism and dogmatism* versus *common law legal realism and pragmatism*. These two schools of thought seem to differ not just in academic styles and legal tradition, but also in the way they are reflected in legislation and in the attitude of the judiciary. For example, costs and funding were one of the main is-

⁴ This view has been criticized in the academic literature. See, e.g., WILLEM VAN BOOM & MATTHIAS BORGERS, *DE REKENENDE RECHTER: VAN "IUDEX NON CALCULAT" NAAR ACTIEVE CIJFERAAR?* (Boom Juridische Uitgevers 2004); Gerdineke de Groot, *HET DESKUNDIGENADVIES IN DE CIVIELE PROCEDURE* (Wolters Kluwer 2008).

⁵ Paul Sluiter has explored the matter empirically in his dissertation, for which he interviewed Dutch judges. PAUL SLUIJTER, *STUREN MET PROCESKOSTEN: WIE BETAALT DE PRIJS VAN STOREND PROCESGEDRAG* (Wolters Kluwer 2011). For many years Dutch law of civil procedure knew a statutory provision—*eigen beursje*—that made it possible to order the lawyer, as opposed to the client, to pay the other party's attorneys' fees if the court believed that the lawyer misbehaved and inadequately represented his client's interests in the case. *Id.* The provision (Art. 58 RV) was rarely used by the courts and was eventually abandoned. *Id.*

⁶ See, e.g., Maurits Barendrecht, *Legal Aid, Accessible Courts or Legal Information? Three Access to Justice Strategies Compared*, GLOBAL JURIST, Jan. 2011, at 1, 1-3; Maurits Barendrecht & Berend de Vries, *Fitting the Forum to the Fuss with Sticky Defaults: Failure in the Market for Dispute Resolution Services?*, 7 CARDOZO J. CONFLICT RESOL. 83, 83-84 (2006); Maurits Barendrecht & W.C.T. Weterings, *Rechtshulp: een groot goed met schadelijke bijwerkingen (Legal Aid: A Large Well with Harmful Side Effects)*, 80 Adv.bl. 435 (2000) (Neth.); M. Faure, T. Hartlief & N. Philipsen (2006), *Resultaatgerelateerde beloningssystemen voor advocaten – Een vergelijkende beschrijving van beloningssystemen voor advocaten in een aantal landen van de Europese Unie en Hong Kong*, (WODC rapport) Den Haag: Wetenschappelijk Onderzoeks- en Documentatiecentrum Ministerie van Justitie; MARK TUIL & LOUIS VISSCHER, *NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL, EMPIRICAL, AND ECONOMIC ANALYSIS* (2010); Edward Elger & Ianika Tzankova, *Financiering en kosten van massaclaims: legal realism*, in MASSACLAIMS, CLASS ACTIONS OP Z'N NEDERLANDS 171 (Nienke van den Berg et al. eds., 2007).

⁷ See, e.g., William M. Landes, *An Economic Analysis of the Courts*, 14 J.L. & ECON. 61 (1971); Richard Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973); D. Rosenberg & S. Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3 (1985).

sues addressed by the Lord Woolf Reforms in the U.K. in 1996⁸ and one of the main subjects of an evaluation of those reforms in 2010 that resulted in the Justice Jackson report.⁹ Moreover, many leading U.S. judges integrate economic models in their rulings.¹⁰ A fundamental review of the Dutch Code of Civil Procedure, which was inspired by the Woolf Reforms, was conducted by the Dutch Ministry of Justice in 2001–2006. Costs and funding were not addressed in the Interim and Final Reports of the Dutch Commission conducting the review,¹¹ although the Commission acknowledged that the topic is important for the functioning of the civil justice system. There are some recent cost-related initiatives that seem to be supported by a broader vision about access to justice and dispute resolution services,¹² including restricting lawyers' monopoly over the litigation process,¹³ but so far those initiatives do not address the specific funding issues that are typical for mass claim disputes.

B. *Why Is Funding of Mass Disputes Problematic?*

In contemporary academic literature, there seems to be a general consensus that group litigation, in its various forms, poses specific financing problems.¹⁴ At least two sets of problems¹⁵ have been identified in the aca-

⁸ See generally Lord Harry K. Woolf, *Access to Justice, Final Report to the Lord Chancellor on the Civil Justice System in England and Wales*, THE NATIONAL ARCHIVES (1996), available at <http://webarchive.nationalarchives.gov.uk/+http://www.dca.gov.uk/civil/final/index.htm>.

⁹ Rupert Jackson, *Review of Civil Litigation Costs: Final Report*, THE STATIONARY OFFICE (Dec. 2009), available at <http://www.judiciary.gov.uk/NR/rdonlyres/8EB9F3F3-9C4A-4139-8A93-56F09672EB6A/0/jacksonfinalreport140110.pdf>.

¹⁰ Richard Posner and Frank Easterbrook from the Seventh Circuit Court of Appeals, among others, are notable law and economics-oriented judges. Vaughn Walker is another example of a judge that applies economic principles in civil procedure (auctioning of class counsel services).

¹¹ See W.D.H. Asser, H.A. Groen, J.B.M. Vranken & I.N. Tzankova, *Een nieuw balans* (Interim Report), Den Haag, SDU (2003); W.D.H. Asser, H.A. Groen, J.B.M. Vranken & I.N. Tzankova, *Uitgebalanceerd* (Final Report), Den Haag, SDU (2005).

¹² J.M. BARENDRECHT & C.M.C. VAN ZEELAND, *KITTY'S KETENS: MEER VOOR MINDER ROND RECHTSBIJSTAND* (Boom Juridische Uitgevers 2009).

¹³ For example, this was accomplished by increasing the fees limit for representation by non-lawyers to EUR 25,000 on July 1, 2011. See also Art. 93 RV.

¹⁴ D.R. Hensler, *Financing Civil Litigation: The US Perspective*, in *NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL, EMPIRICAL, AND ECONOMIC ANALYSIS* 155 (Mark Tuil & Louis Visscher eds., 2010); Ianika Tzankova & Jeroen Kortmann, *Remedies for Consumers of Financial Services: Collective Redress and Improvement of Class Representation*, 2010 EUR. J. CONSUMER L. 117, 119-20 (2010).

¹⁵ Another set of problems that has been identified in the literature, but that is outside the scope of this article, relates to so-called "blackmail settlements" where defendants are forced to settle for nuisance value claims.

demographic literature on funding class actions. The following is a brief summary of that literature.¹⁶

There are rational apathy and free-rider problems. In essence, both minimize the incentive for group members to optimally invest in group litigation, leaving insufficient financial means for their agent to enforce their rights and protect their interests against wealthy and sophisticated repeat players. This results in an investment asymmetry between individual claimants and repeat players. Adequately coping with rational apathy, free-rider problems, and the resulting investment asymmetries requires concentration of claims, preferably through an opt-out mechanism, and a financial arrangement where the class counsel is being paid out of a settlement fund. However, such concentration measures pose a new set of problems.

Opt-out group litigation funded through contingency fees where the class lawyer receives a percentage of the settlement fund, has been found problematic because it creates a conflict of interest between the class lawyer and the class, defined as “the agency problem.” The theory is that the agency problem might lead to so-called sellout or “sweetheart settlements” crafted by the class lawyer and the defendant—serving their financial interests, but not necessarily the best interest of the class. Settlements reached out of court and not in an adversarial environment deserve closer scrutiny.¹⁷ In an opt-out regime there are many absent claimants, and it is undecided whether the class as an independent entity or the individual claimant is the client. This ambiguity raises additional issues.¹⁸

There is no consensus in the academic literature as to the best way to cope with these issues. The various proposals that have been made can be divided roughly into two types of safeguards, both having disadvantages: monitoring and adequate financial incentives. One can think of monitoring proposals as having the settlement outcome and the class counsel fee moni-

¹⁶ See, e.g. David Rosenberg, *Mass Tort Class Actions: What Defendants Have and Plaintiffs Don't*, 37 HARV. J. ON LEGIS. 393 (2000); Note, *Locating Investment Asymmetries and Optimal Deterrence in the Mass Tort Class Action*, 117 HARV. L. REV. 2665 (2004); Note, *Risk-preference Asymmetries in Class Action Litigation*, 119 HARV. L. REV. 587 (2005); John C. Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986).

¹⁷ However, one may wonder whether the criticism is not exclusively founded on distributive notions and whether it sufficiently takes into account one of ADR's main principles: that out-of-court parties are entitled to behave differently and one should expect that any negotiated settlement will involve compromise, making it difficult to distinguish between “good” settlements (i.e., appropriate compromise, taking into account ambiguities of fact and law) and “bad” settlements (e.g., sweetheart deals intended to benefit both plaintiff's counsel and defendant at the expense of the class). See also the decision *DB Investments* case where the Third Circuit U.S. Court of Appeals, for the first time, acknowledged that settlement-only classes do not need to meet the requirements for certification. *Sullivan v. DB Invs., Inc.*, 667 F.3d 273, 301-03 (3d. Cir. 2011).

¹⁸ Nancy J. Moore, *Who Should Regulate Class Action Lawyers*, 2003 ILL. L. REV. 1477, 1477-79 (2003); Jasminka Kalajdzic, *Self-Interest, Public Interest and the Interests of the Absent Client: Legal Ethics and Class Action Praxis*, 49 OSGOODE HALL L.J. 1, 7 (2011).

tored by a sophisticated lead plaintiff, by the court, objectors, or by a competent third party. Monitoring is considered costly and time-consuming, and law and economics scholars doubt whether third parties would ever be sufficiently equipped to reveal potential collusion between defendants and class counsels.¹⁹ Incentives entail the creation of financial incentives that minimize the agency problem between the class counsel and the class, like the auctioning of class counsel services, but they are considered to ultimately jeopardize the quality of class action services and therefore the outcome.²⁰

Some scholars have argued that opt-in group litigation, where the class lawyer is paid on an hourly basis, creates similar agency problems as discussed above because of one essential factor that is constant in mass disputes: the large volume of claims. That volume creates a financial incentive for the class lawyer, which in most cases is disproportionate to the financial stake of the average class member in the outcome of the litigation.²¹ Therefore, the agency problem may derive primarily from the fact that the attorney is representing a large number of claimants rather than an individual claimant—not from the applicable fee regime. With mass representation, whatever the form, it is infeasible for every claimant to exert optimal control over the lawyer. From the individual claimant’s perspective, there is a set of aggregate settlements, whether paid individually or in the aggregate, that may advantage the lawyer more than at least some of the individual claimants. In theory, individual litigation both permits client control and properly aligns the lawyer’s and individual claimant’s interests. However, insisting on individual litigation precludes litigation altogether (the too-small claim value problem), impossibly delays litigation, or makes it impossibly costly. Paying the lawyer on an hourly fee basis does not solve obvious agency problems, as the hourly fee incentivizes the lawyer to prolong litigation, which might not be in the claimant’s interest either. Additionally, a capped fee, by law or practice, serves as a disincentive for the lawyer to invest full effort in the case. Although there is insufficient em-

¹⁹ Alon Harel & Alex Stein, *Law and Economics at the Animal Farm: Offering a New Solution to the Class Action Agency Problem* 6, available at <http://ssrn.com/abstract=271431>; Alon Klement, *Who Should Guard the Guardians? A New Approach for Monitoring Class Action Lawyers*, 21 REV. LITIG. 25, 34-35 n.26 (2002); James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fall to File Claims in Securities Class Actions?*, 80 WASH. U. L. Q. 855, 856 (2002).

²⁰ See Jonathon R. Macey & Geoffrey P. Miller, *The Plaintiff's Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendation for Reform*, 58 U. CHI. L. REV. 1, 3 (1991) (arguing against the lodestar method); Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 COLUM. L. REV. 650, 650 (2002) (proposing an alternative to the “auction” method of selecting class counsel); Alon Klement & Zvika Neeman, *Incentive Structures for Class Action Lawyers*, 20 J.L. ECON. & ORG. 102, 118 (2004) (explaining that courts should return to the “percentage fee” method).

²¹ Note, *Risk-preference Asymmetries in Class Action Litigation*, 119 HARV. L. REV. 587, 588-97 (2005).

pirical evidence about the magnitude or incidence of the agency problems discussed in this paragraph, the underlying economic models are a helpful tool to study and analyze the functioning of both opt-in and opt-out collective redress regimes, regardless of whether the class lawyer in those regimes operates on a contingency fee or hourly fee basis.

Finally, the agency problems that the concentration of claims in mass disputes potentially causes, raises questions of whether concentration and aggregation should be avoided altogether, and whether this solution for rational apathy, free rider problems, and investment asymmetries is worth all the trouble. Whatever normative value one attributes to avoiding rational apathy, free rider problems, and investment asymmetries, one value-neutral conclusion that emerges from the actual experiences with mass disputes to date is that in order to adequately cope with mass disputes, legal systems do not have realistic alternative choices but to aggregate claims (at least to the extent possible) and to cope with the accompanying agency problems. Legal systems do, however, have a choice when designing funding schemes related to aggregate dispute resolution.

C. *The Scope and Aim of This Paper: Mode of Treatment*

The starting point of this paper is that every advanced legal system should have mechanisms in place to secure access to courts and dispute resolution services, and therefore, to litigation funding. This paper will focus on the funding of mass claim disputes in the Dutch legal system as a component of the civil law family. Furthermore, this paper will both explore whether the Dutch legal system has mechanisms in place to secure access to litigation funding in mass claim disputes, and identify potential or actual problems related to the functioning of those mechanisms.

The functioning of the main litigation funding options in the Netherlands will be assessed in the context of a concrete mass claim dispute involving *Dexia*—one of the most prominent Dutch consumer mass cases in the last ten years. That case is particularly interesting because of the combination of main funding options in the Netherlands that were applied—individual contributions, Legal Aid funding, before-the-event LEI,²² and TPF.²³ TPF is a contractual arrangement after the event, “whereby a third

²² Legal Aid and LEI are viewed as the main sources of litigation funding in the few advanced European countries that allow litigation funding since most European countries prohibit contingency fees. See W.H. van Boom, *Financing Civil Litigation by the European Insurance Industry*, in *NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL, EMPIRICAL, AND ECONOMIC ANALYSIS* 94-96 (Mark Tuil & Louis Visscher eds., 2010) (discussing the English system’s comprehensive Legal Aid funding, and the Netherlands and Germany, where LEI plays an important role in litigation funding).

²³ In this paper, the term “third-party litigation funding” is used as a synonym for after-the-event contingency-based funding.

party pays the costs of litigation and in return, if the case succeeds, receives a percentage of the proceeds.”²⁴ Another modality is where a claimant assigns his claim to a third-party funder and receives a percentage of the estimated value of the claim. The percentage that the third-party funder successfully recovers above the percentage paid to the claimant is the profit that the third-party funder gains from the litigation transaction. Notably, TPF appears to be particularly attractive for legal systems that ban contingency fees.

Furthermore, this paper aims to enhance the understanding of how Legal Aid funding and LEI funding function in mass disputes in a European (Dutch) context and to explain the increasing use and popularity of TPF in mass disputes. It aims to identify the impediments that prevent those funding mechanisms from adequately performing in the Netherlands in the context of mass disputes. Further, this paper attempts to define terms for improvement. Despite the focus on the Dutch legal system, this assessment may be relevant to other European legal systems as well, though the actual outcome of the analysis of whether a particular legal system has sufficient means to fund mass claims through Legal Aid, LEI, or other alternatives will inevitably be influenced by the system’s specific design, which may vary by country. While financing mass disputes poses problems for both claimants and defendants, this paper will focus on the financing of mass disputes from the claimants side.

A study of the functioning of funding mechanisms of mass disputes in the Dutch legal context requires basic knowledge of the Dutch system of collective redress. Therefore, relevant elements of Dutch civil procedure will be highlighted first in Part II. Prior to discussing the *Dexia* case study in Part IV, this paper will briefly and generally describe the three main funding options available in the Netherlands in consumer mass claim disputes in Part III—Legal Aid, LEI and TPL. Based on the experiences in *Dexia*, problems encountered by the three main funding mechanisms will be further discussed in Part V. Summary and conclusions with regard to the question whether the Dutch legal system has adequate mechanisms in place to secure access to litigation funding in mass claim disputes follow in Part VI.

²⁴ Michael Legg et al., *Litigation funding in Australia 2* (Univ. of N.S.W., Law Research Paper No. 2010-12, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1579487.

II. THE DUTCH SYSTEM OF COLLECTIVE REDRESS

A. *General Introduction*

The Dutch system of collective redress is governed by two sets of rules. The collective action that is general in nature and not limited to a specific material area of law has been in force since 1994. Since its introduction it has been used increasingly in a variety of cases. Empirical studies or statistics about the use of this provision are lacking. However, one estimation, based on the number of cases reported to date, states that at least 100 collective actions have been initiated since 1994.²⁵

The Dutch Act on Collective Settlements (WCAM) was introduced in 2005.²⁶ The Amsterdam Court of Appeal has approved six collective settlements to date—in *DES*, *Dexia*, *Vie d'Or*, *Shell*, *Vedior*, and *Converium*—and a seventh request is expected in connection with *DSB Bank*. Only *DES* involved personal injury claims. Five out of the six WCAM cases that have been submitted to the Amsterdam Court of Appeal involved financial products and services.²⁷ Three out of the six collective settlements that have been submitted for approval to the Amsterdam Court of Appeal involved non-Dutch claimants and the global resolution of securities claims—*Shell*, *Vedior*, and *Converium*.

The collective action and the collective settlement can be invoked separately and in combination. The *Vie d'Or* and *Dexia* cases are examples of collective actions that eventually resulted in a WCAM collective settlement. Sometimes one or more individual suits serve as a rainmaker and lead to a collective settlement—the *DES* case being an example of this.

²⁵ This estimation is based on the total number of cases the author found after conducting a search in the electronic sources that publish court decisions.

²⁶ For a description and discussion of the collective settlement and collective action regimes, see generally Ianika Tzankova & Daan Lusingh Scheurleer, *The Netherlands*, 622 ANNALS AM. ACAD. POL. & SOC. SCI. 149 (2009). For an extensive discussion of the WCAM in relation to private international law see H. VAN LITH, THE DUTCH COLLECTIVE SETTLEMENTS ACT AND PRIVATE INTERNATIONAL LAW 1 (Erasmus Univ. Rotterdam Law Sch. 2010), available at http://english.wodc.nl/images/1817_Summary_tcm45-303997.pdf.

²⁷ U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, COLLECTIVE REDRESS IN THE NETHERLANDS 8, 13-14 (2012), available at http://www.instituteforlegalreform.com/sites/default/files/Collective_Redress_Netherlands.pdf.

B. *The Collective Action*

1. Standing

In line with the European tradition, under Dutch law an association or foundation representing a group of persons having a similar interest and not an individual person may bring a civil action for the purpose of protecting those interests, provided that in doing so, it acts in accordance with its articles of association.²⁸ Since collective action is initiated in the name of the organization and not in the names of the individual persons, there is no lead plaintiff as in U.S. class action suits. In practice, such Dutch collective actions are frequently initiated both by longstanding organizations having a more general purpose, such as the Consumentenbond (Dutch Consumers Association) or Vereniging voor Effectenbezitters (VEB, Dutch Association for Retail Shareholders), and by special purpose vehicles that have been set up to deal with a specific mass claim.

When collective action was introduced in 1994, the Dutch legislature thought it unnecessary to require that the claiming entity be an “adequate representative” or to anticipate competing organizations. It was a new statute that the legislature wanted to promote and there was fear that courts would apply it too narrowly and undermine the provisions. In those early years, established interest organizations like the Consumentenbond and the VEB were the usual parties to initiate a collective action. The public and even the legislature expected and demanded that those organizations file collective actions. In addition, the legislature believed that the statute already provided for sufficient safeguards against potential abuse. However, as a result of shrinking budgets of longstanding organizations and an increased frequency and detection of mass wrongdoings, a real market for special purpose vehicles has developed in the last ten years. To address concerns for potential abuse, a legislative proposal to reform the WCAM was presented in December 2011. It would render a claim in a class action inadmissible when the organization bringing the claim is not sufficiently representative.²⁹

As an integral part of the adjudication of a case, the court will determine whether the organization has legal standing to bring the action. Before an action can be filed, the organization is required by law to attempt to obtain the desired relief by means of a negotiated out-of-court settlement. However, this requirement does not constitute a real impediment to the initiation of legal proceedings. It will be deemed met if the organization has

²⁸ Art. 3:305(a) BW.

²⁹ MINISTERIE VAN VEILIGHEID EN JUSTITIE, GRIFFIE VAN DE EERSTE KAMER DER STATEN-GENERAAL, (2011), <http://www.rijksoverheid.nl/documenten-en-publicaties/kamerstukken/2012/01/05/memo-wet-collectieve-afwikkeling-massaschade.html>.

asked the prospective defendant(s) to voluntarily comply with its demands and if two weeks have passed without the desired result being achieved.³⁰

2. Similar Interests

The action must seek to protect similar interests. This requirement will be met if the interests in question can be bundled. This will depend on the specific circumstances of the case. As a general rule, aggregation is only possible if, in order to award the relief sought, no individual issues need to be decided. For that reason, the law expressly prohibits awarding monetary damages in such an action, since this would require the court to decide on individual issues such as the amount of damages (if any) suffered by each particular person, causation, and contributory negligence.³¹ As a result, in most cases the organization seeks a declaratory judgment establishing that the defendant(s) acted wrongfully against the person(s) in whose interest the action was brought. If awarded, such a judgment effectively serves as precedent. On this basis, each injured person can subsequently bring a separate action for damages addressing the aforementioned individual issues.

Although the collective action regime has been heavily criticized by consumer protection organizations because of the ban on awarding monetary damages—which is being viewed as a hurdle to impose pressure on unwilling defendants³²—in practice, some collective actions are rather successful. This is because once the court rules that the relevant defendant(s) indeed committed a tortious act, a breach of contract, or fiduciary duty, many defendants seek to resolve the matter through settlement. There have been at least three domestic WCAM settlements to date.³³

³⁰ Art. 3:305 § 2 BW.

³¹ Art. 3:305 § 3 BW.

³² In November 2011, the Dutch Parliament adopted a motion to delete the prohibition on claiming damages in class actions. U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, COLLECTIVE REDRESS IN THE NETHERLANDS 4 (2012), available at http://www.instituteforlegalreform.com/sites/default/files/Collective_Redress_Netherlands.pdf. The motion requested that the government propose a step-by-step plan before February 1, 2012 to implement the reform prior to January 1, 2013. *Id.* However, some scholars have suggested that funding issues and the ban on contingency fees are the real obstacles impeding the use of collective actions in the Netherlands, not the statutory ban on monetary damages. I.N. Tzankova & C.J.M. Van Doorn, *Effectieve en Efficiënte Afwikkeling van Massaschade: Terug Naar de Kern van het Collectieve Actierecht*, in COLLECTIEVE CTIES IN DE FINANCIËLE SECTOR 95-125 (F.M.A. 't Hart ed., 2009).

³³ Hof's-Amsterdam, 6 januari 2006, NJ 2006, 461, LJN: AX6440 (DES); Hof's-Amsterdam, 25 januari 2007, NJ 2007, 427, LJN:AZ7033 (Dexia); Hof's-Amsterdam, 29 april 2009, NJ 2009, 448, LJN:BI2717 (Vie d'Or).

C. *The WCAM*

1. Background

The Netherlands is the only European country to date where a collective settlement of mass claims can be declared binding on an entire class on an opt-out basis.³⁴ The statute is not another example of the Dutch consensual culture. However, the reality is that the resolution of a concrete mass claim case has triggered the design of the statute, and at that time, it was no longer possible to enact a statute governing only that specific mass claim case. Therefore, a general provision had to be introduced. The WCAM was enacted in July 2005. The Dutch legislature has been inspired by the U.S. court-approved class settlement regime but has tried to avoid its negative connotation. One of the main reasons why the Dutch business community has supported the WCAM is most likely that, unlike the U.S. class action, the Dutch collective action provisions do not allow actions for damages.³⁵ Corporations wanted a means of settling damages collectively but did not want to be forced to settle if it was not what they ultimately desired. Although not empirically grounded, the fear still exists that a mechanism like the U.S. class action for damages might increase the pressure on defendants to settle nuisance value claims.

The essence of the WCAM is that an out-of-court settlement agreement entered into by a representative organization and one or more parties agreeing to pay compensation to injured persons with the aim of settling mass damage claims at a collective level can only be certified by the Amsterdam Court of Appeal. The settlement has statutory binding effect on all group members who do not exercise their opt-out right.³⁶ Once the Court of Appeal approves the settlement and the opt-out period has expired, all claimants who have not exercised their opt-out right are bound by the settlement.

2. Standing and Procedure

The representative organization entering the settlement on the part of the claiming parties should either be an association with full legal competence or a foundation. Again, this could be a longstanding organization or a

³⁴ Deborah Hensler, Christopher Hodges & Magdalena Tulibacka, *The Globalization of Class Actions*, 622 ANNALS AM. ACAD. POL. & SOC. SCI. 149 (2009).

³⁵ For a detailed discussion of the background of the WCAM and the resolution of the *DES* case, see generally Ianika Tzankova & Daan Lunsingh Scheurleer, *The Netherlands*, 622 ANNALS AM. ACAD. POL. & SOC. SCI. 149 (2009).

³⁶ Art. 7:908 § 2 BW.

special purpose vehicle. Unlike the collective action that was introduced in 1994, the WCAM contains the requirement that the organization entering the settlement should be sufficiently representative of the interests of the injured persons intended to benefit from the settlement.³⁷ Whether the organization meets this requirement depends on the facts and circumstances of the case at hand.

The WCAM proceedings are initiated by a joint petition to the Amsterdam Court of Appeal by both the organization and the (potential) defendant(s)—the parties distributing the settlement amount. The beneficiaries of the relevant settlement must then be notified of the content of the agreement—the date and time of the court hearing, their right to file an objection against the petition—and their right to appear at the hearing.³⁸ Individual notifications in writing must be sent to known beneficiaries pursuant to applicable regulations and treaties; unknown beneficiaries must be notified by placing advertisements in newspapers within the relevant jurisdictions. Furthermore, the individual notification process that has to be applied pursuant to European regulations and international treaties in the international WCAM cases can be costly.³⁹

Following the hearing, the court will render its decision, either granting or denying the request to certify the settlement agreement. If the request is granted, the court will also determine the duration of the period during which beneficiaries can exercise their right to opt out. This period should be at least three months. The court's decision will be communicated to both known and unknown beneficiaries—the so-called interested parties (*belanghebbenden*). If the court denies the request, appeal (*cassation*) of the decision is only possible for the petitioners jointly and on limited grounds. Standing to appeal a denial or an allowance of the request for the approval of the settlement is not granted to interested third parties. According to the Dutch law of civil procedure, “interested parties” are not parties who have a general or professional interest in the process, the proceedings, or their outcome, but are only those parties who would be entitled to a claim under the settlement agreement, or organizations acting in their interests.

3. Funding Issues

Although the WCAM was inspired by the U.S. class settlement regime, at least one essential feature of that regime did not make it into the

³⁷ Art. 7:907 §§ 3(e)-(f) BW.

³⁸ Art. 7:908 § 3 BW; Art. 1017 § 3 RV.

³⁹ H. VAN LITH, WETENSCHAPPELIJK ONDERZOEK-EN DOCUMENTATIECENTRUM, *THE DUTCH COLLECTIVE SETTLEMENTS ACT AND PRIVATE INTERNATIONAL LAW 77* (2010), available at http://ec.europa.eu/competition/consultations/2011_collective_redress/saw_annex_en.pdf.

statute—the court’s review and approval of class counsel fees. This review safeguards⁴⁰ against the potential abuse of collective settlements. Such a requirement was not considered by the Dutch legislature. The latest legislative proposals aiming to improve the WCAM are also silent on this topic. However, it must be noted that when the class counsel fees are being paid out of the settlement fund, as was the case in *Converium*, the Amsterdam Court will have to review and approve the class counsel fees as part of its assessment of the fairness of the settlement agreement.⁴¹ In considering the fairness of the settlement with respect to the amount of compensation awarded (which was notably considerably lower proportionally than the settlement payment for the smaller group of U.S. shareholders), the court relied heavily on the fact that the non-U.S. shareholders had been excluded from the U.S. class.⁴² It is not plausible that they would therefore have effective remedies in or outside the U.S. absent the settlement agreements. In other words, the difference between the U.S. settlement and the WCAM *Converium* settlement was deemed acceptable because the legal position of the two groups of shareholders was essentially different and could accordingly be treated differently in terms of settlement outcomes.

The court also assessed the reasonableness of the U.S. counsel’s fees that represented 20% of the settlement payment and was perceived by the objecting parties as excessive and incompatible with Dutch public order.⁴³ The Amsterdam Court of Appeal dismissed this objection, finding that in the context of determining the fairness of a collective settlement under Dutch law, the court may take into account customary U.S. fee practices when U.S. law firms are involved and the legal services provided by them took place predominantly in the U.S.⁴⁴ Furthermore, the Amsterdam Court of Appeal pointed out that U.S. lawyers’ fees had also been thoroughly scrutinized by the U.S. courts approving the settlements. The Amsterdam Court of Appeal also stated that a fee calculated on the basis of the lode star method (hourly fees) would lead to a similar remuneration.⁴⁵

Whether an assessment of the counsel fees by the court will take place depends on the design of the settlement agreement and therefore can be “manipulated” by the settling parties. If the settling parties agree that the counsel fees will be paid out of a separate fund based on a separate agreement, there is no requirement for the court to approve the reasonableness of the counsel fees. Statutory provisions that class counsel fees should be presented to and approved by the court increase transparency and are there-

⁴⁰ See *infra* Part III.

⁴¹ Hof’s-Amsterdam 12 november 2010, NJ 2010, 683 (Scor Holdings AG f/k/a Converium Holdings AG).

⁴² *Id.*

⁴³ Hof’s-Amsterdam 17 januari 2012, NJ 2012, 355, ¶6.5.4, LJN: BV1026 (Converium).

⁴⁴ *Id.* at ¶ 6.5.2.

⁴⁵ *Id.* at ¶ 6.5.4.

fore a safeguard against potential abuses. On a more general level the question remains, whether an explicit statutory provision regarding the oversight of funding issues in mass disputes can be omitted. Additional questions include whether a legal system can afford to be entirely dependent on the competence and discretionary powers of individual judges deciding a single case and whether or not to pay attention to funding dynamics in mass claim disputes. The European Commission has acknowledged that financing in class or group actions is a significant issue,⁴⁶ while a vision—let alone concrete proposals—on preserving access to justice while avoiding the potential for abuse, is lacking.

One explanation in line with the European—or at least the Dutch—civil law tradition for the “rational apathy” issue on the side of the legislature and the judiciary could lay in the concept of contractual freedom—a fundamental concept in many advanced legal systems. Contractual issues should be addressed primarily by the parties involved. The remuneration of the lawyer is a matter of contract between a client and his legal counsel and as long as there is no conflict between those parties, third parties should not interfere. In collective actions and settlements under Dutch law the client is an organization (representative) that is deemed capable of dealing with its agent. If and when the client is not satisfied with the financial arrangements and the lawyers’ fees, the client can submit a complaint and follow the disciplinary proceedings established by the Dutch Bar Association or, in the alternative, go to court. Another explanation could be that traditionally in collective actions there has been a funding problem on the plaintiffs’ side.⁴⁷ The danger of an overpaid WCAM class counsel is not the first thing that comes to mind. In view of the agency problems discussed in Part III, one may conclude that those explanations are insufficient justifications for disregarding the funding issue under the Dutch system of collective redress. A final explanation of the absence of a provision on class counsel fees in the WCAM could be that such a provision is not necessary because the class counsel is monitored by powerful and sophisticated players like Consumentenbond and VEB. However, the evolution of Dutch collective action and increased “activism” of special purpose vehicles set up by class lawyers resemble a feature of the U.S. class action system for which it has been heavily criticized—the lawyer without a tangible client monitoring the lawyer’s conduct.

A feature of the WCAM that strengthens this phenomenon is the fact that special purpose vehicles must be granted standing. Recent experiences

⁴⁶ *Towards a Coherent European Approach to Collective Redress*, at 11, SEC (2011) 173 final (Feb. 4, 2011) available at http://ec.europa.eu/justice/news/consulting_public/0054/sec_2011_173_en.pdf.

⁴⁷ Consumentenbond and VEB have to fund collective actions from their members’ fees and have limited resources. Interview with VEB representatives, (date unknown); Interview with Consumentenbond (date unknown).

with mass disputes in the Netherlands show that it is relatively easy to establish an ad hoc entity that, assisted by the media, can generate a lot of nuisance value. This strengthens the phenomenon of “competing organizations,” which seems to be an obstacle for defendants whose litigation strategies require exploration of out-of-court settlement options with groups of claimants. The phenomenon also makes it difficult for claimants to assess which organization to join. What makes it problematic is that special purpose vehicles cannot be missed in the collective redress scene since longstanding organizations like the VEB and Consumentenbond will not always be inclined or able to facilitate group or collective actions. In addition, special purpose vehicles promote diversity among representative organizations and that diversity should be valued because it prevents a limited number of established longstanding organizations from monopolizing the collective resolution process. Moreover, an attempt in *Shell* to contribute to this kind of diversity and to extend the WCAM standing requirements to public pension funds—another type of established longstanding interest organization that has been underappreciated in the Netherlands to date—has failed.

There is at least one recent unregulated initiative aiming to improve the accountability and governance of special purpose vehicles. A Claim Code was drafted by an ad hoc Commission⁴⁸ and presented in 2011 to the Dutch Ministry of Justice. The Claim Code was the result of a broader consultation that took the reactions of various actors involved in collective actions and settlements into account. In essence, the Claim Code is a set of principles that should apply to special purpose vehicles acting as representative organizations in collective actions or settlements. The Claim Code has five principles relating to the promotion of collective interests without a profit motive: (1) the composition, (2) tasks and working procedures of the Board, (3) the independence and avoidance of conflicts of interests, (4) the remuneration of Board members, and (5) the Supervisory Committee, whose task is to overview the functioning of the Board Members.⁴⁹ The Claim Code applies the principle “comply or explain.”

It has the potential to add an extra layer of costs and bureaucracy in the functioning of representative organizations and it remains to be seen whether and how this will improve the functioning of the WCAM. In any event, the issue of competing special purpose vehicles has not been sufficiently addressed to date by either the Claim Code or the legislature. In the

⁴⁸ The Chairman of the Commission was a former president of the Dutch counsel for the judiciary. Members of the legal profession who have experience with collective actions and settlements both on the plaintiff or the defendant side participated in the Commission. Consumentenbond, a law professor who was a communication advisor and one of the Board members of the Foundation that was established in *Shell*, was the Chairman.

⁴⁹ CLAIMCODE, COMMISSIE CLAIMCODE (2011), <http://www.consumentenbond.nl/morello-bestanden/716993/compljuniclaimcodecomm2011.pdf>.

draft Explanatory Memorandum to the legislative proposal for the amendment of the WCAM, the Minister, in the context of the representativeness requirement, stated that whether the claiming organization complies with the Claim Code may also be relevant.

The right of interested third parties to file objections against the settlement agreement could be seen as a safeguard against a potential abusive use of the WCAM. In four out of the six collective settlements to date, interested parties have filed objections and defenses of various natures. The Amsterdam Court of Appeal has responded to those objections differently. Some have been promptly rejected at the same time the binding declaration was issued. Some led to the appointment of an expert to issue an opinion on certain issues. To date, all six collective settlements that have been submitted to the Amsterdam Court of Appeal have been declared binding.⁵⁰

The Amsterdam Court of Appeal has announced, in connection with the case management conference in the *Converium* case, that it will act proactively at the fairness hearing when it reviews the fairness of the settlement agreement.⁵¹ Therefore, it is likely that even without objectors, the Amsterdam Court of Appeal will take a critical approach towards settlement agreements that have been submitted for approval.

Despite the identified imperfections, the use of the WCAM in the cases thus far appear to result from external factors rather than from its current structure. Three out of the six collective settlements that have been submitted for approval to the Amsterdam Court of Appeal concern the spin-off of international securities disputes—*Shell*, *Vedior*, and *Converium*—and aim for a global resolution of securities claims. None of these cases have been litigated in the Netherlands. The *Shell* and *Converium* (securities) settlements are spin-offs of class actions in the U.S. *Vedior* was not litigated at all and it was the Dutch company Vedior that initiated settlement negotiations with the VEB. The non-securities claims settlements—*DES*, *Dexia* and *Vie d'Or*—have national backgrounds. *DES* was a mass tort case and existed prior to the WCAM. The WCAM was drafted at the request of the Dutch insurance industry to facilitate the final resolution in the *DES* matter. Both *Dexia* and *Vie d'Or* concerned financial products and services and both WCAM settlements were crafted in an adversarial environment. Lengthy individual proceedings, an inquiry commissioned by the Dutch Government, and two collective actions preceded the WCAM.

⁵⁰ Respectively; Hof's-Amsterdam, 6 januari 2006, NJ 2006, 461, LJN: AX6440 (*DES*); Hof's-Amsterdam, 25 januari 2007, NJ 2007, 427, LJN:AZ7033 (*Dexia*); Hof's-Amsterdam, 29 april 2009, NJ 2009, 448, LJN:BI2717 (*Vie d'Or*); Hof's-Amsterdam 29 mei 2009, NJ 2009, 506, LJN: BI5744 (*Shell*); Hof's-Amsterdam 15 juli 2009, JOR 2009, 325, LJN: BJ2691 (*Vedior*); Hof's-Amsterdam, 17 januari 2012, NJ 2012, 355, LJN: BV1026 (*Converium*).

⁵¹ MEMORIE VAN TOELICHTING, WIJZIGING VAN HET BURGERLIJK WETBOEK, HET WETBOEK VAN BURGERLIJKE RECHTSVORDERING EN DE FAILLISEMENTSWET TENEINDE DE COLLECTIEVE AFWIKKELING VAN MASSAVORDERINGEN VERDER TE VERGEMAKKELIJKEN (WET TOT WIJZIGING VAN DE WET COLLECTIEVE AFWIKKELING MASSASCHADE) 5-6 (2011).

4. WCAM and Private International Law

The interim and final rulings of the Amsterdam Court of Appeal in *Converium* are expected to have implications for the global resolution of mass claims. In its interim ruling on November 12, 2012, the court preliminarily assumed jurisdiction over a request to declare two international collective settlements binding in a case in which none of the potentially liable parties (and only some of the potential claimants) were domiciled in the Netherlands.⁵² Referring to the recent U.S. Supreme Court opinion in *Morrison v. National Australia Bank*, which limited the scope of securities class actions brought in the U.S. by non-U.S. claimants who purchased shares in non-U.S. companies,⁵³ the Amsterdam Court of Appeal indicated its awareness of the need for global resolutions of international securities class actions.⁵⁴ To that end, a collective settlement approved by a Dutch court complements a U.S. settlement for U.S. claimants. On January 17, 2012, the court reaffirmed its interim decision on jurisdiction in its final ruling.⁵⁵

In two prior matters, the Amsterdam Court of Appeal approved collective settlements with an international scope while assuming jurisdiction on the basis of Article 6(1) of the Brussels I Regulation and Article 6(1) of the Lugano Convention. These decisions related to an Anglo-Dutch company (Shell) and a Dutch company (Vedior) that had offered compensation for losses allegedly suffered by shareholders. In its *Converium* interim and final ruling, the Court of Appeal based its jurisdiction on Articles 6(1) and 5(1) of the Brussels I Regulation and Articles 6(1) and 5(1) of the Lugano Convention.⁵⁶ The court held that article 5(1) was applicable since the settlement agreement was performed in the Netherlands even though the companies involved in the settlement were Swiss companies.

The interim ruling of the Amsterdam Court of Appeal has generated a number of reactions in the legal community. Generally speaking, the interim ruling has been criticized for what is perceived to be a broad interpretation of Article 5(1) of the Brussels I Regulation and 5(1) of the Lugano

⁵² Hof's-Amsterdam 12 november 2010, NJ 2010, 683 (Scor Holdings AG f/k/a Converium Holdings AG).

⁵³ 130 S.Ct. 2869 (2010). See generally Linda Silberman, *Morrison v. National Australia Bank: Implications for Global Securities Class Actions* (N.Y. Law Sch. Pub. Law & Legal Theory Research Paper Series Working Paper No. 11-41) available at <http://ssrn.com/abstract=1864786>.

⁵⁴ Hof's-Amsterdam 17 januari 2012, NJ 2012, 355, ¶ 6.4.2 LJN: BV1026 (Scor Holding AG f/k/a/ Converium Holdings AG); See Jeroen S Kortmann, 'Case note *Converium*,' (2011) 46 JOR, 448-462 at 8.

⁵⁵ *Id.*

⁵⁶ Hof's-Amsterdam, 12 november 2010, NJ 2010, 683 (Scor Holdings AG f/k/a Converium Holdings AG).

Convention.⁵⁷ The court's reasoning would practically allow the court to assume jurisdiction in any international collective settlement approval proceedings as long as one of the parties is a Dutch Foundation representing the potential claimants and there is at least one potential claimant domiciled in the Netherlands. This criticism is understandable, especially in view of the problematic features of the WCAM discussed above. However, there is also appreciation for the approach taken by the Amsterdam Court of Appeal since it attempts to increase access to justice in mass disputes and contributes to a global and final resolution of mass disputes.

The experiences to date show that the Amsterdam Court of Appeal is willing to accommodate parties seeking a global resolution. It must be emphasized that the court's willingness probably stems from the fact that the collective settlements that are submitted for approval before the court are viewed more or less as "amicable settlements." By submitting these settlements to the court, parties demonstrate a perceived need for a global solution and resolution, for which the court, a "public servant," is obviously responsive.

The court's ruling will bind all eligible purchasers of the relevant company's securities who, after having been given notice, do not exercise their right to opt-out. However, it remains undecided whether a court in any of the other EU member states or in Switzerland, Iceland, or Norway would preclude such a decision under the Brussels I Regulation or Lugano Convention.

A decision under the WCAM certifying a settlement agreement with binding effect arguably constitutes a judgment in a civil matter as defined in the Brussels I Regulation (Council Regulation 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters).⁵⁸ Consequently, such a decision should be recognized and its preclusive effect enforced in other EU member states, unless one of the grounds for refusal set out in Article 34 of the Regulation applies. Since there is no case law on this at the time of this writing it is uncertain if and when a court in another EU member state will refuse recognition and enforcement of a decision under the WCAM on the basis of one of the grounds mentioned above.

The international scope of the WCAM is one of the topics on the agenda of the Dutch Ministry of Security and Justice. When introducing the WCAM, the Dutch legislature did not expect it to be used successfully

⁵⁷ See Jeroen S Kortmann, 'Case note *Converium*,' (2011) 46 JOR, 448-462; H el ene van Lith, 'Case note *Converium*' (2011) 3 *Ondernemingsrecht* 2011, 117-21; H. van Lith, THE DUTCH COLLECTIVE SETTLEMENTS ACT AND PRIVATE INTERNATIONAL LAW 32-47 (Erasmus Univ. Rotterdam Law Sch. 2010), available at http://english.wodc.nl/images/1817_Summary_tcm45-303997.pdf.

⁵⁸ H. van Lith, THE DUTCH COLLECTIVE SETTLEMENTS ACT AND PRIVATE INTERNATIONAL LAW 26 (Erasmus Univ. Rotterdam Law Sch. 2010), available at http://english.wodc.nl/images/1817_Summary_tcm45-303997.pdf.

in a cross-border context. Currently, the Ministry commissioned a study to help consider amendments to the WCAM.⁵⁹ In any event, only some of the questions regarding the international scope of the WCAM can be dealt with by the Dutch legislature. There are also interpretation issues that stay beyond the reach of the Dutch legislature that only the EU Court of Justice or the EU Commission and Parliament can address.

The Dutch legislature has also proposed to amend the law because there is another prominent financial services case that has to be resolved—the DSB Bank bankruptcy, which involves thousands of consumers. The proposal reforms the WCAM and the Bankruptcy Act so consumer claims do not need to be individually assessed and evaluated through regular bankruptcy proceedings. These amendments are expected to lead to a more efficient verification process in bankruptcies.

The draft legislative proposal for the private international law aspects of the WCAM contains only rules that aim to improve the notification of non-Dutch shareholders. For example, the proposal allows the Court to set a minimum number of successful notifications and to postpone the oral hearing until a sufficient number of known interested parties have been adequately notified. The draft legislation does not contain proposals regarding the jurisdiction of the Dutch court as discussed during the round table in Rotterdam. It is not clear how the Ministry will proceed with amendments of the WCAM that might delay the resolution of the DSB bankruptcy—like those regarding the international scope of the WCAM—given the perceived urgency for resolving DSB bankruptcy.

The private international law implications of collective redress mechanisms in the EU are also on the EU's legislative agenda.⁶⁰ However, the result is not expected to come expeditiously because the topic is delicate and complicated.

D. *Other Relevant Procedural Themes*

1. Fact-finding

Although discovery and fishing expeditions are not allowed in the Netherlands, fact-finding alternatives are improving. In securities litigation, the so-called enquiry proceedings (*enquête procedure*) are increasingly significant for gathering evidence used in securities litigation against corporations and their directors and officers.

⁵⁹ See generally *id.*

⁶⁰ See *European Parliament Report on Towards a Coherent European Approach to Collective Redress*, at 26-8 (Jan. 1, 2012) available at <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2012-0021>.

In civil cases, it is relatively easy to hear witnesses pretrial. The hearings are public and there is a trend among lawyers to cross-examine witnesses, which used to be unusual for the Netherlands. Those preliminary hearings not only serve fact-finding purposes but can also impose nuisance costs in high profile cases.

There have been some proposals to introduce limited discovery rules (extension of *exhibitieplicht*), but these proposals do not improve the safeguards against abuse. Moreover, Dutch lower courts have ruled that evidence obtained through discovery in a U.S. case can be used in Dutch civil proceedings.⁶¹ A plaintiff's securities litigation bar is slowly being established and they are increasingly cooperating with U.S. plaintiff's lawyers in the area of securities litigation. In fact, U.S. plaintiff's lawyers appear to act not just as a co-counsel but also serve as yet another category of entrepreneurial third-party litigation funders in the Netherlands. This is illustrated in the *Shell* and *Converium* cases.

2. Cost-shifting Rules

Under Dutch law of civil procedure, a cost-shifting rule applies. Although the effect thereof is mitigated, the bailiff costs, witness costs, and the court fees are being fully shifted to the losing party. However, the winning party's lawyer's fees, which typically are quite substantial, are not fully compensated. The compensation that the losing party has to pay to the winning party is determined by a schedule.⁶²

However, the system is predictable since the amount of money that the losing party has to pay relates to the amount at stake and the number of procedural steps taken by the parties. Indeed, the loser has to pay, albeit relatively little, for an entrepreneurial third-party funder. There is also a rule in the Netherlands that the winning party has the right to claim reimbursement of certain pretrial costs and expenses.⁶³ Although the current practice of the courts is to grant modest amounts, there is a statutory basis to claim substantial amounts if the claimant can show that there were substantial pretrial costs, or parties reach an out-of-court settlement. Moreover, in its *Vie d'Or* ruling on 13 October 2006, the Dutch Supreme Court ruled that an organization or a foundation is allowed to claim the pretrial costs it incurred in the preparation for collective actions.⁶⁴

⁶¹ See K.J. Krzeminsky, *U.S. Discovery for use in Dutch Civil Proceedings*, 2 TCR 47.(2008) (Neth.) (discussing how the President of the Utrecht District Court and the Amsterdam Court of Appeal "addressed the issue of whether § 1782 discovery can be used as a method of obtaining evidence for use in a Dutch civil proceeding.").

⁶² Tuil, *supra* note 3, 415-17.

⁶³ Art. 6:96 § 2 BW.

⁶⁴ HR 13 October 2006, NJ 2008, 527 m.nt. (Stichting Begaclaim/ De Staat Der Nederlanden).

III. FUNDING OF CONSUMER MASS DISPUTES IN THE NETHERLANDS

A. *Legal Aid Funding*⁶⁵

The Netherlands has a strong tradition in legal aid funding and is internationally known as a country with one of the best legal aid systems in the world. In 2008, 42% of the Dutch population was entitled to Legal Aid. Moreover, there are probably not many national legal aid systems that provide Legal Aid to non-citizens.⁶⁶

Under the Dutch Legal Aid regime, there is free choice of legal services providers, even in mass claim matters. Only natural persons, rather than entities, are eligible for legal aid.⁶⁷ This means that interest organizations acting in collective actions or collective settlements, like Consumentenbond and VEB or special purpose vehicles, are not eligible for Legal Aid. The Dutch legal aid system is basically a two-fold model that encompasses two lines that provide legal aid. A total of thirty Legal Services Counters throughout the country, being the first line, provide front services such as primary legal advice. Legal matters are clarified and information and advice are given. If necessary, clients will be referred to a private lawyer or a mediator. These professionals act as the secondary line of legal aid. Clients can also apply to fund a lawyer directly, but the focus is on conflict prevention and conflict resolution in an early stage by the Legal Services Counters.

The functioning of Legal Aid in the Netherlands is under pressure as a result of shrinking budgets and an increased demand. Public expenditure on Legal Aid is increasing every year. In order to stop this trend, the Dutch government has imposed a cost reduction of €50 million per year. The challenge for the Legal Aid Board in the years to come will be to maintain the same level of service at a lower cost. Although the Legal Aid Board is a not-for-profit public interest organization, one might expect that imposed cost reductions and shrinking budgets will cause dynamics similar to the agency problems experienced by LEI providers that will be discussed be-

⁶⁵ The information about the Dutch legal aid system incorporated in this section was obtained from materials of the Legal Aid Board, including a presentation given by Mr. Herman Schilperoort on December 10, 2010, at the 4th International Conference on the Globalization of Collective Litigation in Miami, Florida. Herman Schilperoort, *Remarks at the 4th International Conference of the Globalization of Collective Litigation* (Dec. 10, 2010), <http://itunes.apple.com/us/itunes-u/fiu-law-events-and-speakers/id397852777> (beginning at 47:24).

⁶⁶ National legal aid is not available for non-Dutch citizens if they have a claim against the Dutch State or a Dutch entity. For example, the Srebrenica model case, Hof 5 July 2011, LJN: BR0133 (Hasan Nuhanovic/Netherlands) against the Dutch State, and the Nigerian collective action against a Royal Dutch Shell, Hof 14 September 2011, LJN: BU3538 (Royal Dutch Shell PLC), were both funded through the Legal Aid Board.

⁶⁷ See Tuil, *supra* note 3, at 406-07 for a brief description of the Dutch Legal Aid system.

low—the Legal Aid Board will have an incentive to resolve mass disputes early and reduce costs without any correlation with what might be decided as justified demand.

B. *LEI*

LEI providers are the second significant category of litigation financiers in the Netherlands. The number of LEI providers in the Netherlands is rising. There is a market for businesses, mainly small and mid-sized enterprises, and one for households and traffic accidents. The number of LEI policies taken out by SMEs in the Netherlands nearly doubled between 2000 and 2005.⁶⁸ Generally, LEI penetration increased from 14% in 2000 to 19% in 2004.⁶⁹ In 2000, 14% of Dutch households had a legal aid insurance policy, and that number rose to 28% of households in 2006.⁷⁰ This percentage increases approximately 2% every year.⁷¹ Therefore, it can be estimated that by the end of 2012, about 38% of the Dutch households will have LEI.

Generally speaking, there are two markets: (1) a market for “in-kind” policies where the legal services can also be provided by the in-house counsel of the LEI provider, and (2) a market for legal expenses incurred when an external qualified lawyer⁷² has been instructed. For example, the Netherlands, unlike Germany, has a market for in-kind policies. This is because in the Netherlands, lawyers do not have a statutory monopoly to provide legal advice, and litigants do not need the assistance of a member of the bar in disputes with a monetary value up to € 25,000 and in many consumer law related matters. Obviously, a market for in-kind policies will be more favorable to the business model of LEI providers than a market for legal expenses since it allows them to minimize costs by using predominantly in-house or qualified lawyers. Similar to the Legal Aid Board, a LEI provider cannot build a portfolio of selected profitable cases to spread the litigation risks and therefore has to fund the cases as they come. The financial incentives of LEI providers who already received their premium by the time they have to render a service is such that the insurer’s effort will be directed towards keeping a claim out of court and settling swiftly at an acceptable

⁶⁸ Van Boom, *supra* note 24, at 104 n.3

⁶⁹ *Id.*

⁷⁰ L. COMBRINK-KUITERS, S.L. PETERS & M. VAN GAMMAREN-ZOETEWELJ, MONITOR GESUBSIDIEERDE RECHTSBIJSTAND 2008 92 (Boom Juridische Uitgevers 2009).

⁷¹ AANHANGSEL VAN DE HANDELINGEN, TWEDE KAMER DER STATEN-GENERAAL (2009-2010).

⁷² It must be noted that in the Netherlands, qualified lawyers can be employees of the LEI provider.

level, rather than maximizing the number of hours spent on a file⁷³ or outcome.⁷⁴

The institutional environment in which the LEI providers operate, which includes both intense national regulation of legal services and predictable costs in the national system, influences the market for LEI. At the European level, LEI providers are regulated to some extent under Directive 87/344 (Directive), which addresses the coordination of laws, regulations, and administrative provisions relating to legal expense insurance.⁷⁵ The Directive aims at neutralizing agency problems, including potential conflicts of interest between insured and insurer, which stem from the fact that the LEI provider also acts as an insurer for other individuals or other classes of insurance. Furthermore, meritorious issues between the LEI provider and the insured should be settled efficiently. Another distinct feature is that, like the Dutch Legal Aid scheme, the Directive guarantees the free choice of lawyers as well, including mass claim disputes. The European Court of Justice determined on September 10, 2009, (Case C 199/08) in a case against an Austrian LEI-provider that the practice of selecting lawyers to represent policy holders contravenes Article 4 (1) of the 1987 Legal Expenses Insurance Directive.⁷⁶ European Law guarantees policy holders the freedom to choose their own legal representation. Even in a group action, where several parties wish to pursue a claim against the same opposing party, the insurers are not entitled to select the legal team for the insured. The decision implies that LEI providers cannot insist that the insured be represented by a class representative on the insurer's panel. Furthermore, the insured cannot be penalized for choosing their own representative.

C. *TPF*⁷⁷

Contingency fees are not allowed in the Netherlands for members of the Dutch bar. Virtually anyone else, however, could enter into an unregulated contingency fee agreement with a potential claimant. Contingency fee-based legal assistance is sometimes offered by special purpose vehicles set up and run by entrepreneurial lawyers who are no longer members of the bar.⁷⁸ In this arrangement the consumer commissions the special pur-

⁷³ Van Boom, *supra* note 22, at 97.

⁷⁴ *See id.* at 94-99 (providing a general analysis of the business model of LEI and related agency problems).

⁷⁵ The provisions of the LEI Directive are to be copied into the Solvability II Directive.

⁷⁶ Case C-199/08, *Eschig v. UNIQA*, 2009 E.C.R. I-08295.

⁷⁷ *See* van Boom, *supra* note 22, at 99-104 (explaining the relation of after-the-event funding and litigation to third-party funding in general).

⁷⁸ These lawyers include those who terminate their membership in the Dutch Bar Association and establish a special purpose vehicle for litigation. Sometimes, those entities are designed as a commercial entity, and sometimes they are designed as a foundation. There are also examples where the finan-

pose vehicle on contingency fee basis and the special purpose vehicle subsequently commissions a lawyer on a traditional hourly fee arrangement.⁷⁹ In typical third-party litigation funding arrangements, the funder will enter into an agreement with one or more potential litigants. The funder pays the costs of the litigation and usually accepts the risk of paying the other party's costs in the event that the claim fails, which indemnifies the claimant. In return, if the claim is successful, the funder will receive a certain percentage of any funds recovered by the litigants, either by way of settlement or judgment, and the litigants will assign the funder the benefit of any cost orders they receive. The funder and the litigants agree to the division of the proceeds—typically between one-third and two-thirds of the proceeds—usually after reimbursement of costs.⁸⁰ Ideally, the percentage of recovery going to the funder should reflect the risk inherent in the proceedings. The riskier the proceedings, the greater the share of the proceeds the litigants must pay the funder to make the investment attractive.⁸¹

The literature distinguishes two main business models of litigation funding. The first is an incorporated company that obtains funds from debt and equity sources and subsequently invests those funds in litigation. Under this model, the company is listed on a stock exchange and as such, will comply with prospectus requirements in obtaining equity. The company will also comply with the usual requirements for listed public corporations, such as continuous disclosure obligations. In the second business model used by litigation funders, the funder receives funds from domestic or foreign companies, wealthy individuals, or both.⁸²

In common law countries, TPF has been considered problematic from a dogmatic point of view because of the doctrines of maintenance and champerty.⁸³ The case law however, is evolving in such a way that in the main common law jurisdictions, there are examples of cases successfully funded by TPF. Unlike common law jurisdictions, the Netherlands is unfamiliar with doctrines such as maintenance and champerty. In addition,

cier is an individual. In theory, this could be anyone, including U.S. plaintiffs' lawyers or law firms, as long as the individual is not a member of the Dutch Bar Association. The Amsterdam Court of Appeal approved, in a personal injury case, a contingency fee arrangement made by a special purpose vehicle where the mother and an uncle of the lawyer handling the case were on the Board of the special purpose vehicle. Hof.'s-Amsterdam 13 december 2011, NJF 2011, 141 (Appellants/Dutch Inquiry Foundation). The agreed success fee was a 40%. *Id.*

⁷⁹ Tuil, *supra* note 3, at 408.

⁸⁰ Legg, *supra* note 24, at 4-5 n.15.

⁸¹ *Id.* at 5.

⁸² See *id.* at 5-6 (discussing the two models in the Australian context, which also apply for the Netherlands).

⁸³ Jern-Fei Ng, *The Role of the Doctrines of Champerty and Maintenance in Arbitration*, 76 ARB. 208 (2010).

the Dutch cost-shifting rules and a Dutch Supreme Court case from 1994⁸⁴ unintentionally facilitated the business model of TPF.⁸⁵ Moreover, in the Netherlands there is already extensive experience with assigning claims after adjudication in the context of debt collection and asset tracing, where the debt collector retains a percentage of the recovery. As stated previously, such assignment of claims is a modality of TPF. Assigning collection of claims prior to legal proceedings will be viewed as yet another application of the option to assign claims, and there are already specific statutory provisions governing such transactions.

Especially where the assignment of claims takes place in what can be viewed as business disputes involving sophisticated commercial players on both sides,⁸⁶ it will be difficult to explain why an exception to the principle of contractual freedom is justified. Such parties are capable of making informed business decisions and choices with regard to the terms and conditions of the funding contract and the assignment, the monitoring of the group lawyer, and similarly related decisions. It will be assumed that most companies who assign their claims to a funder would have only done so after seeking advice of counsel.⁸⁷

Although after-the-event third-party litigation funding differs substantially from before-the-event third-party litigation funding—as in the LEI⁸⁸—the general concept of entrepreneurial TPF is not novel for the

⁸⁴ Here, the court decided that a representative association that files court proceedings for the benefit of numerous named claimants can add additional claimants at a later stage of the proceedings without issuing new writs of summons. The court also held that it is essential for third-party financiers to bundle claims that can easily be bundled as the litigation proceeds. HR 2 december 1994, NJ 1996, 246 m. nt. DWFV (ABN-AMRO/Coopag) (Neth.).

⁸⁵ An attempt of the VEB in the World Online securities collective action to develop case law to facilitate the assignment of claims in mass disputes, however, did not succeed. The collective action was combined with a number of individual model proceedings for damages on behalf of representative shareholders, and the suggestion to allow a simplified method for proving the validity of claim assignment agreements was rejected by the Dutch Supreme Court. The VEB was required to submit, as exhibits to the court, a copy of the agreements, including all details stipulated in the applicable statutory provisions. The Supreme Court explained its decision by referring to due process that provides the defendant a procedural right to be informed about his opposition. Even though administratively burdensome, assuming that the claiming entity can meet the requirements and submit valid copies of the assignment agreements, there is no obstacle to recognize the validity of contracts between the third-party financier and its client. HR 27 november 2009, JOR 2010, 43 m.nt. H.M. (Verening Van Effectenbizziters/World Online Int'l N.V.) (Neth.).

⁸⁶ For example, competition disputes between members of a cartel and direct purchasers.

⁸⁷ In that respect, the claimant company will probably not only consider the chances of success of the action and the success fee of the funder, but also opportunity costs and cost savings as a result of the fact that the management of the company is no longer intensively involved in the monitoring of the progress of the litigation. Ideally, such assumptions should be empirically tested to find out what sophisticated businesses litigants value and really care about when they contract a third-party litigation funder.

⁸⁸ After-the-event third-party financiers select cases that are profitable to them. For a litigation funder to determine whether to fund an action, it must calculate the risk associated with the litigation

Netherlands. Therefore, it is unlikely that the business model of third-party financiers in and of itself will be considered unethical under Dutch law or against Dutch public order. The default position with regard to TPF in the Netherlands is likely to be that the principle of contractual freedom allows parties to make an informed business decision about their financial interests and to decide to what extent they are willing to grant decision-making power to third-party litigation funders.

Interestingly enough, agency problems that have been identified with relation to LEI, and that have led to the introduction of the Directive, have not inspired EU legislatures to invoke similar discussions regarding TPF.

Experiences in other jurisdictions show that traditionally, third-party litigation funders invest in bankruptcy disputes, commercial disputes, and group actions.⁸⁹ Indeed, in September 2010, the first antitrust mass claim funded by a professional third-party litigation funder using the assignment model was filed before the Amsterdam District Court.⁹⁰ However, *Dexia* was the first case where TPF's implications became apparent in consumer mass claim disputes.

and the likelihood of success. It must also quantify the amount of a successful recovery and its potential liability for the costs of the proceedings. To be successful, the third-party financier must be able to spread the risk associated with a particular proceeding by adopting a portfolio approach to its case inventory. In that way, third-party financiers' business models resemble the business model of U.S. plaintiffs' lawyers operating under contingency fee arrangements. The selection criteria applied by after-the-event providers assure a relatively comfortable chance of collecting high revenues. Third-party financiers typically favor contractual money claims over tort claims, which may turn out to be especially complicated if liability and causation are contested, and they assure themselves of the defendant's solvency. See van Boom, *supra* note 22, at 100.

⁸⁹ Legg, *supra* note 24, at 4 n. 14.

⁹⁰ The Air cargo cartel case was initiated before the District court of Amsterdam against KLM, Air France, and other airlines on behalf of a number of direct purchasers. The case was funded by the Irish branch of the Australian Claims Funding International (CFI), a spin-off of the professional Australian third-party funder, IMF Australia Limited. See *CFI Commences Europe's Largest Ever Cartel Damages Claim*, CLAIMS FUNDING INT'L (Sep. 30, 2010), available at www.claims-funding.eu/fileadmin/.../Media_Release_for_Website.pdf. In March 2008, Claims Funding International was established in a joint venture with interests in Maurice Blackburn Pty, Ltd. in Ireland to pursue opportunities in Europe. CFI's special purpose company, Equilib, filed the Dutch air cargo claim. The Court was advised that the total expenditure of companies on airfreight exceeds €5.3 billion. *European Air Cargo Cartel: 30th March 2011 Court Hearing Report*, CLAIMS FUNDING INT'L (Mar. 30, 2010), [http://www.claims-funding.eu/10.html?&tx_ttnews\[tt_news\]=34&tx_ttnews\[backPid\]=4&cHash=7810525223](http://www.claims-funding.eu/10.html?&tx_ttnews[tt_news]=34&tx_ttnews[backPid]=4&cHash=7810525223). CFI has signed up companies in its group from eleven European Union member states to pursue extensive damages claims. These claims arising from the Air Cargo cartel cover major names in the pharmaceutical, automotive, electronics, food, and fashion industries. CFI pays all the costs of the legal proceedings and assumes all the risk in return for a commission of awards received. Interestingly enough, the case is not designed as a collective action, but resembles the features of an American-style inventory of cases or non-class mass litigation. There is not much information available in the public domain about the design of the action and more details about its structure remain to be seen. Other third-party litigation funders that are active in Europe or have announced plans in the field of mass claim litigation funding are Alliantz Litigation Funding and Omni Bridgeway.

IV. *DEXIA* CASE STUDY⁹¹A. *The Facts*

For many years, the *Dexia* case was a weekly news item in the Dutch media. It was the first massive consumer mass claim dispute in the Netherlands. *Dexia* is a European Bank of French-Belgian origin that expanded its activities to the Netherlands in 2002 by acquiring two Dutch banks. One of the acquired banks was a market leader in structured financial products. The product, so-called financial lease contracts, was invented in the mid-1990s with the idea to make stock markets available for consumers generally, regardless of income level. The bull market in the 1990s made the product look like a risk-free investment. For a variety of tax and other reasons the product became very popular. Between 1992-2003, that specific provider sold 713,000 lease contracts to 395,000 consumers. Ten percent of the Dutch households owned a product that relied on big profits made on the stock markets (only if there were big profits would the buyer be able to sell and make profits).⁹²

During the acquisition negotiations and until early 2001, the acquired bank portfolio looked rather good, but only a year later the stock market fell, leaving about 391 Dutch households with 713 lease contracts. The average loss per household amounted to €3, but some households suffered losses of €50 or more in exceptional cases. At the end of 2001, Consumentenbond started receiving phone calls from its members about their financial lease contracts, but the magnitude of the problem did not become visible until at least a year later. In March 2002 a popular Dutch consumer TV program issued a special about the product and its provider. After the show, an unusually high number of disgruntled consumers contacted the service line of the TV show.⁹³ Following this, Consumentenbond established a special purpose vehicle—the Foundation—to pursue consumers' interests and found a lawyer to represent their interests. About 80,000 households joined the foundation and contributed €45 apiece, generating about €3.6 million in lawyers' fees.

⁹¹ This paragraph builds in part on the results of a case study of the *Dexia* case conducted in collaboration with Professor D. Hensler. Funding was only one of the topics explored in the case study.

⁹² Its structure was that consumers buy a "basket of shares" funded by a loan. The loan and the basket of shares, both provided by *Dexia*'s successor, were sold as a package deal that would end after a number of years. Consumers had to pay a monthly interest on the loan. In the meantime, the stock market was supposed to go up, which it did at first. The gains from the stocks were used to pay back the loan. At the end of the contract, consumers would receive any positive difference between the profits made on the shares and the amount of money the consumer had paid for the loan and the interest on the loan.

⁹³ Radar received between 15,000 and 20,000 phone calls.

Subsequently, two collective actions were initiated against Dexia. In 2003, Dexia had started individual debt collection suits against those consumers who did not meet their contractual obligations and refused to pay their debts. Many consumers chose to sue Dexia for breach of fiduciary duty. In 2005, tens of thousands of individual cases were pending before the lower Dutch courts, resulting in duplicative and contradictory case law. The matter was highly complicated from a legal and factual point of view, and in the course of the litigation, novel questions of law continued to emerge. The Dutch judiciary was overwhelmed by the magnitude of the problem and established a special “Dexia task force” to deal with the coordination and logistical issues among the judges.

A mediation attempt in 2004 commissioned by the Dutch government failed. Yet, under the supervision of Mr. Wim Duisenberg, a prominent Dutch financial expert and former president of the European Central Bank, Dexia settled with the Foundation, Consumentenbond, and VEB in the summer of 2005 for €1 billion.⁹⁴ A petition was filed and the Amsterdam Court of Appeal declaring the settlement binding on an opt-out basis in January 2007, pursuant to the provisions of the WCAM. The settlement was criticized for being unfavorable for consumers with spouses who were not aware of the contracts. Special purpose vehicles operating on contingency fee basis succeeded in mobilizing about 23,000 clients to opt-out from the collective settlement.⁹⁵ After the settlement agreement was declared binding, a number of test cases were decided by the Supreme Court, resulting in rulings that could be used as a guide to resolve other cases out of court. Nevertheless, some of the suits of those who opted out of the settlement were still pending as this paper was written.

B. *Litigation Funding in Dexia*

1. Individual Contributions

In *Dexia*, a number of funding methods were applied, some of which emerged and were developed in the course of the litigation. A substantial part of the litigation was resolved through the collective actions initiated by

⁹⁴ The remedy consisted of a reduction in consumer debt and not a payment by Dexia.

⁹⁵ However, it must be noted that in *Dexia*, lawyers who are non-members of the Dutch Bar Association and operating on contingency fee basis could be involved in the litigation on a larger scale than usual, because the financial lease contracts were consumer contracts. In those types of consumer matters, the lowest courts, where a representation by a member of the Dutch Bar Association is not mandatory, have exclusive jurisdiction. Until July 2011, those courts had jurisdiction in matters with value up to €5,000. As discussed above, the government has raised the financial interest threshold to €25,000. That makes it easier for lawyers who are not member of the Dutch Bar association to represent clients in court. Kamerstukken II, 2008/09, 32 021, 2009/10 and 2010/11.

the special purpose vehicle and the subsequent WCAM settlement, funded primarily through the individual contributions of €45 by the members of Consumentenbond.⁹⁶ According to the terms of the settlement agreement, Dexia had to reimburse €45 to consumers who contributed to the initial litigation fund, leaving a significant part of the proceeds in that fund unexhausted. Furthermore, under the settlement agreement, the remaining proceeds were redirected to *cy pres* distribution, a precedent under Dutch law.⁹⁷ In theory, those proceeds can be used to fund subsequent collective actions.

From the perspective of the consumers and Consumentenbond, the funding in *Dexia* was successful, and the success can be attributed to the high number of consumers that were willing to contribute to the litigation fund, and to the collective resolution of the matter.⁹⁸ One explanation for the latter is the incentive provided by LEI providers for policy holders to join the action of the Consumentenbond, which will be discussed below. Another is that this was the first massive consumer financial services case in the Netherlands and Dutch consumers were not yet aware of the litigation dynamics in these types of disputes, particularly that they would profit from the results of the collective action even if they did not contribute funding to the litigation or settlement negotiations. The question is whether the free-rider problem would become more manifest in subsequent consumer mass disputes.⁹⁹

2. Legal Aid

Consumentenbond was able to concentrate the representation and aggregate claims by establishing a special purpose vehicle for the purpose of the collective action, hiring one lawyer and law firm, and raising a substantial fund by requiring a modest contribution from its members. The Legal Aid Board, on the other hand, had to take a different approach with regard

⁹⁶ The WCAM settlement involved about 300,000 consumers. Hof's-Amsterdam, 25 januari 2007, NJ 2007, 427, LJN:AZ7033 (Dexia).

⁹⁷ A new foundation was established promoting research and education with regard to collective actions and the resolution of mass disputes. Subsequently, a chair on mass claim litigation was established at Erasmus University Rotterdam in 2011. Erasmus School of Law, Prof. Astrid Stadler appointed to the Erasmus School of Law Chair in Comparative Mass Litigation (August 2011), http://www.esl.eur.nl/home/research/programmes_institutions/programmes/behavioural_approaches_to_contract_and_tort_relevance_for_policymaking/news_2012/news_2011/.

⁹⁸ Brechje Krijen, *Remarks at the 4th International Conference of the Globalization of Collective Litigation* (Dec. 10, 2010).

⁹⁹ This appears to be the case in another recent matter related to unit-linked insurances. While in the time period 1993-2010, 7.2 million unit linked insurances have been sold. CENTRUM VOOR VERZEKERINGSSTATISTIEK, *FACTSHEET INDIVIDUELE BELEGGINGSVERZEKERINGEN* (2011), <http://www.verzekeraars.nl/UserFiles/Image/factsheet%20beleggingsverzekeringen%2028022011.pdf>. The organizational grade of consumers here is much lower. However, this could be to the result of a variety of factors and goes beyond the scope of this paper to discuss those.

to the claimants eligible for Legal Aid. The statutorily-guaranteed free choice of legal services provider turned out to be an obstacle for the Legal Aid Board to appoint a small number of lawyers or law firms to deal with the matter and facilitate aggregation of the claims. About 4,200 individual cases in connection to the Dexia financial lease contracts were funded by the Legal Aid Board¹⁰⁰ and from 2002–2010 the Legal Aid Board spent about €3.3 million on lawyers' fees with about 150 individual cases still pending.¹⁰¹

In terms of litigation dynamics, Legal Aid clients had a financial incentive to pursue their individual case—they could gain from the collective action and settlement and simultaneously try to do better for themselves without worrying about costs. About 50% of the Legal Aid customers¹⁰² opted out of the collective settlement, whereas the overall percentage of opt-outs was about 10%. The difference suggests that litigants eligible for Legal Aid opted out more frequently. One may assume that the funding in *Dexia* was successful from the perspective of those litigants eligible for Legal Aid—they were able to profit without restriction from the available legal aid schemes.

The Legal Aid Board had a different perspective on the expenditure and the success of litigation funding in *Dexia* as a result of the unrestricted free choice of legal services provider. Although the lawyers' fees paid by the Legal Aid Board were comparatively and relatively modest (€3.3 million),¹⁰³ the amount is disproportionate to the number of consumers involved in the matter.¹⁰⁴ Furthermore, the €3.3 million does not include the costs incurred by the Legal Aid Board in disputes related to financial lease contracts with providers other than Dexia. The *Dexia* WCAM collective settlement and related case law set a minimum standard for other providers of financial lease contracts as well, and their clients could try to do better at practically no cost. Although, overall, Legal Aid services providers are being paid a relatively humble hourly rate of €107 per hour, in the course of

¹⁰⁰ The actual number of cases in connection to financial lease contracts is higher, since there are also individual law suits against other financial services providers.

¹⁰¹ Status per 2011.

¹⁰² Figures provided by the Legal Aid Board in 2011, on file with author.

¹⁰³ For example, the total budget of the Legal Aid Board for civil cases in 2011 was about €188 million and the overall budget in 2011, including criminal cases, was €378.7 million. Figures provided by the Legal Aid Board in 2011, on file with author.

¹⁰⁴ In contrast, in *Vie d'Or*, involving 11,000 consumer policy holders, the lawyers' fees were about €2–3 million and were incurred between 1995 and 2011. Those fees related to (1) criminal and disciplinary proceedings against some of the defendants, (2) an inquiry proceeding at the Enterprise Chamber of the Amsterdam Court of Appeal against one of the defendants, and (3) a subsequent collective action, including selected individual test cases for the calculation of damages, all litigated in three instances (District Court, Court of Appeal and Supreme Court) against three defendants, and (4) the WCAM settlement discussions and proceedings. HR 13 oktober 2006, NJ 2008, 527 m.nt (Vie d'Or) (Neth.).

the litigation some of them discovered that, due to the volume of many similar cases and the economies of scale that could be achieved by informal aggregation, the financial lease contracts cases could be profitable.¹⁰⁵

3. LEI

Figures about the number of Dexia clients that had a LEI are not publicly available but it has been estimated that it was substantial enough to unbalance the day-to-day operations of LEI providers without exceptional measures.¹⁰⁶ The LEI providers reimbursed the membership fee of €45 to those policy holders who chose to join the Foundation, and in fact, many policy holders did just that. In that way, LEI providers co-funded the collective action initiated by Consumentenbond while at the same time achieving substantial economies of scale.

Some Dutch LEI providers anticipated problems as a result of the free choice of legal advisor as experienced by the Legal Aid Board. The Legal Aid Board experienced this because it stipulated, in their general terms and conditions, that in case of a mass dispute, the insurer retains the right to limit the client's choice of a legal services provider. Clients who opted out from the WCAM settlement agreement were represented in the subsequent individual settlement negotiations by in-house lawyers of the LEI provider or by selected qualified external lawyers. This "informal aggregation" by LEI providers has not been reported by the latter as giving rise to concerns or being problematic. This could be explained by the fact that there is no statutory obligation for LEI providers to actively disclose the right of free choice of counsel to the policy holder.

Since most policy holders are not aware of this right, they are likely to simply follow the suggestion of their LEI provider. Moreover, the right of free choice of legal counsel cannot be invoked during settlement negotiations, which gives LEI providers of in-kind policies a powerful tool to control the out-of-court resolution of mass disputes and provides an additional incentive for LEI providers to promote an out-of-court resolution of mass disputes.

LEI providers did not seem to experience significant difficulties with the funding of the *Dexia* claims either. They could redirect most of their clients to the special purpose vehicle and Consumentenbond at virtually no cost. After the collective settlement was declared binding and some of their

¹⁰⁵ A similar dynamic has led to the collapse of the previously successful English Legal Aid system. See CHRISTOPHER HODGES, MULTI-PARTY ACTIONS 307-10 (Oxford University Press 2001) (discussing case studies on personal injury funding). For discussion of the subsequent litigation funding issues see Woolf, *supra* note 8 and Jackson, *supra* note 9.

¹⁰⁶ The estimates were derived based on interviews that the author conducted with employees of a LEI provider involved in the matter.

clients opted out, LEI providers of in-kind polices were able to resolve most cases by their in-house lawyers out of court without incurring costs related to instructing external lawyers. The evaluation would have been different in a system where the emphasis is on a resolution through litigation and in an institutional environment where LEI providers are obliged to cover the full costs of “free chosen” legal services providers.

4. TPF

The last funding mechanism that was used in *Dexia* was third-party litigation funding. Whether the special purpose vehicle that organized the opt-outs of about 23,000 consumers from the collective settlement has been commercially successful is unclear, though there are indications that this has been the case. Although *Dexia* was the first consumer mass claim dispute for that funder, it was not the first case that funder ever funded. Such commercial entities tend to develop an inventory of cases to spread litigation risks.

In relation to *Dexia*, there has been some public indignation with regard to the advertising methods used by the funder to mobilize the 23,000 consumers to opt out from the collective settlement and to the success fee. For example, *Dexia* considered it inappropriate, misleading, and disproportionate to the investment of the funder and the effort the funder put into the case. As discussed, after the settlement agreement was declared binding by the Amsterdam Court, the Supreme Court ruled favorably in selected test cases for a large portion of those who opted out.

Absent empirical data it is difficult to assess whether the funding was successful from the perspective of the consumers in light of the concerns that were publicly expressed about the high cost of the success fee.

C. *Intermezzo*

Overall, it seems that from the perspective of consumers, and in terms of the availability of funding mechanisms, *Dexia* can be viewed as successful. For the influence of the respective funding methods on outcomes and a normative evaluation of the funding methods, additional empirical research is required on, for example, litigant's satisfaction.

Another question that remains unanswered is whether the “success” in *Dexia* would be repeated in subsequent consumer matters. Assuming that consumers have discovered the advantages of concentration as a tool to adequately deal with structural investment asymmetries in mass disputes,¹⁰⁷ it is expected that in the future consumers will increasingly rely on collec-

¹⁰⁷ See discussion *supra* Part I.B.

tive actions and settlements that are being initiated in the Netherlands by special purpose vehicles. At the same time, it is to be expected that a decreasing number of consumers will be willing to individually contribute to funding those special purpose vehicles because they can profit from the initiatives without contributing.

Given that special purpose vehicles initiating collective actions or negotiating collective settlements are not eligible for Legal Aid, and that the Legal Aid Board cannot impose concentration measures on litigants eligible for Legal Aid,¹⁰⁸ Legal Aid will not be a funding mechanism from which special purpose vehicles can profit. LEI, on the other hand, could be such a venue, but this will depend on the number of consumers that have LEI in a concrete mass dispute.¹⁰⁹ It will also depend on whether the legal infrastructure of a national legal system facilitates concentration measures by LEI. The Dutch (in-kind) market for LEI, in combination with the specific Dutch legal infrastructure, seems to be successful in facilitating concentration in the resolution of mass disputes by LEI providers.¹¹⁰

An alternative for special purpose vehicles remains TPF, provided that consumer mass disputes are an interesting business proposition to TPF providers. In *Dexia*, that was apparently the case. It remains to be seen, however, whether the track record of TPF will indicate interest in funding consumer mass disputes. A closer look at the function of funding options used in *Dexia* reveal additional concerns with broader implications that are not necessarily limited to the Netherlands.

V. CONCERNS

A. *Legal Aid*

The *Dexia* case study demonstrates that applying the principle of party autonomy mechanically to the funding of mass disputes serves as an obstacle¹¹¹ for adequate funding of mass disputes through Legal Aid. This ob-

¹⁰⁸ See discussion *supra* Part III.A.

¹⁰⁹ That number should be sufficiently large.

¹¹⁰ See *supra* Parts III.B, IV.B.3.

¹¹¹ See generally Filippo Valguarnera, *Legal Tradition as an Obstacle: Europe's Difficult Journey to Class Action*, 10 GLOBAL JURIST 2 (2010). Valguarnera explains the difference between the U.S. and the European approaches to group litigation partially on the basis of Professor Mirjan Damaška's seminal work, "The Faces of Justice and State Authority." In this work, he distinguishes between a "coordinate ideal of authority" towards which the American legal system leans, and a "hierarchical ideal" closer to the continental European tradition. The discussion of the hierarchical ideal explains why most European legal systems resist prominent elements from the U.S. class action regime like standing to sue individuals, opt-out, etc. One could state that another phenomenon that strengthens this resistance is the mechanical application of the principle of party autonomy in mass disputes, whereas the latter requires

servation appears to be applicable to the EU and not just to the Netherlands. Although there is not a uniform system of European civil procedure and it is not very likely that there will be one in the near future,¹¹² the principles of party autonomy, free choice of legal counsel, and the right to determine one's litigation strategy influence the operation of most funding mechanisms available throughout Europe.¹¹³

In the absence of a properly functioning concentration mechanism, the free choice of legal services provider that most EU member states guarantee in mass disputes, weakens finality of resolution and the effective use of public funds in mass claim disputes. In times of shrinking budgets for Legal Aid, it is difficult to find a convincing justification for spending disproportionate amounts of publicly available funds to resolve thousands of similar individual cases. Jointly resolving generic issues relevant for all members of the group is a more intelligent way to proceed, not only in terms of expected reductions in costs, but also in terms of improving the quality of legal representation and, therefore, outcomes. Furthermore, concentration reduces investment asymmetries between individual consumers and repeat corporate defendants. Moreover, reorganizing the Legal Aid system of mass dispute funding to facilitate concentration in dispute resolution and focus on generic, rather than individual issues, is expected to have advantages not only for individuals eligible for Legal Aid funding but for members of the group in general.¹¹⁴

In support of proposals made in the legal literature,¹¹⁵ the Legal Aid Board has demonstrated itself to be a proponent of legislative reform that limits the free choice of legal services providers in mass disputes to only those lawyers or law firms on a newly formed Legal Aid Board mass disputes panel. Another position that is being advanced by the Legal Aid Board concerns amending the eligibility criteria to make it possible to fund special purpose vehicles acting in collective actions or WCAM settlements.

rethinking and redefinition of concepts and principles that are being viewed as fundamental. MIRJAN R. DAMAŠKA, *THE FACES OF JUSTICE AND STATE AUTHORITY* (1986).

¹¹² See Tzankova & Gramatikov, *supra* note 1, for discussion about the challenge for the European legal order.

¹¹³ Party autonomy has many exponents. Richard B. Capalli & Claudio Consolo, *Class Actions for Continental Europe? A Preliminary Inquiry*, 6 *TEMP. INT'L & COMP. L.J.* 217, 219 (1992). Capalli and Consolo identify the right to choose one's legal counsel, the right to be heard before suffering the consequences of a judgment, and notice of proceedings as three procedural rights that secure the principle of party autonomy.

¹¹⁴ A 2003 study of the Ministry of Justice showed that in terms of access to legal services, the middle incomes, as opposed to the low incomes, experience difficulties. Those results were not confirmed in a subsequent 2009 study. However, the latter revealed that increased income, correlated with a decrease of contacting a legal services provider, does not establish a decrease of legal problems for people with higher incomes. B.C.J. VAN VELTHOVEN & M. TER VOERT, *GESCHILBESLECHTINGSDELTA 2003* (Boom juridische uitgevers, WODC 2004); B.C.J. VAN VELTHOVEN & C.M. KLEIN HAARHUIS, *GESCHILBESLECHTINGSDELTA 2009*, 104-105 (Boom juridische uitgevers, WODC 2010).

¹¹⁵ See generally Elger & Tzankova, *supra* note 6, at 171-204.

Involving the Legal Aid Board in selecting the class lawyer may benefit potential governance and transparency problems that are signaled by the function of special purpose vehicles in collective actions and settlements. At the same time, concentration enables the Legal Aid Board to effectively cooperate with and monitor the conduct of other third-party financiers of consumer mass disputes like LEI and TPF.

Since the Legal Aid Board and LEI providers share a common interest in early detection of (mass) disputes and early conflict resolution (partly as a result of the negative experiences of the Legal Aid Board in *Dexia*), there have been informal initiatives by the Legal Aid Board and LEI providers to cooperate and establish an informal management level network to share information. The idea is that problems with providers or services can be detected, monitored, and addressed at an early stage in order to avoid litigation (preferably). Another field of cooperation that has been identified and that could decrease costs and improve the quality of legal services is joint selection and instruction of expert witnesses in mass disputes. This joint selection and instruction could promote and facilitate the out-of-court resolution through collective settlements.

B. *LEI*

The European Court of Justice case law relating to the Directive builds on the principle of party autonomy and the right to choose legal counsel could have a negative impact on funding mass claim disputes through LEI. Although LEI providers seem to be able to avoid some of the negative implications of that case law, a question that has not been answered to date is how the Directive and related case law of the European Court of Justice will influence the practice of LEI providers in mass disputes to restrict the right to choose legal counsel and promote “informal aggregation” by instructing selected (in-house) lawyers.

The Amsterdam Court of Appeal case law shows that the ruling of the European Court of Justice relates only to situations where the decision to hire an external lawyer has already been taken by the LEI provider. It does not apply to in-kind policies—where the LEI provider has decided to handle the matter, or when the proceedings have already been commenced by an in-house legal counsel who is not qualified as a lawyer.¹¹⁶ According to the Amsterdam Court of Appeal, a policy holder has the right to legal counsel only after the LEI provider has decided to instruct a qualified (internal or external) lawyer to represent the client in legal proceedings. According

¹¹⁶ Hof's-Amsterdam 26 juli 2011, NJF 2011, 368 ¶¶ 3.5, 3.6 m.nt. (Das Dutch Legal). As pointed out earlier in relation to *Dexia*, in the Netherlands lawyers who are not members of the Dutch Bar Association are allowed to represent clients in court if the financial interest at stake is less than €5,000 and in a consumer related matter. The threshold was increased on July 1, 2011, to €25,000.

to the Amsterdam Court of Appeal, the policy holder's right is not based on EU law but on a Regulation of the Dutch Bar Association,¹¹⁷ which also governs the conduct of the qualified lawyers employed by LEI.¹¹⁸ Moreover, Dutch courts¹¹⁹ have ruled that the right to free choice of counsel exists from the moment proceedings are issued. This means that prior to proceedings, or in the context of WCAM settlement negotiations, the policy holder is restricted in his choice, allowing the LEI provider to facilitate the concentration of representation by instructing selected lawyers to deal with the matter.

It remains to be seen whether this interpretation of applicable Bar regulations, EU law, and European Court of Justice case law will stand the test of the Dutch Supreme Court and the European Court of Justice. For the moment, the status quo has significant implications in the Dutch institutional setting—the WCAM mechanism aims to facilitate the out-of-court resolution of mass disputes. The current setting favors the business model of LEI providers of in-kind polices. This allows for concentrated claims and promotes out-of-court collective resolution of mass disputes. It may be expected that LEI providers will play an increasingly important role in the resolution of future mass disputes,¹²⁰ although that role will probably be restricted to domestic consumer mass disputes since this seems to be the most significant market of LEI providers. The extra incentive for LEI providers to more frequently use the WCAM mechanism to resolve mass disputes is a positive side effect but this might create additional agency problems that need to be addressed by the courts approving collective settlement agreements.

Moreover, one may assume that a different institutional setting would transform mass disputes and threaten the business model of legal expense insurers. In Germany, for example, there is an emphasis within the legal system to resolve disputes through litigation and lawyers that have a monopoly for legal services.¹²¹ In this situation, the aforementioned European

¹¹⁷ *Id.* at ¶ 3.8.

¹¹⁸ VERBOND VAN VERZEKERAARS, KWALITEITSCODE RECHTSBIJSTAND (2010), http://www.verzekeraars.nl/UserFiles/File/download/kwaliteitscode_rechtsbijstand.pdf.

¹¹⁹ *Id.*

¹²⁰ A provision that was enacted in 2011, Art. 93 RV, that is expected to increase the role of LEI providers in Dutch courts is the raising of the financial interest threshold to €25,000 when determining if the claim must be adjudicated by a member of the Dutch Bar. This aims to make it cheaper and easier for litigants to bring claims but it will also extend the possibility for LEI providers offering in-kind polices to make use of in-house lawyers and reduce costs.

¹²¹ It is sometimes stated that Germans are more litigious by nature than, for example, the English. Van Boom, *supra* note 4, at 95. The recent KapMuG Referententwurf is yet another example of Germans litigious nature. Although it aims to introduce a court-approved opt-out settlement regime along the lines of the Dutch WCAM, it still requires that the individual claimants who are going to be bound by the collective settlement agreement to have filed a suit. Kapitalanleger- Musterverfahrensgesetz

Court of Justice case law that prohibits promoting aggregation in mass claim disputes would cause a different litigation funding dynamic than in the Netherlands. Indeed, it has been reported that the German legal expenses insurers involved in the litigation funding for the massive Deutsche Telekom case are considering excluding mass disputes from their coverage.¹²² This illustrates that mass disputes pose challenges not only to Legal Aid, but also to LEI providers, thus leaving the market of legal services to commercial litigation financiers who are not restricted or regulated by European or national legislatures.

C. TPF

As pointed out earlier, the default position for TPF in the Netherlands is likely to be that the principle of contractual freedom allows parties to evaluate their own financial interests and make an informed business decision about how much decisional power they are willing to give to a third-party litigation funder.¹²³ However, academic studies focusing on funding dynamics in mass disputes have identified several issues related to TPF.

In the first place, who has a fiduciary duty when the class lawyer is instructed by a third-party funder who is funding a case for a percentage of the outcome? In other words, who is the client and who ultimately decides the litigation strategy? The classic agency problem of the class counsel in mass disputes¹²⁴ is being extended or “enriched” with yet another actor—the funder. The answer to this question is not merely of theoretical importance. The interests of the third-party funder and the client may diverge. For example, an acceptable outcome might be sufficient for the funder to recover costs and make some profit but this might not be the best alternative for the class. Since the funder is paying the class lawyer, in practice, the class lawyer has two clients—the group and the funder. Whether this problem will manifest itself in a specific case will depend on the practice of the respective TPF providers.¹²⁵ Ideally, the contract between the class lawyer

[KapMuG] [The Act on the Initiation of Model Case Proceedings in Respect of Investors in the Capital Markets] Nov. 1, 2005 Bundesgesetzblatt, Teil I [BGBl I.] at 2437 (Ger.).

¹²² Axel, Halfmeier, *The People’s Stock Gone Bad: An Unfinished Story of Collective Proceedings in German Capital Markets Law* (May 30, 2011) (unpublished manuscript) (paper presented at the annual meeting of The Law and Society Association, Westin St. Francis Hotel, San Francisco, CA).

¹²³ See *supra* Part III.C.

¹²⁴ Nancy J. Moore, *Who Should Regulate Class Action Lawyers?*, 2003 U. ILL. L. REV. 1477 (2003); Jasminka Kalajdzic, *Self-Interest, Public Interest and the Interests of the Absent Client: Legal Ethics and Class Action Praxis*, 49 OSGOODE HALL L.J. 1 (2011).

¹²⁵ Some TPF providers only fund and leave the strategies to the lawyers and the clients; others prefer a more “hands on” approach. See Paul Karlsgodt, *Notes from the 5th Annual Conference on the Globalisation of Class Actions and Mass Litigation, Session II – Who’s paying?* CLASSACTIONBLAWG.COM (Dec. 17, 2011), <http://classactionblawg.com/2011/12/17/notes-from-the->

and his clients should address potential conflicts and should stipulate how the lawyer will act when such a conflict of interests emerges between the funder and the class.

Another potential problem relates to the success fee of the third-party funder. The agency problems inherent to class and group litigation have been extended and multiplied by the involvement of third-party funders.¹²⁶ It could be expected that the type of remedies identified in the literature to cope with agency problems in the relationship between the class lawyer and the class should be sufficient to address agency problems in the relationship between the third-party funder and the class. The main ways to prevent these problems are through monitoring and financial incentives.¹²⁷ Academic proposals advanced to address the specific agency problems in relation to third-party funding vary from soft regulation and judicial oversight to strictly enforced statutory provisions that prescribe safeguards to promote transparency and good governance.¹²⁸ These are classified as “monitoring” proposals. According to some authors, soft regulation should at least address (1) monitoring the conduct of third-party financiers prior to and in the course of the litigation, (2) the level of involvement of the financier with the litigation strategy, (3) the fiduciary duty of the class lawyer, and (4) the award of the third-party litigation funder.

Those concerns are particularly relevant in the Dutch context where TPF enjoys favorable institutional treatment. Although it is yet uncertain whether and how future national and EU legislative initiatives in the field of private international law or European Court of Justice case law will influence the functioning of the WCAM, for the moment, the Netherlands is the only European jurisdiction with a device such as the WCAM. This might attract third-party litigation funders who may use the WCAM more frequently as part of their global litigation options and strategies. The WCAM will be particularly attractive since, according to its statutory provisions, there is no judicial control over the remuneration of lawyers and success fees.¹²⁹

5th-annual-conference-on-the-globalization-of-class-actions-and-mass-litigation-session-ii-whos-paying/.

¹²⁶ Although the opposite argument could also be made that a third-party litigation funder helps monitor the conduct of the class lawyer and in that way helps decrease agency problems in the class-lawyer relationship. See Ianika Tzankova, *Kwaliteitsbewaking van belangenbehartiging bij collectieve acties en massaschade: ‘Who will guard the guardians?’* in GESCHRIFTEN VANWEGE DE VERENIGING CORPORATE LITIGATION 135-158 (M. Holtzer et al. eds., Deventer: Kluwer 2010).

¹²⁷ See *supra* Part I.B.

¹²⁸ Rachael Mulheron & Peter Cashman, *Third-Party Funding of Litigation: A Changing Landscape*, CIV. JUST. Q. 312-42 (2008). See generally Tzankova & Kortmann, *supra* note 14 (discussing monitoring remedies).

¹²⁹ Although the Amsterdam Court of Appeal has demonstrated in *Converium* that it is willing to take a position with regard to class counsel fees, absent an explicit statutory provision or guidelines this

However, regulation of third-party funding cannot take place without having a clear view of what is actually going on “on the ground.” Regulators should know what the business models of the various third-party funders are, their practices with regard to the control of litigation and negotiation strategies, and how all this is being valued by the different types of litigants, e.g., consumers and businesses. Another area of further research is the potential effect a market for liability claims will have on the judiciary, particularly the implications for the judiciary decision-making process.¹³⁰ TPF is becoming an essential mechanism for the funding of mass disputes and for securing access to justice. Therefore, regulatory restrictions should be accompanied by measures that at least improve the already available funding mechanisms (Legal Aid and LEI).

SUMMARY AND CONCLUSIONS

Advanced legal systems should have mechanisms in place to secure access to the courts and dispute resolution services and therefore to litigation funding. This paper explored whether the Dutch legal system has mechanisms in place to secure access to litigation funding in mass claim disputes in the context of a concrete consumer mass claim dispute—*Dexia*. The *Dexia* dispute contained a combination of the main funding options available in the Netherlands—individual contributions, Legal Aid funding, LEI, and TPF. TPF is particularly attractive for jurisdictions such as the Netherlands that ban contingency fees.

From the perspective of consumers and in terms of the availability of funding mechanisms, *Dexia* can be viewed as a success. It is unclear whether the “success” in *Dexia* will be repeated in subsequent consumer matters. Assuming that consumers have discovered the advantages of concentration as a tool to adequately deal with the detrimental structural investment asymmetries in mass disputes, it is expected that they will increasingly rely on collective actions and settlements that are being initiated by special purpose vehicles in the Netherlands. At the same time, it is to be expected that a decreasing number of consumers will individually contribute to funding special purpose vehicles because they will profit from the initiatives anyway. Given the fact that special purpose vehicles initiating collective actions or negotiating collective settlements are not eligible for Legal Aid and the Legal Aid Board cannot impose concentration measures, Legal Aid will not be an option for special purpose vehicles. LEI could be

remains an arbitrary process. See generally Hof’s-Amsterdam 12 november 2010, NJ 2010, 683 (Scor Holdings AG f/k/a Converium Holdings AG).

¹³⁰ See Andrea Pinna, *Financing Civil Litigation: The Case for the Assignment and Securitization of Liability Claims*, in *NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE* 109, 126 (M. Tuil & L. Visscher ed. 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1396682.

an option, but this will depend on the number of consumers that have LEI in a mass dispute. It will also depend on whether the legal infrastructure of a national legal system facilitates concentration measures by LEI. The Dutch (in-kind services) market for LEI, in combination with the specific Dutch legal infrastructure, appears to be successful in facilitating concentration while resolving mass disputes by LEI providers. TPF is the alternative, provided, however, that consumer mass disputes are a good business proposition for TPF providers. In *Dexia*, that was apparently the case, and it remains to be seen if TPF will be used to fund consumer mass disputes in the future.

A closer look at the function of various funding options used in *Dexia* revealed additional concerns with broader implications not necessarily limited to the Netherlands.

The functioning and significance of litigation funding for mass disputes is being influenced by the principle of party autonomy and its exponents—the free choice of legal counsel and the right to determine one’s litigation strategy. Applying those principles mechanically is an obstacle to the adequate funding of mass disputes through Legal Aid. Case law of the European Court of Justice that builds on the principle of free choice of legal counsel could have a similar impact on LEI and be disadvantageous to LEI providers’ business models, eliminating that group of litigation financiers from funding mass disputes.

Redefining the meaning of party autonomy and free choice of legal counsel, or simply limiting the impact of these principles in mass disputes, will provide only a partial improvement in funding mass disputes. Even provided that these concepts are “properly” framed in the context of mass disputes, as a result of institutional and market restraints, Legal Aid schemes and LEI will be primarily limited to (1) national and (2) consumer related matters. Without additional coordination efforts at national and supranational levels, there will be a deficit in the funding for international consumer mass disputes and non-consumer mass disputes.

To secure access to justice in these categories of mass disputes, alternative funding options—third-party financing—will remain necessary and will become increasingly available. The emerging practice in Europe already proves that there is a need and a market for this type of funding, despite dogmatic and ethical objections put forward by some legal scholars. Although the practice and business models of third-party financiers vary considerably, both the opponents and proponents of third-party financing agree that it should be regulated. However, opinions on the scale and intensity of proposed third-party financing regulation varies considerably. Regulation, or at least awareness of the funding issues, in mass disputes is of an even greater importance in legal systems such as the Netherlands, where the legislature and the judiciary have traditionally been less focused on the influence of underlying financial incentives on litigation dynamics. However, regulation of third-party funding should be consciously considered—

there is a lot we do not know. For example, the influence of the respective funding methods on outcomes and litigant's satisfaction is still unknown. At the end of the day realism and pragmatism prevail over idealism—what is one's day in court worth if that is one more day than one can afford?



IDEAL VERSUS REALITY IN THIRD-PARTY LITIGATION FINANCING

Joanna M. Shepherd*

Third-party financing of commercial litigation has grown considerably in the United States. Many legal scholars assert that third-party financing can reduce barriers to justice that result when risk-averse, financially constrained plaintiffs are pitted against risk-neutral, well-financed defendants. However, as discussed in this article, third-party investors have little incentive to finance cases where plaintiffs face significant barriers to justice. In contrast, investors face the highest potential returns in the types of cases where the underlying substantive law creates risk and cost imbalances that advantage, not disadvantage, plaintiffs. Indeed, data from the investment decisions of the largest third-party financiers of U.S. litigation demonstrate that investors are financing many cases where the existing law favors plaintiffs. As a result, rather than improving access to justice, third-party financing is increasing inefficiency and threatening both the compensatory and deterrent functions of the legal system.

INTRODUCTION

Third-party litigation financing is not an entirely new phenomenon in the United States; indeed certain forms have been in practice since the 1980s.¹ The cash advance industry offers pre-settlement funding agreements that loan a few thousand dollars to personal injury victims while their lawsuits are pending.² In another form of third-party litigation financing, the syndicated lawsuit, plaintiffs directly solicit individual lenders to invest

* Associate Professor of Law, Emory University School of Law. I am grateful to the Searle Civil Justice Institute for helping to fund this research. I also received helpful comments from participants at the SCJI Global Conference on Third-Party Financing of Litigation, New York, NY, October 5-6, 2011 and participants at the SCJI Global Conference on Third-Party Financing of Litigation, Brussels, Belgium, November 9-10, 2011.

¹ Jason Lyon, Comment, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 574 (2010).

² STEVEN GARBER, RAND INSTITUTE FOR CIVIL JUSTICE PROGRAM, ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWN, AND UNKNOWN 12 (2010), available at http://www.rand.org/pubs/occasional_papers/OP306.html (“two industry leaders estimate the average sizes of their cash advances to be \$1,750 and \$4,500. . .”).

in claims and share proportionally in the recovery.³ Both of these forms of third-party litigation financing are non-recourse loans because the plaintiff need only pay back the loan if the lawsuit succeeds.

However, in recent years, a new breed of third-party litigation financing has evolved in the United States. Large litigation finance corporations now exist that provide capital in exchange for a share of a corporate plaintiff's eventual recovery. Whereas the cash advance industry makes pre-settlement loans of a few thousand dollars in exchange for a share of recoveries that tend to peak in the low hundred thousands, the new litigation finance corporations routinely loan several million dollars in exchange for shares of recoveries that can be in the billion dollar range.⁴ Currently, six corporations invest in commercial lawsuits in the United States.⁵ However, only two publicly traded corporations exist primarily to invest in American commercial litigation: Juridica Investments and Burford Capital.⁶ Both of these corporations manage investment funds of well over \$100 million. Of the remaining four corporations, three are private companies that provide little information about their investments—ARCA Capital, Calunius Capital, and Juris Capital—and the other, IMF Ltd., is publicly traded but invests primarily in litigation outside of the United States.⁷ A handful of other corporations, investment banks, and hedge funds have recently formed litigation funding divisions to buy interests in commercial lawsuits.⁸

The legal status of third-party litigation finance in the United States is far from clear. For centuries, common law prohibited third-party financing by the doctrines of maintenance and champerty. "Maintenance" is the provision of support for a lawsuit to which one is not a party, and "champerty," a form of maintenance, involves acquiring an interest in the recovery from the lawsuit.⁹ The current laws regarding maintenance and champerty vary across jurisdictions: twenty-seven states and the District of Columbia explicitly permit champerty, albeit with varying limitations, and sixteen of those states explicitly cite the investment by contract into a stranger's suit as a permissible form of maintenance.¹⁰ Although no American court has yet considered the legality of third-party finance in commercial litigation,

³ Susan Lorde Martin, *Syndicated Lawsuits: Illegal Champerty or New Business Opportunity?*, 30 AM. BUS. L.J. 485, 498 (1992); Daniel C. Cox, *Lawsuit Syndication: An Investment Opportunity in Legal Grievances*, 35 ST. LOUIS U. L.J. 153, 154-59 (1990).

⁴ Lyon, *supra* note 1, at 578.

⁵ GARBER, *supra* note 2, at 14-16.

⁶ Lyon, *supra* note 1, at 578.

⁷ GARBER, *supra* note 2, at 15-16.

⁸ Lyon, *supra* note 1, at 578.

⁹ See generally 14 AM. JUR. 2D *Champerty and Maintenance* §§ 1-18 (1964 & Supp. 2011).

¹⁰ GARBER, *supra* note 2, at 17-18.

courts have split on whether pre-settlement funding agreements in personal injury litigation are legal and enforceable.¹¹

Third-party litigation financing has substantial support from practitioners and legal scholars. The basis of their support is that third-party financing of litigation can reduce barriers to justice that result when risk-averse, financially constrained plaintiffs are pitted against risk-neutral, well-financed defendants. By relieving a risk-averse plaintiff of much of the litigation risk, third-party financing can offset a risk-neutral defendant's bargaining advantage and level the playing field in negotiations. This would improve plaintiffs' compensation and promote more accurate deterrence.

However, the goal of third-party investors is not to improve access to justice for financially constrained or risk-averse plaintiffs. Instead, third-party investors aspire only to maximize the returns from their investments in litigation. Moreover, the cases with the largest potential return are often the cases where the existing substantive law advantages, rather than disadvantages, the plaintiffs. As a result, many of the cases financed by third-party investors are the opposite of the types of cases where financing could improve access to justice for vulnerable plaintiffs. Thus, the reality of third-party financiers' investment strategy directly conflicts with the theoretical ideal of third-party financing.

Illustrating this conflict, *Juridica* regularly invests in patent infringement cases and price-fixing cases, and *Burford Capital* invests in multi-party litigation. The underlying substantive law in these types of cases creates cost and risk imbalances that generally favor plaintiffs. In patent infringement cases, defendants face exorbitant costs of defending claims, the possibility of preliminary injunctions and the risk of significant losses at trial, including treble damages, attorneys' fees, and permanent injunctions. Defendants in price-fixing cases also face the risk of exorbitant damages at trial due to the possibility of treble damages, attorneys' fees, joint and several liability rules that prohibit proportional liability, rules against contribution, and the potential for tolling of the statute of limitations. In class actions, defendants face exposure to catastrophic losses at trial when individual plaintiffs' claims are aggregated and exorbitant litigation expenses can last for decades. The asymmetric costs and risks that defendants face in these cases result in significant imbalances in risk preferences that weaken the defendants' bargaining positions compared to the plaintiffs'.

By increasing the supply of funds available in these types of cases, third-party financing exacerbates existing cost and risk imbalances created by the underlying substantive law. Third-party investors absorb much of the plaintiffs' risk in the cases they finance, so they worsen the existing risk

¹¹ See, e.g., *Saladini v. Righellis*, 687 N.E.2d 1224 (Mass. 1997); *Osprey, Inc. v. Cabana Ltd. P'ship*, 532 S.E.2d 269 (S.C. 2000) (finding that litigation loans are legal). But see *Rancman v. Interim Settlement Funding Corp.*, 789 N.E.2d 217, 219 (Ohio 2003), and *Odell v. Legal Bucks, L.L.C.*, 665 S.E.2d 767 (N.C. Ct. App. 2008) (declining to enforce a litigation lending agreement).

imbalances that already favor plaintiffs. Similarly, by financing much of the plaintiffs' litigation costs, third-party investors worsen existing cost imbalances that favor plaintiffs. These imbalances induce defendants to accept even less favorable settlements than they would have without third-party financing. Settlements that are systematically larger than expected trial outcomes or outcomes dictated by the underlying substantive law lead to the overcompensation of some plaintiffs and the over-deterrence of certain behaviors.

Thus, although third-party litigation finance has the potential to improve access to justice, it is instead increasing inefficiency. Part I discusses how third-party financing of litigation can correct certain distortions in justice that result when risk-averse, financially-constrained plaintiffs are pitted against risk-neutral, well-financed defendants. However, Part II explains that third-party financiers are investing not in the cases where plaintiffs face significant barriers to justice, but in cases where substantive law generally favors plaintiffs. Part III shows that as a result, rather than improving access to justice, third-party financing is increasing inefficiency and threatening both the compensatory and deterrent functions of the legal system.

I. THE IDEAL OF THIRD-PARTY FINANCING OF LITIGATION

Numerous legal scholars support third-party litigation financing.¹² The basis of their support is the assumption that third-party financing removes

¹² See, e.g., Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 73 (2010) ("Indeed, by enlisting the help of a third party that holds a diverse portfolio of litigation risk and is better able to bear the risk, the weaker party could bolster its negotiating position and secure a settlement that reflects the merits of the lawsuit rather than the relative bargaining positions of the parties."); David Abrams & Daniel L. Chen, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes 2* (April 2012) (unpublished manuscript), available at <http://www.duke.edu/~dlc28/papers/MktJustice.pdf> (selling litigation rights to parties with the resources to pursue the claims may address the problem of litigation "undersupply. . . due to credit constraints, risk aversion, collective action problems, or simply unawareness, even when a plaintiff or defendant has a positive expected payoff."); PAUL H. RUBIN, ON THE EFFICIENCY OF INCREASING LITIGATION 5 (2009), available at <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf> ("An important role for third party financing would be to allow financing and diversification over such large cases, each of which would otherwise impose large risks on an individual attorney who accepted the case or large transactions costs if brought by consortiums of attorneys."); Lauren J. Grous, Note, *Causes of Action for Sale: The New Trend of Legal Gambling*, 61 U. MIAMI L. REV. 203, 204 (2006) (characterizing the litigation finance industry as an antidote for situations in which "a plaintiff with a strong cause of action may lack the finances to either pursue the claim or to pay medical bills and other living expenses during the litigation's pendency"); MICHAEL B. ABRAMOWICZ, A FEE LIMITATION RULE FOR LITIGATION FINANCE 3 (2009), available at http://www.law.northwestern.edu/searlecenter/papers/Abramowicz_Finance_Final.pdf ("Such financing enables liquidity-constrained plaintiffs to bring more cases and to prosecute cases more effectively. Increased funding for litigation should thus reduce legal error and help achieve the legal system's goals, including both compensation and deterrence of negligent or wrongful acts.").

barriers to justice resulting from plaintiffs' financial constraints and risk aversion.¹³ As a result, the supporters contend that third-party litigation financing will improve the efficiency of the legal system by increasing both the compensation of deserving plaintiffs and the deterrence of wrongful conduct.¹⁴

Cost barriers represent a major barrier to justice in the U.S. legal system.¹⁵ Because litigation is costly, many plaintiffs with limited financial resources cannot afford to bring legal claims. When deserving plaintiffs do not bring claims, they go uncompensated. Moreover, because the cost barriers result in under-compensation, they lower the expected cost of engaging in activities that pose a risk to low-wealth individuals. As a result, the cost barriers produce suboptimal deterrence of wrongful behavior in activities in which low-wealth individuals engage.¹⁶

Plaintiffs' risk aversion is another barrier to justice in many situations. Risk-averse plaintiffs might not pursue meritorious claims even when they can afford the legal fees.¹⁷ The uncertain nature of legal proceedings and damage awards reduces the expected value of legal claims to risk-averse plaintiffs. If the expected value of an uncertain claim decreases below the expected cost of bringing the claim, a risk-averse plaintiff will choose not to bring an otherwise meritorious claim. As a result, deserving plaintiffs will go uncompensated and the tort law will not adequately deter wrongful conduct.

Moreover, even when the expected values of uncertain claims' are high enough to induce risk-averse plaintiffs to pursue those claims, imbalances in risk preferences between plaintiffs and defendants can distort settlement incentives. Risk-averse plaintiffs will be willing to settle legal claims for lower amounts than risk-neutral plaintiffs because the uncertainty of trial lowers the expected value of legal claims to risk-averse plaintiffs. As a result, risk-averse plaintiffs pitted against risk-neutral defendants will result in settlements that are lower than the mean expected damage awards (which equal the expected value of claims for risk-neutral plain-

¹³ *Id.*

¹⁴ *Id.*

¹⁵ See Marc Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95, 103-04 (1974) (discussing the disadvantages presented to those who have limited access to legal services).

¹⁶ See, e.g., Paul H. Rubin & Joanna M. Shepherd, *The Demographics of Tort Reform*, 4 REV. OF L. & ECON. 591 (2008) (finding that there is less deterrence of wrongful behavior directed towards lower income groups).

¹⁷ David Abrams & Daniel L. Chen, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes* 3 (unpublished manuscript), available at <http://www.duke.edu/~dlc28/papers/MktJustice.pdf>.

tiffs).¹⁸ Similarly, risk-neutral plaintiffs pitted against risk-averse defendants will result in settlements that are higher than the mean expected damage awards because the uncertainty of trial raises the cost of legal claims to risk-averse defendants. Such settlements that systematically differ from trial expectations threaten the substantive law regime because tort law does not achieve its compensatory and deterrent goals when defendants pay damages that differ from what the substantive law obligates them to pay.¹⁹

Fortunately, legal arrangements have evolved which reduce the financial and risk barriers to justice and enable plaintiffs to pursue litigation that they would otherwise not pursue. For example, when attorneys take low-wealth plaintiffs' cases on contingency, they are removing cost barriers that could otherwise restrict those plaintiffs' access to justice. Similarly, contingency fee attorneys that can diversify the risk inherent in litigation across many lawsuits will be less risk-averse than many individual plaintiffs will. As a result, contingency fee arrangements enable risk-averse plaintiffs to bring cases that they would otherwise not bring or reject low settlements that they would otherwise accept.

However, there are some situations where contingency fee arrangements are not sufficient to provide access to justice for all deserving plaintiffs. For example, contingency fee attorneys are often unwilling to represent low-wealth plaintiffs because the expected contingency fees do not cover the costs of litigating the cases.²⁰ Oftentimes, the expected compensatory awards for low-wealth plaintiffs are low due to the low economic damages arising from their modest incomes. As a result, the expected contingency fees will be too low to induce attorneys to take such cases on contingency.

¹⁸ See Alfred F. Conard, *The Economic Treatment of Automobile Injuries*, 63 MICH. L. REV. 279 (1964); Robert J. Rhee, *Tort Arbitrage*, 60 FLA. L. REV. 125, 153-55 (2008); Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J. LEGAL STUD. 329, 329, 335-36 (1987).

¹⁹ Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367 (2009).

²⁰ Troy L. Cady, Note, *Disadvantaging the Disadvantaged: The Discriminatory Effects of Punitive Damage Caps*, 25 HOFSTRA L. REV. 1005, 1033 (1997) ("Lawyers will become increasingly unwilling to represent plaintiffs in lawsuits that have little or no prospect of yielding adequate compensation for the large amount of time and money invested."); Stephen Daniels & Joanne Martin, *The Texas Two-Step: Evidence on the Link Between Damage Caps and Access to the Civil Justice System*, 55 DEPAUL L. REV. 635, 661 (2006) (from an interview with a personal injury lawyer in Texas: tort reform has "essentially closed the courthouse door to the negligence that would kill a child, a housewife or an elderly person." The reason is that "there are no medical expenses, no loss of earning capacity . . ."); Catherine M. Sharkey, *Unintended Consequences of Medical Malpractice Damage Caps*, 80 N.Y.U. L. REV. 391 (2005) (showing that awards for overall damages have stabilized while economic damages have increased possibly because plaintiffs' lawyers have screened out women, minorities, and children who are less likely to receive high economic damages); Rachel Zimmerman & Joseph T. Hallinan, *As Malpractice Caps Spread, Lawyers Turn Away Some Cases*, WALL ST. J., Oct. 8, 2004, at A1 ("Caps on damages for pain and suffering . . . [are] turning out to have the unpublicized effect of creating two tiers of malpractice victims. . . . [L]awyers are turning away cases involving victims that don't represent big economic losses - most notably retired people, children and housewives . . .").

In other cases, litigation is so costly and risky that even attorneys that can spread risk and costs across numerous cases are unwilling to accept the cases on contingency.²¹ For example, major long-term cases, such as large class actions, often have costs that run “into the millions of dollars” and often take “a decade or more” to resolve.²² Although large, well-capitalized law firms or consortiums of attorneys from different firms take some of these cases in order to spread the cost and risk, there is a limit to the amount of diversification that individual firms can achieve.²³ As a result, some plaintiffs will not bring meritorious cases, which results in under-compensation and under-deterrence.

In situations where contingency fee arrangements fail to provide access to justice, third-party financing can allow the pursuit of meritorious claims that plaintiffs would not otherwise file.²⁴ Third parties that finance much of the expense of litigation reduce cost barriers to justice that financially constrained plaintiffs may otherwise face. Third parties that diversify their investment portfolio across numerous lawsuits can spread the risk of unfavorable judgments and allow plaintiffs to take a more risk-neutral approach to litigation decisions. This will reduce the occasions where plaintiffs’ risk aversion leads them to accept settlements below the expected value. Thus, third-party litigation financing can result in both improved compensation and more accurate deterrence of wrongful behavior.

II. THE REALITY OF THIRD-PARTY FINANCING OF LITIGATION

Although third-party financing of litigation has the potential to improve access to justice, whether this goal is attained depends on the types of cases third-party investors choose to finance. If third-party financiers invest in cases brought by low-wealth plaintiffs, then the financing may remove cost barriers to justice. Similarly, if they invest in cases brought by risk-averse plaintiffs against risk-neutral defendants, then the financing may reduce distortions in justice resulting from imbalances in risk preferences.

²¹ PAUL H. RUBIN, ON THE EFFICIENCY OF INCREASING LITIGATION 5-6 (2009), available at <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

²² Sarah Northway, Note, *Non-Traditional Class Action Financing and Traditional Rules of Ethics: Time for a Compromise*, 14 GEO. J. LEGAL ETHICS 241, 247 (2000).

²³ PAUL H. RUBIN, ON THE EFFICIENCY OF INCREASING LITIGATION 5-6 (2009), available at <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

²⁴ For a discussion of whether third-party financing improves justice even in cases brought on contingency, see MAX SCHANZENBACH & DAVID DANA, HOW WOULD THIRD-PARTY FINANCING OF LITIGATION CHANGE THE FACE OF AMERICAN TORT LITIGATION? THE ROLE OF AGENCY COSTS IN THE ATTORNEY-CLIENT RELATIONSHIP (2009), available at http://www.law.northwestern.edu/searlecenter/papers/Schanzenbach_Agency%20Costs.pdf.

However, the goal of third-party financiers is not to improve access to justice. Although improving justice may be a positive side effect of third-party financing, the financiers are ultimately investing in commercial litigation to maximize the expected returns on their investments. As a result, the types of cases that third-party investors finance often diverge from the types of cases where third-party financing can improve access to justice.

Emphasizing the return-maximizing goal over the justice-improving goal, Chris Bogart, CEO of Burford Capital, explains:

We're fundamentally a capital provider. We take a share of the ultimate recovery, having taken the risk of funding the case. Forget this being about the law or litigation - we're providing risk funding for an investment in the same way as in any other sector of the market. If the investment pays off we make a return on the capital we're investing.²⁵

Similarly, Timothy Scranton, President of Juridica Capital Management, a subsidiary of Juridica Investment that identifies potential investments, explains that Juridica's focus on U.S. litigation is purely profit driven:

Why is the U.S. legal industry so large and attractive to claim investors? Some of the influences include the role of the jury trial in civil cases and the substantial awards that plaintiffs can recover. In some cases, special damages, such as treble and punitive damages, make claims a potentially profitable asset. Likewise, special litigation regimes (such as class actions) allow the aggregation of potentially thousands of low-value claims and present another opportunity to create value.²⁶

Unfortunately, third-party financiers seeking to maximize investment returns have little incentive to finance cases where plaintiffs face significant barriers to justice. In contrast, investors face the highest potential returns in the types of cases where the underlying substantive law creates risk and cost imbalances that favor plaintiffs. In these cases, defendants often agree to inefficiently large settlements to avoid the risk of disastrous losses at trial.

²⁵ Matt Byrne, 'World's largest dispute financier' targets US litigation market uptick, THE LAWYER, Nov. 29, 2010, <http://www.thelawyer.com/%E2%80%98world%E2%80%99s-largest-dispute-financier%E2%80%99-targets-us-litigation-market-uptick/1006248.article>.

²⁶ GEOFFREY MCGOVERN, NEIL RICKMAN, JOSEPH W. DOHERTY, FRED KIPPERMAN, JAMIE MORIKAWAN & KATE GIGLIO, RAND INSTITUTE FOR CIVIL JUSTICE, THIRD-PARTY LITIGATION FUNDING AND CLAIM TRANSFER: TRENDS AND IMPLICATIONS FOR THE CIVIL JUSTICE SYSTEM 11 (2010), available at http://www.rand.org/pubs/conf_proceedings/CF272 (summarizing remarks of Timothy D. Scranton).

Indeed, data from the investment decisions of one of the largest third-party financiers of U.S. litigation demonstrate that investors are financing many cases where the existing law favors plaintiffs. Juridica currently has \$134 million invested in twenty-five cases.²⁷ Over 60% of this total is invested in antitrust price-fixing cases, while another 28% is invested in patent infringement cases.²⁸ The remaining 12% is invested in various statutory claims, property damage claims, contract claims, and arbitration.²⁹

Although Burford has not reported the exact allocation of its investment capital, its CEO has said that “Burford’s focus will be on cases with big potential rewards. These could include patent thefts, antitrust proceedings or corporate torts.”³⁰ Burford has also invested in a multi-party lawsuit brought by 30,000 plaintiffs in Ecuador who accuse Texaco—bought by Chevron in 2001—of damaging the forest and their health.³¹

Although data on investment in U.S. litigation is currently only available for Juridica Investments, the investment strategies of other third-party financiers of commercial litigation are likely similar. Third-party financiers have little incentive to invest in cases where plaintiffs face significant barriers to justice. In contrast, as discussed in the next section, investors face the highest potential returns in the types of cases where the underlying substantive law creates risk and cost imbalances that advantage plaintiffs.

A. *Patent Infringement Litigation*

The U.S. patent system was created to encourage innovation by granting property rights to intellectual property. Patent infringement litigation protects these property rights. However, characteristics of patent infringement litigation and much of the applicable substantive law creates cost and risk imbalances that favor plaintiffs. These imbalances strengthen the bargaining power of plaintiffs relative to defendants, resulting in settlements that often diverge from expected trial outcomes. As a result, legal scholars

²⁷ *The Fund*, JURIDICA INVESTMENTS LTD., <http://www.juridicainvestments.com/about-juridica/the-fund.aspx> (last visited May 6, 2011).

²⁸ *See id.*

²⁹ *See id.*

³⁰ Jason Douglas, *UPDATE: Burford Capital Raises GBP80 Million In 5th AIM Float Of '09*, DOW JONES NEWSWIRES, Oct. 16, 2009, available at http://www.advn.com/news_UPDATE-Burford-Capital-Raises-GBP80-Million-In-5th-AIM-Float-Of-09_39926053.html.

³¹ Braden Reddall, *Chevron-Ecuador case only at beginning of the end*, REUTERS, Feb. 15, 2011, available at <http://www.reuters.com/article/2011/02/15/us-ecuador-chevron-analysis-idUSTRE71D7II20110215>; Irene Caselli, *Chevron’s Ecuador problem: Oil giant vows to fight \$9 billion environmental ruling*, THE CHRISTIAN SCIENCE MONITOR, Feb. 15, 2011, available at <http://www.csmonitor.com/World/Americas/2011/0215/Chevron-s-Ecuador-problem-Oil-giant-vows-to-fight-9-billion-environmental-ruling>.

argue that many patent infringement cases are opportunistic—initiated not to protect property rights, but to bully quick settlement agreements out of defendants.³² This subsection discusses the characteristics of patent infringement suits that can lead to cost and risk imbalances.

First, defending patent infringement claims is very costly. For patent suits with less than \$1 million at risk, the median estimated total litigation cost was \$650,000 in 2005; for suits with \$1–\$25 million at risk, the median estimated total litigation cost was \$2 million; for suits with more than \$25 million at risk, the median estimated total litigation cost is \$4.5 million.³³ Defendants typically bear the bulk of these costs because they usually have higher discovery burdens than plaintiffs; plaintiffs often have few documents beyond the patent and prosecution history.³⁴ Moreover, patents are presumptively valid as a matter of law, which requires the defendant to prove that the patent is invalid by a standard of clear and convincing evidence, whereas the plaintiff must only prove infringement by a preponderance of the evidence.³⁵

Second, plaintiffs can obtain preliminary injunctions against the defendants' accused infringing products. Despite the restrictive standard that generally applies to preliminary injunctions, they are relatively common in patent infringement cases.³⁶ Preliminary injunctions placed on major product lines for the duration of litigation can impose significant financial burdens on defendant firms. There is no analogous financial risk for many plaintiffs in patent infringement cases.

³² See, e.g., Michael J. Meurer, *Controlling Opportunistic and Anti-Competitive Intellectual Property Litigation*, 44 B.C. L. REV. 509 (2003).

³³ AM. INTELL. PROP. LAW ASS'N, 2005 REPORT OF THE ECONOMIC SURVEY 22-23 (2005); James Bessen & Michael J. Meurer, *Lessons for Patent Policy from Empirical Research on Patent Litigation*, 9 LEWIS & CLARK L. REV. 1, 2 (2005).

³⁴ Christopher A. Harkins, *Fending Off Paper Patents and Patent Trolls: A Novel "Cold Fusion" Defense Because Changing Times Demand It*, 17 ALB. L.J. SCI. & TECH. 407, 443 (2007).

³⁵ See, e.g., *id.* at 437; *SRAM Corp. v. AD-II Eng'g, Inc.*, 465 F.3d 1351, 1357 (Fed. Cir. 2006) (explaining that the presumption of invalidity "can be overcome only through facts supported by clear and convincing evidence"); *Cross Med. Prods., Inc. v. Medtronic Sofamor Danek, Inc.*, 424 F.3d 1293, 1310 (Fed. Cir. 2005) ("To prove direct infringement, the plaintiff must establish by a preponderance of the evidence that one or more claims of the patent read on the accused device literally or under the doctrine of equivalents."); *Warner-Lambert Co. v. Teva Pharm. USA, Inc.*, 418 F.3d 1326, 1341 n.15 (Fed. Cir. 2005) (stating that preponderance of the evidence "simply requires proving that infringement was more likely than not to have occurred.").

³⁶ See Jean O. Lanjouw & Josh Lerner, *Tilting the Table? The Use of Preliminary Injunctions*, 44 J.L. & ECON. 573, 595 (2001); John G. Mills, *The Developing Standard for Irreparable Harm in Preliminary Injunctions to Prevent Patent Infringement*, 81 J. PAT. & TRADEMARK OFF. SOC'Y 51, 55-56 (1999).

Third, defendants' potential losses at trial are significant. If found infringing, then the defendant may have to pay an established or reasonable royalty to the plaintiff.³⁷ If the defendant has substantial past sales and established profits, this royalty can be substantial. Moreover, the defendant may have to pay treble damages and attorneys' fees if the court finds that it willfully infringed.³⁸ In addition, the court may issue a permanent injunction to stop all future sales of the allegedly infringing product.³⁹ The uncertainty inherent in patent infringement cases increases the risk of these potential losses, even for defendants that believe the evidence shows they are not infringing.⁴⁰

The asymmetric costs of litigation, the risk of preliminary injunctions, and the potential losses at trial result in significant cost and risk imbalances in patent infringement cases. These imbalances weaken the defendants' bargaining position compared to plaintiffs' and often result in defendants settling claims at levels above which the substantive law would otherwise obligate.

Juridica has allocated 28% of its \$134 million investment fund to patent infringement cases.⁴¹ Similarly, the CEO of Burford Capital has indicated that they may also focus investment in patent infringement cases.⁴²

Moreover, recognizing the significant profit potential in patent infringement litigation, Juridica has recently branched out to add patents to its investment portfolio—a job description commonly referred to as a “patent troll”:

During 2008, we identified multiple opportunities to acquire patents outright for litigation. It also became evident that the cost of patent litigation was often significantly higher than the purchase price of a patent or portfolio of related patents. In addition, we identified multiple law firms that are willing to take the best of these cases on pure contingency-fee basis and carry risk of the litigation, occasionally including the cost of experts and third party disbursements. We also identified market participants that have been successful in monetising patents by settlement prior to litigation through licensing programs. We organized Turtle Bay Technologies Limited (“TBT”) in December of 2008 as a wholly owned subsidiary of JCML to take advantage of these market characteristics. TBT gives JIL an opportunity to fund the purchase price of patent assets for significantly less than the cost of litigation and to retain a much larger equity stake in the outcome of litigation or settlement activities for less money. In addition, by purchasing patents outright or the majority equity stake in a patent and using law firms that assist in settlement or prosecute litigation on a pure contingency-fee basis, these particular investments have a much lower risk profile. In 2009, we expect to

³⁷ See, e.g., J.P. Mello, *Technology Licensing and Patent Trolls*, 12 B.U. J. SCI. & TECH. L. 388, 392-393 (2006).

³⁸ 35 U.S.C. § 284 (2006) (A “court may increase the damages up to three times the amount found or assessed.”); 35 U.S.C. § 285 (2006) (“The court in exceptional cases may award reasonable attorney fees to the prevailing party.”).

³⁹ See, e.g., Mello, *supra* note 37, at 393.

⁴⁰ Meurer, *supra* note 32, at 512-513.

⁴¹ *About Juridica: The Fund*, JURIDICA, <http://www.juridicainvestments.com/about-juridica/the-fund.aspx> (last visited May 6, 2011).

⁴² Douglas, *supra* note 30.

make further investments in patents through TBT. These investments will be structured so that 100% of investment returns are paid to JIL under a funding agreement.⁴³

A pejorative term, “patent troll” was originally coined to describe “somebody who tries to make a lot of money off a patent that they are not practicing and have no intention of practicing and in most cases never practiced.”⁴⁴

Litigation brought by patent trolls suffers from all of the previously mentioned problems that weaken defendants’ bargaining position relative to plaintiffs’ in patent infringement cases—asymmetric costs of litigation, the risk of preliminary injunctions, and the potential for substantial losses at trial. However, patent troll litigation exacerbates the imbalance in bargaining positions because the patent troll is immune from counterclaims that can level the playing field in patent infringement cases. In some patent infringement cases between two similarly situated competitors, the plaintiff faces the risk that the defendant will file a counterclaim asserting that the plaintiff is infringing on a patent held by the defendant.⁴⁵ The threat of this counterclaim reduces the imbalance in risk aversion between plaintiffs and defendants. In contrast, the defendant cannot counterclaim a suit brought by a patent troll to reduce the imbalance in risk aversion and bargaining position because patent trolls do not manufacture any products.⁴⁶ As a result, patent trolls are often successful in bullying a quick settlement from an otherwise innocent defendant.⁴⁷

B. *Price-fixing Cases*

The underlying substantive law also imposes asymmetric costs and risks on defendants in price-fixing cases. As a result, defendants often agree to unfavorable settlement terms to avoid the risk of disastrous losses.

⁴³ *Limited Annual Report & Accounts 2008*, JURIDICA INVESTMENTS 10 (2008), available at http://www.juridicainvestments.com/~media/Files/JJuridica/pdfs/2008_Annual_Report.pdf.

⁴⁴ Daniel J. McFeely, *An Argument for Restricting the Patent Rights of Those Who Misuse the U.S. Patent System to Earn Money Through Litigation*, 40 ARIZ. ST. L.J. 289, 294 (2008).

⁴⁵ See Patent Reform Act of 2005, H.R. 2795, 109th Cong. (2005).

⁴⁶ Mello, *supra* note 37, at 394-395.

⁴⁷ Harkins, *supra* note 34, at 448.

First, the potential damages defendants face if found liable of price fixing are substantial. Measured by the entire cartel's overcharge, damages often exceed \$1 billion.⁴⁸ Moreover, under Section Four of the Clayton Act, the court automatically trebles damages in price-fixing cases.⁴⁹ Such exorbitant damage awards have the potential to cripple many firms.⁵⁰ In addition, victorious plaintiffs in price-fixing cases are entitled to recover reasonable attorneys' fees from liable defendants.⁵¹ In contrast, absent a finding of misconduct on the part of the plaintiff,⁵² successful defendants in price-fixing cases are not entitled to attorneys' fees.

Second, defendants in price-fixing cases are jointly and severally liable to plaintiffs.⁵³ Thus, each price-fixing firm is potentially liable for the overcharges on all if its co-conspirators' sales. Moreover, because plaintiffs may sue one, some, or all of the alleged price-fixing firms, the court may saddle one firm with the entire damage award. As a result, a deep-pocketed defendant who was only marginally involved in the price-fixing conspiracy or reaped only minor benefits can be accountable for the trebled value of the cartel's total overcharges.⁵⁴

⁴⁸ See *Antitrust Damage Allocation: Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 97th Cong. 141 (1981-82) (statement of Robert P. Taylor, Att'y., Pillsbury, Madison & Sutro); *In re Visa Check/Mastermoney Antitrust Litig.*, 297 F. Supp. 2d 503, 507 (E.D.N.Y. 2003) (over \$3 billion settlement).

⁴⁹ 15 U.S.C. § 15(a) (2006).

⁵⁰ See Edward D. Cavanagh, *Contribution, Claim Reduction, and Individual Treble Damage Responsibility: Which Path to Reform of Antitrust Remedies?*, 40 VAND. L. REV. 1277, 1283 (1987).

⁵¹ 15 U.S.C. § 15 (2006).

⁵² Sanctions imposed pursuant to Federal Rule of Civil Procedure 11 for filing frivolous claims frequently involve the award of attorneys' fees to the prevailing defendant. See *Oliveri v. Thompson*, 803 F.2d 1265, 1271, 1273 (2d Cir. 1986) (stating that "sanctions for misconduct and abuse of the legal system seem to be inevitably interwoven with the problems of shifting the burden of attorneys' fees, which have become the primary cost factor in litigation"). Attorneys' fees also may be shifted pursuant to 28 U.S.C. § 1927 if an attorney multiplies the proceedings "unreasonably and vexatiously." Finally, courts may shift fees pursuant to the court's inherent equitable power if plaintiff files or maintains the action in bad faith. *Roadway Express, Inc. v. Piper*, 447 U.S. 752, 765-66 (1980).

⁵³ *Perma Life Mufflers, Inc. v. Int'l Parts Corp.*, 392 U.S. 134, 144 (1968) (White, J., concurring) ("[D]amages normally may be had from either or both defendants without regard to their relative responsibility for originating the combination or their different roles in effectuating its ends."); *Wilson P. Abraham Constr. Corp. v. Tex. Indus., Inc.*, 604 F.2d 897, 904 n.15 (5th Cir. 1979), *aff'd sub nom. Tex. Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630 (1981); *Wainwright v. Kraftco Corp.*, 58 F.R.D. 9, 11 (N.D. Ga. 1973) ("It is well settled that an antitrust action is a tort action and that in multi-defendant antitrust actions the co-conspirator joint tortfeasors are jointly and severally liable for the entire amount of damages caused by their acts") (citations omitted).

⁵⁴ Christopher R. Leslie, *Judgment-Sharing Agreements*, 58 DUKE L.J. 747, 752 (2009).

To make matters worse, a liable defendant in a price-fixing case has no right to contribution from its co-conspirators.⁵⁵ As a result, a liable conspirator who has paid the trebled value of the entire cartel's total overcharges cannot sue its co-conspirators to pay their fair share. This magnifies the potential damage exposure of an individual defendant in a price-fixing case.

Moreover, even when plaintiffs sue several of the alleged co-conspirators, an early settlement from one firm leaves the remaining defendants at risk of paying a portion of the damages inflicted by the settling party. Although the remaining defendants receive a credit for any settlement, the settlement is subtracted from the treble damages award, rather than the amount of actual damages.⁵⁶ As a result, the remaining defendants risk liability for the trebled damage component of the settling defendant's overcharges.⁵⁷

Third, the statute of limitations may toll upon a finding of fraudulent concealment on the part of the defendant.⁵⁸ As a result, damages may go back much farther than antitrust law's four-year statute of limitation would otherwise imply.⁵⁹ Once again, this increases the risk of a substantial damage award if a defendant proceeds to trial.

⁵⁵ *United States v. Atl. Research Corp.*, 127 S. Ct. 2331, 2337-38 (2007) ("Contribution is defined as the 'tortfeasor's right to collect from others responsible for the same tort after the tortfeasor has paid more than his or her proportionate share, the shares being determined as a percentage of fault.'") (quoting BLACK'S LAW DICTIONARY 353 (8th ed. 1999)).

⁵⁶ *Burlington Indus. v. Milliken & Co.*, 690 F.2d 380, 391 (4th Cir. 1982); *Flintkote Co. v. Lysfjord*, 246 F.2d 368, 398 (9th Cir. 1957); ABA ANTITRUST SECTION, MONOGRAPH NO. 11, CONTRIBUTION AND CLAIM REDUCTION IN ANTITRUST LITIGATION 5 (1986); see also Donald J. Polden & E. Thomas Sullivan, *Contribution and Claim Reduction in Antitrust Litigation: A Legislative Analysis*, 20 HARV. J. ON LEGIS. 397, 402-03 (1983) (discussing *Burlington Indus.*).

⁵⁷ See ABA ANTITRUST SECTION, MONOGRAPH NO. 13, TREBLE-DAMAGES REMEDY 15 (1986) ("Settling defendants rarely pay treble the overcharge resulting from their sales. Therefore, settlements have the potential of leaving the last co-conspirator in a suit liable for damages enormously greater than the overcharge caused by its sales pursuant to the conspiracy."); Paula A. Hutchinson, Note, *A Case Against Contribution in Antitrust*, 58 TEX. L. REV. 961, 980 (1980) ("[T]he nonsettling defendants bear the risk that the plaintiff will settle with another defendant for less than the amount of damages directly attributable to it.").

⁵⁸ See 15 U.S.C. § 15b (2006); see, e.g., *In re Vitamins Antitrust Litig.*, No. MISC 99-197(TFH), 2000 WL 1475705, at *2-3 (D.D.C. May 9, 2000) (explaining that the plaintiffs' case survived a motion to dismiss in which fraudulent concealment tolled the statute of limitations, extending the period for which recovery was available); *In re Catfish Antitrust Litig.*, 826 F. Supp. 1019, 1029 (N.D. Miss. 1993) ("[Fraudulent concealment tolls the Clayton Act's statute of limitations.]).

⁵⁹ 15 U.S.C. § 16(a) (2006). The normal statute of limitations in private actions is four years. 15 U.S.C. § 15(b) (2006). Nevertheless, the statute for private actions is tolled during the pendency of a government action, and to bring a suit, private plaintiffs must file within one year following the termination of a prior government proceeding.

The combination of these factors in price-fixing cases creates potentially staggering exposure for defendants and, in turn, gives plaintiffs significant bargaining power in settlement negotiations. The resulting cost and risk imbalances have the potential to lead to inefficient case outcomes as defendants agree to unfavorable settlement terms to avoid the risk of catastrophic judgments.

Juridica has allocated over 60% of its investment fund to price-fixing cases⁶⁰ and Burford has indicated that it plans to focus its investment in these cases.⁶¹ In fact, in its 2008 Annual Report, Juridica recognized that many of the factors in price-fixing cases that create imbalances in risk aversion and bargaining power make these cases particularly attractive investment possibilities:

Antitrust litigation is brought in the US under the Sherman Act or the Clayton Act and carries the possibility of statutory treble damages for the defendants. . . . The price-fixing cases are particularly attractive investment opportunities for JIL, as they are perceived to have a low risk profile and high potential damages. Civil litigation in this arena often, but not always, follows either criminal prosecution by the US Department of Justice or early settlement by a cartel member in exchange for giving evidence against co-conspirators. These events help to establish liability. The multi-defendant nature of these cases increases the likelihood of pre-trial settlements.⁶²

C. *Multi-Party Litigation*

Third-party financing in multi-party litigation may increase access to justice if the cases are too costly or risky for contingency fee attorneys or consortiums of attorneys to otherwise take the cases. However, multi-party cases, such as class actions or mass tort litigation, also have the potential to create an even stronger imbalance between plaintiffs and defendants than patent infringement or price-fixing cases. Because these multi-party cases expose defendants to endless litigation and potentially ruinous judgments at trial, defendants are under enormous pressure to accept inefficient settlements that do not reflect the case's merits or the obligations dictated by the substantive law.

By aggregating the claims of numerous plaintiffs, multi-party cases expose corporate defendants to enormous losses at trial. Even *de minimis* individual damage claims multiply at the class level into massive sums of money.⁶³ Whereas individual trials rarely pose a solvency threat, a multi-party claim with even a remote risk of financial ruin triggers defendants'

⁶⁰ *About Juridica: The Fund*, JURIDICA, available at <http://www.juridicainvestments.com/about-juridica/the-fund.aspx> (last visited May 6, 2011).

⁶¹ Douglas, *supra* note 30.

⁶² *Limited Annual Report & Accounts 2008*, JURIDICA INVESTMENTS 9 (2008), available at http://www.juridicainvestments.com/~media/Files/J/Juridica/pdfs/2008_Annual_Report.pdf.

⁶³ See HENRY J. FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 120 (1973).

risk-aversion and motivates them to settle claims for more than their expected value.⁶⁴

Moreover, corporate defendants fear debilitating and expensive litigation defending against even weak multi-party suits. Defending against these suits can easily cost tens of millions of dollars annually and the suits can drag on for decades.⁶⁵ To avoid the “gargantuan scale” of discovery and endless litigation, defendants often choose to settle early to avoid the exorbitant costs.⁶⁶

Thus, many defendants have no choice but to settle to avoid company-threatening trial verdicts and preserve economic value for innocent shareholders.⁶⁷ Legal scholars and jurists have recognized that the cost and risk imbalances in multi-party litigation often lead to inefficient outcomes. Judge Friendly, the revered Second Circuit jurist, claimed that class actions are “blackmail” because the defendants’ only choice is to settle or face economic ruin.⁶⁸ Judge Posner has recognized “the sheer magnitude of the risk” facing class action defendants and argues that defendants are “forced by fear of the risk of bankruptcy to settle even if they have no legal liability.”⁶⁹ Similarly, Judge Easterbrook claims that class action settlements “reflect the risk of a catastrophic judgment as much as, if not more than, the actual merit of the claims.”⁷⁰

In fact, it is the defendants’ vulnerable position in multi-party litigation that makes these cases particularly attractive to third-party financiers. The potential return on investment is high in cases where defendants are under enormous pressure to settle cases in order to avoid endless litigation and potentially devastating judgments at trial. Although Juridica has refused to invest in class action lawsuits, Burford has recently invested millions in a large multi-party case.⁷¹ Other third-party financiers also have strong incentives to invest in these cases where defendants are particularly vulnerable.

⁶⁴ Charles Silver, “We’re Scared to Death”: *Class Certification and Blackmail*, 78 N.Y.U. L. REV. 1357, 1370 (2003).

⁶⁵ Mark Herrmann, *From Saccharin to Breast Implants: Mass Torts, Then and Now*, 26 LITIG. 50, 52 (1999).

⁶⁶ Silver, *supra* note 64, at 1362.

⁶⁷ *Id.*

⁶⁸ FRIENDLY, *supra* note 63, at 120.

⁶⁹ *In re Rhone-Poulenc Rorer Inc.*, 51 F.3d 1293, 1299 (7th Cir. 1995).

⁷⁰ *In re Bridgestone/Firestone, Inc.*, 288 F.3d 1012, 1016 (7th Cir. 2002).

⁷¹ Reddall, *supra* note 31.

Unfortunately, inefficient settlement outcomes result in over-deterrence while often doing little to compensate victims; many multi-party cases result in millions of dollars of attorneys' fees, but only small amounts of compensation for plaintiffs.⁷²

III. CONSEQUENCES OF THIRD-PARTY FINANCING

The underlying substantive law in patent infringement and price-fixing cases and the practical reality of multi-party litigation create cost and risk imbalances that generally favor plaintiffs. In fact, it is the plaintiffs' relatively strong bargaining position that makes these cases particularly attractive from a third-party investors' perspective. Risk-averse defendants facing catastrophic trial judgments are eager to settle cases for amounts well above the expected damages at trial, increasing both the certainty and magnitude of third-party investors' returns. Moreover, even if cases fail to settle and proceed to trial, potential damages are significant and often trebled, increasing the expected return for third-party investors. As a result, many of the cases financed by the largest third-party investors are the opposite of the types of cases where financing could improve access to justice for vulnerable plaintiffs.

By increasing the supply of funds available in these types of cases, third-party financing exacerbates existing cost and risk imbalances created by the underlying substantive law. Because third-party investors absorb much of the plaintiffs' risk in the cases they finance, they worsen the existing risk imbalances that already favor plaintiffs. Similarly, by financing much of the plaintiffs' litigation costs, third-party investors worsen existing cost imbalances that favor plaintiffs. These imbalances induce defendants to accept even less favorable settlements than they would have without third-party financing, leading to more inefficient outcomes. As James E. Tyrrell, Regional Managing Partner of Patton Boggs LLP and outside counsel to Burford Capital, has pointed out, the "abundance of funds now available to plaintiffs may have 'tipped the funding scales' toward plaintiffs, creating an imbalance of resources," creating "some concern about access to justice" for defendants.⁷³

⁷² DEBORAH R. HENSLER ET AL., RAND INSTITUTE FOR CIVIL JUSTICE CLASS ACTION DILEMMAS: PURSUING PUBLIC GOALS FOR PRIVATE GAIN 83 (2000), available at www.rand.org/publications/MR/MR969. To some observers, it seems inappropriate in most, if not all, circumstances for the plaintiff attorneys to pocket more in fees than the class members receive in the aggregate. Moreover, when—as in the case in small damage class actions—the attorneys pocket much more than any one individual class member receives because of the suit, many feel that it is a clear indication that something has gone awry in the process.

⁷³ MCGOVERN ET AL., *supra* note 26, at 9 (summarizing remarks of James E. Tyrrell).

Thus, instead of improving access to justice, third-party financing may hinder access to justice for defendants and lead to inefficient outcomes in many cases. Settlements that are systematically larger than expected trial outcomes otherwise dictated by the substantive law lead to overcompensation of some plaintiffs and over-deterrence of certain behaviors. Although overcompensation of a particular plaintiff is merely a distributional effect, prolonged overcompensation leads to over-deterrence—wasteful, inefficient defensive actions by potential defendants that fail to provide significant social benefits. Moreover, these welfare losses will be intensified if, as many scholars argue, third-party financing increases litigation.⁷⁴ An increase in litigation magnifies the underlying nature of the legal system.⁷⁵ Thus, an increase in litigation among the types of cases where cost and risk imbalances lead to inefficient case outcomes will magnify these inefficiencies.

CONCLUSION

Legal scholars have recognized that third-party financing of litigation can correct certain distortions in justice that result when risk-averse, financially-constrained plaintiffs are pitted against risk-neutral, well-financed defendants. By relieving a risk-averse plaintiff of much of the litigation risk, third-party financing can offset a risk-neutral defendant's bargaining advantage and level the playing field in negotiations. This would improve plaintiffs' compensation and promote a more appropriate level of deterrence.

However, third-party investors have little incentive to finance cases where plaintiffs face significant barriers to justice. In fact, investors face the highest potential returns in the types of cases where the underlying substantive law creates risk and cost imbalances that already give plaintiffs the advantage. Indeed, the largest third-party financiers of U.S. litigation are currently financing many cases where the existing law favors plaintiffs—patent infringement cases, price-fixing cases, and class actions.

Moreover, by absorbing much of the plaintiffs' litigation risk and steering significant resources into the litigation, third-party financing exacerbates existing cost and risk imbalances that favor plaintiffs. This intensifies the settlement pressure on defendants, causing them to agree to inefficient settlements that do not reflect the merits of the case or the obligations of the substantive law.

⁷⁴ See generally Rubin & Sheperd, *supra* note 16.

⁷⁵ Jeremy Kidd & Todd Zywicki, *Does Increased Litigation Increase Justice in a Second-Best World?*, in *THE AMERICAN ILLNESS* (Frank Buckley, ed., Yale Univ. Press) (forthcoming 2012), available at <http://ssrn.com/abstract=1762160>.

Thus, although third-party litigation financing has the potential to improve access to justice, it is instead leading to inefficient case outcomes. Unless steps are taken to change the nature of third-party financing, it will continue to threaten the compensatory and deterrent goals of our legal system.



TO FUND OR NOT TO FUND: THE NEED FOR SECOND-BEST SOLUTIONS TO THE LITIGATION FINANCE DILEMMA

*Jeremy Kidd, Ph.D.**

Litigation financing promises to promote greater justice and efficiency in tort law by reducing financial barriers to litigation and changing the allocation of litigation risks. In the case of personal injury cases, however, broad litigation financing also has the potential to diminish justice and efficiency by increasing the total amount of litigation, increasing the frequency of frivolous litigation, and distorting the incentives for bringing and maintaining lawsuits generally. This article adds to the litigation financing literature by addressing the danger of path manipulation, a form of judicial rent-seeking. In a system of binding precedent, litigation financiers will be faced with incentives to use case selection to maximize profits by pressuring the courts to open new areas of tort liability. These efforts, driven by investment returns instead of justice, could divert tort law from both justice and efficiency objectives. The costs of litigation financing make it prudent to consider alternative financing regimes that can capture some benefits of litigation financing while minimizing costs and distortions.

INTRODUCTION

“A poor man may have the right upon his side, but be without means to enforce such rights in the courts, and possibly against some powerful adversary.”¹

Over a century ago, the Colorado Court of Appeals expressed the frustration of many tort victims: that compensation for the wrongful damages they have suffered is beyond their reach simply because they lack the resources to file and maintain their claims.² The intervening years have not served to minimize the financial barriers; to the contrary, the financial bar-

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¹ *Casserleigh v. Wood*, 59 P. 1024, 1026 (Colo. App. 1900).

² *Id.*

riers to litigation have increased dramatically, leaving many poor and middle-class victims at a disadvantage in pursuing their claims.³

The question is not whether tort litigation is becoming more costly, but what efforts, if any, are necessary to aid litigants in the pursuit or defense of legitimate claims. Some have argued in favor of a full assignment regime, where someone other than the tort victim would purchase the right to prosecute the claim.⁴ Others have argued for something short of full assignment, allowing third parties to finance lawsuits, purchasing a share in any damages award or settlement by funding the legal and living expenses of the tort victim.⁵ It is even possible to argue that the ideal answer to this problem lies in the reform of our credit markets, allowing tort victims to borrow against the value of their claims much as homeowners borrow against the equity in their homes.

Implementation of any of these solutions would likely require the relaxation of legal rules prohibiting assignment of claims,⁶ maintenance,⁷ champerty,⁸ and fee sharing with non-lawyers.⁹ Loosening these restrictions may be nothing more than refusing to be governed by “blind imitation of the past.”¹⁰ Throwing off antiquated rules¹¹ may be liberating and beneficial. Some might even argue that these rules are nothing more than rules designed to protect lawyers’ cartel power.¹² However, it is also possible that these rules are based on an understanding of human nature and the incentives that arise in a common law system.

³ Various forms of litigation financing already exist, such as contingency fee arrangements and collateral sources, *infra* Part IV.A and B, but increases in the cost of litigation appear to have outpaced all attempts to overcome them.

⁴ See, e.g., Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697 (2005); Peter Charles Coharis, *A Comprehensive Market Strategy for Tort Reform*, 12 YALE J. ON REG. 435 (1995); Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J. LEGAL. STUD. 329 (1987).

⁵ See, e.g., Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367 (2009).

⁶ Under a regime that allowed assignment, the plaintiff could sell her legal claims to any other individual, who could then pursue all available remedies against the defendant.

⁷ Black’s Law Dictionary defines maintenance as “[a]n officious intermeddling in a lawsuit by a non-party by maintaining, supporting or assisting either party, with money or otherwise, to prosecute or defend the litigation.” BLACK’S LAW DICTIONARY 954 (6th ed. 1990).

⁸ Champerty is a form of maintenance, and is defined by Black’s Law Dictionary as “[a] bargain between a stranger and a party to a lawsuit by which the stranger pursues the party’s claim in consideration of receiving part of any judgment proceeds.” BLACK’S LAW DICTIONARY 231 (6th ed. 1990).

⁹ In every United States jurisdiction except the District of Columbia, ethical rules prohibit lawyers from sharing fees with non-lawyers, making it difficult for a potential financier to contribute funds via the law firm. Jonathan T. Molot, *A Market Approach to Litigation Accuracy*, SEARLE CTR. ON LAW, REG., & ECON. GROWTH 28 (2009), available at http://www.law.northwestern.edu/searlecenter/papers/Molot_Accuracy.pdf.

¹⁰ Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

¹¹ Coharis, *supra* note 4, at 463-64.

¹² *Id.* at 475.

Each of the bold proposals described above rely on certain assumptions regarding the incentives of potential litigants, lawyers, and potential third-party financiers. If they are correct, and the ideal circumstances hold, each proposal would likely result in a much more efficient and just tort system. Unfortunately, the world we live in may not be able to achieve the ideal circumstances, and there are significant dangers involved with attempting an ideal solution under non-ideal circumstances. In the case of litigation finance, those dangers include the possibility that increased frivolous litigation would degrade whatever justice and efficiency presently exist in our tort system. Opponents of broader litigation finance are often criticized for failing to justify their claims that a broader financing regime would lead to greater volumes of litigation and, specifically, greater numbers of frivolous cases.¹³ This article attempts to answer those challenges, identifying the incentives presented by broader financing that would lead to more frivolous litigation. However, it does so with a few important caveats. First, the arguments here are limited to personal injury cases and may not extend well to commercial tort litigation.¹⁴ Second, this article contrasts a world in which all litigation funding is prohibited with the broad financing regimes described above to illustrate both the benefits and costs of financing generally.¹⁵ This article also offers examples of intermediate, alternative solutions, each of which has its own strengths as well as weaknesses that account for the impossibility of achieving the ideal solutions.

The argument proceeds in four parts. Part I introduces the economic theory of the “second-best,” which offers insights into how society should proceed when the ideal solution proves suboptimal. Part II discusses the moral and economic advantages of broad financing regimes. Part III shows how the self-interest of financiers and lawyers will likely lead to increased litigation costs, increased litigation, and increased path manipulation. Part IV examines some intermediate forms of third-party financing in an effort to better define what a second-best solution to the problem of litigation funding would look like. The article concludes with some ideas for future works.

¹³ Anthony J. Sebok, *Betting on Tort Suits After the Event: From Champerty to Insurance*, 60 DEPAUL L. REV. 453, 455 (2011).

¹⁴ For a discussion of why commercial and private tort litigation face different incentives and should therefore be treated separately, see Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 97 (2010).

¹⁵ Neither of the two extremes adequately represents the present state of the American legal system. Instead, the present state of the American system represents a midway point between extremes. Understanding the costs and benefits of the two extremes will allow society to better choose whether a move towards either extreme is likely to be beneficial.

I. A BRIEF INTRODUCTION TO THE THEORY OF THE SECOND-BEST

Much of economic analysis relies on simplifying assumptions about the world. Economists are not alone in this—most disciplines that employ predictive models use assumptions that may not perfectly reflect reality. The use of simplifying assumptions is not necessarily fatal to the analysis conducted. So long as the assumptions reasonably approximate reality, then the conclusions predictive models reach tell us *something* about the scenario being modeled. But what do we do when the assumptions do not reasonably approximate reality?

In the theory of the second-best,¹⁶ economists have developed a method for determining the optimal course of action when pursuit of the ideal is inadvisable. When the number of ideal assumptions that cannot be reconciled to reality grows, the ideal outcome may be out of reach. Moreover, pursuit of the ideal under those circumstances may lead to a decidedly suboptimal outcome. As a rough example, consider climbers somewhere on the slopes of Mount McKinley, the highest peak in North America. They may wish to reach the highest point on Earth, the summit of Mount Everest, but if they begin to walk there directly without accounting for surrounding terrain, they may find themselves in the Pacific Ocean. Given the immediate constraints that they face, the best they can do is to concentrate on getting to the peak before them, which may mean saving Mount Everest for another day.

For a more topical example, consider that societies regularly face a choice between establishing rules or standards to govern the conduct of individuals. In an ideal world where information was costless and resultant errors rare, legal systems could provide detailed standards that would allow fact finders to accurately weigh and consider all relevant facts and provide highly-tailored guidance to private parties. In the real world, however, information is costly and errors occur. As a result, it will often be optimal to adopt bright-line rules that regulate categories of cases, even though those rules will often be over- or under-inclusive in terms of their fit with the facts of a given situation.¹⁷ Thus, while standards might be optimal in an ideal world, in the world of the second-best we often turn to rules as the least-costly alternative—even though we know that those rules sometimes will result in errors.

To determine whether or not the theory of the second-best applies here, we must first identify one or more first-best litigation financing options. We can then determine whether pursuit of those options will lead to

¹⁶ R. G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. OF ECON. STUD. 11 (1956).

¹⁷ Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEG. STUD. 257 (1974).

improved or degraded conditions in the American tort system. Finally, we can attempt to identify some second-best solutions.

II. BROAD LITIGATION FINANCING AS A FIRST-BEST OPTION

The question of how to solve litigation financing problems is not new. Many thoughtful proposals have been offered, including full assignment of claims¹⁸ and broad financing by hedge funds and other investment firms.¹⁹ Both of these solutions have the advantage of allowing new markets to arise, which, as a general rule, is presumed to enhance efficiency for participants in the new market.²⁰ To the list might be added credit market reforms that would allow individuals to borrow against the value of their claims at normal market rates, much as they now may borrow against the value of their homes or other physical assets.²¹ To understand why these options are likely first-best solutions, we must review why litigation funding is a problem in the first place.

A. *Not Having Litigation Funding is Costly*

Any litigant must weigh the costs of pursuing a case against the perceived benefits of prevailing, adjusted for the probability of success.²² If

¹⁸ Abramowicz, *supra* note 4; Coharis, *supra* note 4.

¹⁹ Molot, *supra* note 9. In the United States, there are six companies willing to openly invest in litigation; two of these are publicly traded corporations that were established for the express purpose of litigation financing: Juridica Investments and Burford Capital. Jason Lyon, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 578 (2010); Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND CORP., 14-16 (2010), http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf. These companies invest almost exclusively in commercial litigation, as opposed to personal injury tort litigation, leaving personal injury victims with only one option—cash-advance firms. *Id.* at 12.

²⁰ Paul H. Rubin, *On the Efficiency of Increasing Litigation* (Searle Ctr. on Law, Regulation, & Econ. Growth Pub. Policy Roundtable on Third-Party Financing of Litigation, Sep. 24-25, 2009), <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

²¹ Each of these proposals is innovative because of the direct connection between financing and the lawsuit. Less direct methods of financing have been available for some time, but they are not typically considered in discussions of litigation financing because of their indirect nature. For example, a law firm has a range of assets against which it may borrow in order to finance additional cases, and a defendant corporation (or individual) may borrow against the value of various corporate assets (or a family home) to finance a defense against legal claims. These less-direct methods of financing are fundamentally different from the type of direct litigation financing being discussed here and elsewhere. While they provide funds for litigation, the funds are not tied to the litigation itself, but are merely a means by which the litigant or law firm accesses wealth they already possess in the form of illiquid assets.

²² Of course, some litigants will derive sufficient utility from the pursuit of the claim that they will move forward even in the absence of a reasonable probability of success. For example, a medical mal-

the expected returns are greater than the cost, then the case will proceed. In a perfect system, claims with clear legal support would be easily resolved, leading to low costs and assuring that “good” claims would yield positive net returns. Within that perfect system, the more speculative a claim is, the greater the uncertainty regarding its validity; as a result, the expected benefit would be low, the cost of resolution would be high, and “frivolous” claims would yield negative net returns.²³ As a result, litigants would bring the vast majority of legitimate claims, while filing very few frivolous claims.²⁴ However, the fact that individuals have differing levels of willingness and ability to accept the costs and risks associated with bringing a lawsuit complicates this simple scenario in reality.

In a world where litigation funding is entirely absent, litigants must bear all the costs of litigation. Those costs not only include the costs associated with formal resolution of a legal claim—lawyers’ fees, court-imposed filing fees, expert witness fees, etc.—but also the opportunity costs of litigation, such as time spent away from work and other productive activities. Those with lower levels of wealth and income, for example, will face higher opportunity costs when choosing to pursue a legal claim, especially when doing so requires forgoing wage income that is needed for food, shelter, and even recuperation. The costs of filing and maintaining a lawsuit may, for those with lower incomes and wealth, become insurmountable obstacles.

Consider the following hypothetical scenario, which occurs in the zero-finance world.²⁵ Wendy, a wealthy investment banker, Martin, a middle-class electrician, and Phil, a poor college student who works at a retail clothing store, all have lunch at the same delicatessen in Manhattan. The building in which the deli is located is being renovated, and GenCo, the

practice victim may see very little chance of recovery, but may believe that there is a moral obligation to create a formal complaint regarding the alleged malpractice.

²³ The term frivolous has unfortunate negative connotations and is often used only as a pejorative to describe cases that seek to expand liability in ways that the speaker or author finds disagreeable. I attempt to use the term in a more technical, albeit admittedly imprecise manner. For the purposes of these arguments, a frivolous case is one that has no support in existing precedent, either directly or as a reasonable extension. *See* FED. R. CIV. P. 11(b)(2). Every lawsuit is subject to some uncertainty, so the existence of uncertainty regarding the outcome cannot be the standard; instead, a lawsuit is frivolous if a truly ethical lawyer could not attest that the claim meets the requirement of Rule 11. Some have suggested such alternative descriptors as “innovative lawsuits” or “entrepreneurial lawsuits,” but even these terms could give rise to significant misunderstanding. I will therefore retain “frivolous,” with the technical definition implied by Rule 11.

²⁴ Even in that perfect world, some legitimate claims will never be brought if the marginal utility to the individual litigant is sufficiently lower than the marginal utility to society. It is an interesting question, although not one I will attempt to address here, whether society should consider mandating prosecution of such claims, in order to improve total social welfare.

²⁵ By a zero-financing world, I mean a world in which contingency fee arrangements are disallowed, and even minor options such as insurance subrogation, Mary Carter Settlement Agreements, and others are absent.

general contractor responsible for the renovations, is working on the exterior of the building. By coincidence, the three of them finish their lunches at the same time and leave the deli, intending to return to their respective jobs. One of GenCo's workers negligently dislodges a large piece of granite, which falls to the ground and shatters. Wendy, Martin, and Phil are all struck by the resulting shrapnel, suffering severe lacerations. Each is physically incapacitated for six months of medical treatment and rehabilitation. In addition to the fact that each victim has been unjustly harmed, there is also a loss of productivity as three employers are deprived of the victims' labor and human capital for six months. Corrective justice would require that GenCo compensate the three victims for their injuries,²⁶ and a law and economics approach would, in the name of efficiency, typically require that compensation be paid to the three victims to deter such wasteful negligence in the future.²⁷

If GenCo refuses to voluntarily make the three victims whole, each must determine whether to file a lawsuit and pursue remedies through formal channels. The costs of doing so would be similar for each victim, if measured in monetary value, but the burden of those costs will not be felt equally. Starting at the bottom of the income ladder, a poor college student like Phil will find it difficult to obtain redress because he has little or no disposable income or savings to sustain him for the duration of a lawsuit.²⁸ A middle-class laborer like Martin will also find the road to compensation equally challenging. A higher salary may have allowed Martin to build up some savings, and personal frugality may provide him with some disposable income, but any claim will have to be prosecuted on a shoestring budget, if it can be prosecuted at all. Phil and Martin must also consider that prosecuting a claim offers only some probability of future compensation, compared to the certain and immediate needs of food, shelter, clothing, and so on.²⁹ If the costs, alone, are insufficient to deter the filing of a claim, the risks associated with doing so may tip the scales.³⁰ Of the three, only Wendy will find the path relatively unobstructed, due to a higher disposable income and the resulting likelihood of having savings and passive income. The nature of her employment is also more likely to allow her to continue working during her convalescence, unlike the other two. These and other factors mean that Wendy will likely have little difficulty shouldering the

²⁶ See, e.g., Jules L. Coleman, *The Mixed Conception of Corrective Justice*, 77 IOWA L. REV. 427, 433-35 (1992).

²⁷ See, e.g., Richard A. Posner, *A Theory of Negligence*, 1 J.L. STUD. 29 (1972).

²⁸ I assume that all of the victims have sufficient knowledge to understand the existence of a valid claim, in order to avoid an interesting but tangential discussion regarding the role of imperfect information in tort victims' decisions.

²⁹ Shukaitis, *supra* note 4, at 334-35.

³⁰ Molot, *supra* note 9, at 68-69.

various costs (court costs and medical and living expenses) of pursuing compensation from GenCo.

The disparities arising in this example are troubling on a number of levels. On a very basic level, it is disquieting to think that certain socioeconomic classes in our society may find themselves effectively barred from the remedial institutions designed to protect all citizens, regardless of means. From an economic standpoint, the prospects are equally disturbing, for the inability of lower socioeconomic classes to obtain compensation for tortious harms means that tort law will provide woefully incomplete deterrence to behavior which burdens not only the victim, but also society's economic productivity. Moreover, if tort law provides deterrence unequally between socioeconomic classes, there will be distortionary effects.

Potential tortfeasors balance the costs and benefits of wrongful behavior, and tort damages are a potential cost that must be considered. Because poor and middle-class victims are unable to bring a lawsuit in a zero-finance world, there is no credible threat of tort damages and potential tortfeasors can effectively ignore the possibility. At the margin, therefore, potential tortfeasors will aim their negligent behavior in the direction of the middle class and the poor. As one possible example, imagine a home construction company that builds every type of housing, from mansions for the ultra-wealthy to low-rent duplexes for the poor. Always looking for ways to improve its bottom line, the construction company will be tempted to cut corners and, given the potential for tort liability, there is a strong probability that the corners that will ultimately be cut will be those affecting low-rent properties. To see why this is so, recall that there will be few financial barriers to a wealthy client seeking to recover for negligent construction of her mansion. In contrast, the inhabitants of low-rent properties will find it nearly impossible to bring a lawsuit if their domicile is negligently constructed. To the extent wealthy individuals or corporations own the low-rent properties, and to the extent that the negligent construction impairs the owners' ability to rent the property, a lawsuit might still be brought, but it would likely seek compensatory damages under contract, rather than tort, and the resulting damages would be significantly lower.³¹ In more concise terms, the inability of low-rent tenants to bring lawsuits lowers the probability of a lawsuit and, in this particular case, shifts the damages from tort to contract, reducing the total potential liability.

These factors combine to yield a lower expected cost of negligence, which will lead to greater negligence on the margin. This also has both moral and economic consequences. The legitimacy of a legal system must be questioned if it promotes negligent exploitation of those least capable of bearing those burdens. Likewise, those sectors of the economy that rely heavily on the poor and middle class—either in production or in consump-

³¹ WILLIAM LLOYD PROSSER, *THE LAW OF TORTS* § 92, 613 (4th ed. 1971) (noting that tort and contract law exist to protect different interests and to foster different incentives).

tion—will be negatively impacted, potentially causing repercussions in other areas of the economy.

Before proceeding, an important distinction must be made. It is that the concern is not simply that people who feel aggrieved cannot have their day in court. The courts have long employed screening procedures that keep people from accessing the halls of justice.³² Screening cases at an early stage allows the courts to eliminate those claims that are based on inadequate legal grounds. In other words, the courts expend some resources early on to stop frivolous claims from proceeding. Frivolous lawsuits impose costs without providing any remedial or deterrence benefits; by definition, they are not based on legitimate claims.³³ In fact, frivolous claims may reduce deterrence by diverting precautionary efforts away from legitimate dangers or by using up judicial resources and reducing the likelihood that legitimate claims can be heard in a timely fashion. Therefore, to the extent that screening procedures are successful in filtering out frivolous lawsuits, they can increase efficiency.

The problem is that in a zero-financing world, financial barriers exclude based on socioeconomic status, not on the strength of litigants' claims. The only way financial barriers would enhance efficiency is if the strength of legal claims were directly correlated to financial status. Ultimately, that is a complex empirical question, but there is little theoretical support for such a link. Therefore, unlike traditional screening procedures, financial barriers are likely—over time—to reduce valuable deterrence by preventing legitimate claims.

Litigation financing options offer some ways to avoid that outcome. A full assignment regime would allow victims to sell their claims to someone who would then have the right (and presumably the resources) to prosecute the claims. A broad third-party financing regime would allow victims to contract with non-party investors and obtain funding for legal and living expenses in return for a share of any damages award or settlement. Finally, if it were possible to effectively reform U.S. credit markets to facilitate victims' borrowing against the value of their legal claims, banks would provide a defined sum—or perhaps a defined line of credit—under traditional loan terms.³⁴ These options differ significantly on a number of important

³² See, e.g., FED. R. CIV. P. 12; *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949-50 (2009).

³³ But see Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 105 (2011) (arguing that courts often define as frivolous claims those that impose high costs, even though the claims are based on “a plaintiff’s idiosyncratic yet deeply held principles . . .”).

³⁴ Some have argued that the market for tort claims should be extended to unmatured tort claims. Robert Cooter, *Towards a Market in Unmatured Tort Claims*, 75 VA. L. REV. 383 (1989). See also Stephen Marks, *The Market in Unmatured Tort Claims: Twenty Years Later* (Boston Univ. Sch. of Law Working Paper No. 11-14, 2011), available at <http://www.bu.edu/law/faculty/scholarship/workingpapers/2011.html>. Those proposals raise a host of additional questions, which are beyond the scope of this paper. Therefore, the arguments here are confined to proposals to expand financing options for matured tort claims.

points—who bears ultimate responsibility for financial decisions, who controls litigation strategy (including settlement), who bears the risk of failure, and so on—but each would eliminate financial barriers to litigation by providing the financial means to bring legitimate claims.

Even before the first financing check was written, efficiency would begin to improve. Recall that it is not the tort remedies themselves that deter wrongful conduct; by definition, those remedies are available only after tort damages have been inflicted. It is the credible threat of tort remedies that yield the increased deterrence benefits. With a litigation financing regime in place, the poor and middle class would find that the doors of justice had opened a little wider and that their lives were improved by the reduction in tortious activities directed at them. Whether broad litigation takes the form of an assignment regime, a third-party financing regime, or a lawsuit-equity loan regime, it has the potential to improve both efficiency and fairness in our justice system.³⁵ That potential may remain unrealized, however, if conditions preclude a first-best solution. We must therefore consider what costs might be imposed by a broad litigation financing regime.

III. THE COSTS OF LITIGATION FINANCING

Litigation financing makes it easier to file a lawsuit. That is the primary source of its benefits, as described above, but is also the source of its costs. According to the most basic of economic principles, when the price of something declines, the quantity demanded increases. Lowering the price of litigation should therefore result in an increase in litigation. If so, society would face increased costs, both in resources expended by litigants in pursuit of justice and in resources expended by society in order to provide a forum for the claims.

According to some scholars, those costs are not insignificant. It is estimated that the American tort system had a total price tag of \$252 billion in 2007, with direct costs making up almost 2% of the nation's Gross Domestic Product ("GDP"), over half of which is the administrative cost of run-

³⁵ Some scholars have noted that litigation financing, particularly an assignment regime, would improve the ability of litigants to bear the risk of litigation, allowing them to hold out for a settlement that more accurately reflects the true merits of the case. See Molot, *supra* note 14. That conclusion is almost certainly correct. However, the analyses that have been conducted to date have considered neither the additional costs that are incurred due to the perseverance of the parties—both private and social—nor whether continuance of the case is individually or socially optimal after consideration of those costs. Furthermore, increased settlements might actually be harmful, if they deprive society of useful precedents. Leandra Lederman, *Precedent Lost: Why Encourage Settlement, and Why Permit Non-Party Involvement in Settlements?*, 75 NOTRE DAME L. REV. 221, 268-69 (1999). It is therefore impossible to know whether more accurate settlements are a net benefit or cost of litigation finance.

ning the system.³⁶ There are also indirect costs. While tort liability has arguably made products safer, it has done so at a price. Increases in safety are accompanied by increases in price, and it is not clear that the increases in safety adequately compensate society for the increased cost and corresponding reduction in total purchasing power.³⁷ In other cases, consumers have simply been denied the benefits of certain products entirely due to the potential costs to the producers of releasing the products for sale.³⁸ As a result, American businesses miss out on billions of dollars in lost sales each year,³⁹ and society suffers by the loss of the jobs those lost sales represent.

The rewards from litigation also divert numerous non-legal personnel from productive work, costing businesses thousands of man-hours in foregone productivity.⁴⁰ The riches transferred through the tort system draw talented youth into law schools to become tort lawyers (both plaintiffs' and defense), thereby drawing them away from more highly-valued social uses.⁴¹ Finally, the fear of lawsuits results in wasteful defensive actions, such as "defensive medicine," which makes the avoidance of malpractice suits, rather than the best medical interests of the patients, the basis of medical judgments.⁴² It is estimated that doctors expended, during 2007 alone, \$124 billion in unnecessary health care costs in response to the threat of medical malpractice lawsuits.⁴³ When all direct or indirect costs are totaled, it is estimated that the American tort system costs between \$600 billion and \$900 billion per year, or between 4.3% and 6.5% of GDP.⁴⁴

But the issue is not merely one of numbers. While high, these costs might be defended on the grounds that they are required to correct wrongful

³⁶ TOWERS PERRIN, 2008 UPDATE ON U.S. TORT COST TRENDS 3 (2008), available at http://www.towersperrin.com/tp/getwebcachedoc?webc=USA/2008/200811/2008_tort_costs_trends.pdf.

³⁷ See, e.g., A. Mitchell Polinsky & Steven Shavell, *The Uneasy Case for Product Liability*, 123 HARV. L. REV. 1437 (2010).

³⁸ Theodore H. Frank, *Riverboat Poker & Paradoxes: The Vioxx Mass Tort Settlement*, 23 LEGAL BACKGROUNDER 12 (2008), available at http://www.aei.org/files/2008/03/21/20080325_FrankLB1.pdf.

³⁹ LAWRENCE J. MCQUILLAN, HOVANNES ABRAMYAN, & ANTHONY P. ARCHIE, JACKPOT JUSTICE: THE TRUE COST OF AMERICA'S TORT SYSTEM 26-28 (2007), available at http://www.pacificresearch.org/docLib/20070327_Jackpot_Justice.pdf.

⁴⁰ Laurence H. Silberman, *Will Lawyering Strangle Democratic Capitalism?*, 1978 REG. 15, 21 (1978).

⁴¹ Theodore H. Frank, *Protecting Main Street from Lawsuit Abuse*, Testimony before the S. Republican Conf. (Mar. 16, 2009), available at <http://www.aei.org/files/2009/03/16/Frank%20testimony.pdf>.

⁴² U.S. DEP'T OF HEALTH & HUMAN SERVS., CONFRONTING THE NEW HEALTH CARE CRISIS (2002), available at <http://aspe.hhs.gov/daltcp/reports/litrefm.pdf>. The U.S. Department of Health and Human Services reported that 79% of all physicians report ordering more tests than they believed were medically necessary because of litigation fears. *Id.* at 4. The same survey indicated that 74% report referring patients to specialists, 51% report recommending invasive procedures, and 41% report prescribing more medications than they believed medically necessary. *Id.* at 5.

⁴³ MCQUILLAN, ET AL., *supra* note 39, at 19.

⁴⁴ Frank, *supra* note 41, at 2.

conduct. Costs imposed on tortfeasors, for example, are unavoidable and necessary for the moral and economic reasons discussed earlier. Taking it a step further, if those tortfeasors are doctors or manufacturers, then the increased costs of health care and manufacturing products may be nothing more than the cost of eliminating injuries resulting from bad medical or manufacturing processes. Those are the type of costs that we should expect from our tort system—in other words, they could be a feature, not a flaw. Also, because everyone in society benefits from having a system that will compensate all future victims, it is not inherently unjust to impose some tort-related burdens on society as a whole.

The question then becomes whether those costs are justified, and that requires an inquiry into whether or not claims tend to be frivolous. Before proceeding to that discussion, however, it is important to point out that it is not undisputed that litigation finance will increase the volume of litigation. The law of demand leads to that conclusion, but it relies, as do all basic economic principles, on the assumption of *ceteris paribus*—that all other factors are held constant. A number of scholars have suggested reasons why other factors would not be held constant and have argued that litigation finance would not increase the amount of litigation.

A. *Must Litigation Finance Lead to Increased Litigation?*

One persuasive argument is that the emergence of a market for tort claims will lead to more accurate and transparent pricing of tort lawsuits, as financiers are incentivized to objectively price claims.⁴⁵ Because claims will be accurately priced, all parties will have better information about the correct value of claims.⁴⁶ Competition in the marketplace will require all financiers to keep their fees low, especially on less risky claims.⁴⁷ This, in turn, will minimize financiers' ability to subsidize high-risk claims.⁴⁸ Related to this conclusion is an argument, raised by Professors Ribstein and Kobayashi, that financiers will be able to diversify risk in capital markets,

⁴⁵ See Max Schanzbach & David Dana, *How Would Third-Party Financing Change the Face of American Tort Litigation? The Role of Agency Costs in the Attorney-Client Relationship*, (Searle Ctr. on Law, Regulation, & Econ. Growth Pub. Policy Roundtable on Third-Party Financing of Litigation, Sep. 24-25, 2009), available at http://www.law.northwestern.edu/searlecenter/papers/Schanzbach_Agency%20Costs.pdf. It is worth mentioning that, if true, this result would be only after a period of transition, during which pricing will be uncertain. For the purposes of this discussion, however, I assume that the transition period is short and mild.

⁴⁶ *Id.* at 9.

⁴⁷ *Id.* at 2.

⁴⁸ *Id.* But see Abramowicz, *supra* note 4, at 738 (arguing that competition on legal fees is difficult to achieve because "litigants may interpret a low contingency fee as a signal of a low-quality lawyer.").

reducing the *need* to subsidize riskier cases with low-value “strike” suits.⁴⁹ Whether financiers are freed from their dependence on strike claims, or whether they give up strike claims only because they are no longer profitable, the resulting reduction in low-value, low-profit claims might outweigh any increase in high-value, high-profit claims, causing the total amount of litigation to decrease.⁵⁰

This argument has much to recommend it, but there are also reasons to doubt it. First, the fact that financiers no longer bring low-value cases does not mean that those cases will not be brought by anyone. It is possible that a clever legal entrepreneur will find a different, more profitable way to process strike claims. The legal profession would be required to change to accommodate litigation financing, and those changes could be varied, including the emergence of a price-taker market⁵¹ in strike claims. If the number of strike claims remains constant, and the volume of high-value claims increases, total litigation would increase as well.

The second reason to doubt this argument is that, whether driven by competition or lured by diversification of risk, the increase in high-value claims may mean an increase in litigation financiers’ willingness to finance frivolous claims. This point is developed at greater length below, but if financiers are motivated to change the type of cases normally brought, there is always the possibility that the new cases that are brought will be cases for which there is no legitimate legal basis.

A third, related concern is that competition among financiers may not occur solely in price, or the fee that financiers charge in return for financing a case. In most industries, competition occurs in both price and product quality. In litigation, product quality might mean the amount of damages that can be reasonably promised at the beginning of a case. There are limits to the amount that might be promised, but lawyers have previously been successful in expanding the limits of “reasonable” damages, and there is no reason to believe that financiers would not engage in the same behavior. Assuming reasonableness of the promised damages award, even risk averse clients would be willing to assume some additional risk in return for a higher promised award amount. If competition occurs in quality instead of price, or even simultaneous with price, claims that litigation finance could reduce litigation would be weakened.

Another possibility is that litigation funding could lead to more effective deterrence and thereby decrease the total number of torts committed. This would happen as a consequence of two separate trends. The first is that as more financing is available, more claims could be filed, increasing

⁴⁹ Bruce H. Kobayashi & Larry E. Ribstein, *Law’s Information Revolution*, 53 ARIZ. L. REV. 1169, 1213-14 (2011).

⁵⁰ *Id.* at 1214.

⁵¹ A price-taker market is one in which no individual producer has market power. ARMEN A. ALCHIAN & WILLIAM R. ALLEN, *UNIVERSITY ECONOMICS* 287 (2d ed. 1964).

the likelihood that tortious conduct would be punished. The second is that, as litigation finance leads to more accurate pricing of tort lawsuits, potential tortfeasors would have a clearer view of the cost of any wrongful actions and would be better able to adjust their behavior to avoid the consequences. Unfortunately, this argument only addresses the effects on legitimate claims; no deterrence is possible for the type of actions that lead to frivolous claims because those actions are not tortious and will not be punished. If, as described below, the availability of litigation finance causes an increase in frivolous litigation, increased deterrence potential may not lead to a reduction in total litigation.

A third possibility is that litigation financing will reduce litigation by encouraging settlements. Over time, litigation finance could lead to greater sophistication on the part of financiers and lawyers.⁵² The parties would not only become more knowledgeable about the value of cases, but also about each other as parties.⁵³ This increased knowledge would reduce uncertainty and allow divergent expectations about the “value” of claims to converge over time.⁵⁴ This, in turn, could lead to early and increased settlement.⁵⁵ Auto collision is one area of law that has followed this path and has achieved efficiencies in reducing litigation costs. Most cases are resolved rapidly because insurers pay injured parties immediately, and then insurance companies negotiate amongst themselves regarding the companies’ share of settlement costs. The companies are repeat players who are familiar with one another, and thus are incentivized to play nicely with each other. Under a litigation financing regime, other areas of law might gain the same benefits.⁵⁶

Unfortunately, it is not clear that litigation finance is the only necessary requirement to replicate the successes of the auto collision sector. Auto collision lawsuits in most states are tied to state no-fault regimes, which mandate rapid payment to victims and then remove them from the equation. At first glance, this looks like a mandatory assignment regime, which would raise a host of economic and ethical concerns.⁵⁷ However, it is also a regime with strict limitations on the amount of money that is awarded to victims, so negotiations do not include any discussion of the total amount in question. These are fundamental distinctions between a no-fault regime and litigation finance. While the notion of adopting no-fault regimes for other areas of tort law is not unheard of,⁵⁸ it is a different question than

⁵² Schanzenbach & Dana, *supra* note 45, at 11-12.

⁵³ *Id.*

⁵⁴ *Id.* at 12.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ Abramowicz, *supra* note 4, at 760-70, 776.

⁵⁸ See Jeffrey O’Connell, Jeremy Kidd & Evan Stephenson, *An Economic Model Costing “Early Offers” Medical Malpractice Reform: Trading Noneconomic Damages for Prompt Payment of Economic Damages*, 35 N.M. L. REV. 259, 261 (2005).

adopting a broad financing regime, and the successes of the former are no guarantee of success in the latter.⁵⁹

There are potentially many more ways in which various aspects of a particular litigation financing regime would affect and therefore counter the general effect of increasing litigation. However, the general implications of the law of demand remain extremely persuasive. To date, the only empirical analysis of the issue, which considered the advent of litigation financing in New Zealand, has reached some conclusions consistent with the prediction of the law of demand, but without strong support for the ultimate conclusion that litigation financing caused an increase in the volume of litigation.⁶⁰

B. *Harms Arising from Litigation Financing*

The danger of litigation financing is not just that litigation will increase and society will be burdened with additional costs. That danger is real and potentially significant, especially in terms of efficiency, as much of the costs of litigation are not borne directly by the litigants and their lawyers, but are externalized to society as a whole.⁶¹ However, even more troublesome than mere increases in litigation are increases in *frivolous* litigation and the potential for financiers to attempt to affect the law's evolution through development of inefficient and potentially unjust precedent.⁶²

1. Increased Frivolous Litigation

Proponents of litigation finance argue that litigation financing will not result in an increase in frivolous lawsuits.⁶³ Their persuasive arguments are based on the rational self-interest of the financier: why would any financier

⁵⁹ Schanzenbach and Dana also make a broader point regarding the similarities between litigation financing and liability insurance. Schanzenbach & Dana, *supra* note 45, at 12.

⁶⁰ David Abrams & Daniel L. Chen, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes* 31-32 (U. Penn., Working Paper, 2011) (empirical evidence showing an increase in litigation in New Zealand resulting from expanded use of third-party financing), available at <http://www.law.upenn.edu/cf/faculty/dabrams/workingpapers/MarketforJustice.pdf>.

⁶¹ Michael P. Stone, *Optimal Attorney Advertising* 12-15 (Univ. of Conn. Dep't of Econ., Working Paper No. 2010-14, 2010).

⁶² See Maxwell L. Stearns, *Standing Back From the Forest: Justiciability and Social Choice*, 83 CALIF. L. REV. 1309, 1350-52 (1995); Lederman, *supra* note 35, at 235.

⁶³ Sebok, *supra* note 33, at 106 ("Frivolous litigation is not a necessary byproduct of maintenance . . ."); Sebok, *supra* note 13, at 455-56 ("The fear that a market in champerty will result in lawsuits that are more likely to be frivolous . . . seems far-fetched."); Molot, *supra* note 14, at 106 ("Although opponents of third-party financing predict that such financing might encourage meritless filings rather than meritorious ones, the claim makes little sense.").

knowingly invest in a lawsuit that is likely to be dismissed?⁶⁴ One answer is that a rational, self-interested financier would knowingly invest in a frivolous lawsuit because she knows that the courts' screening procedures are imperfect and that there is always a chance that a claim will slip through and either achieve a damages award from a jury or lead to a settlement offer by the defendant. The fact that rational, self-interested lawyers currently file frivolous lawsuits under the same circumstances makes clear that there is some positive net benefit to filing frivolous claims.

It is arguable that, under a litigation financing regime, incentives would change sufficiently that frivolous lawsuits would be further deterred. In fact, as described above, some have argued that low-value strike claims would decrease under litigation financing.⁶⁵ I have argued that those claims are overstated, but even if true, they would only show that low-value frivolous claims would be less frequent. In return, the number of high-value frivolous claims could very easily increase, as such claims might offer sufficient potential for reward that they would be brought, even if the probability of making it through the screening procedures was low.

Recall that, as a general rule, whether or not the tort system's costs are justified depends on whether the claims being filed are frivolous or legitimate. The public resources expended on the judicial process are only one type of cost. Plaintiffs bear the costs associated with time delays in obtaining their day in court, including depletion of defendants' assets, which may not be available to satisfy any damages award. Defendants must expend resources defending themselves, including the opportunity cost arising from the time executives must expend participating in trials, as well as potential reputational harm.⁶⁶ All of these costs are legitimate to the basic functions of tort law—compensation, deterrence, etc.—so long as they arise from legitimate claims. If the claims are frivolous, the compensation is not legitimate and no reasonable deterrence is possible.

All that would be required for an increase in the total number of frivolous cases is for the total number of cases filed to increase and the frequency of frivolous lawsuits to stay the same. Even under those circumstances, however, it is possible that the percentage of frivolous lawsuits that make it through the courts' screening procedures would increase. The courts are responsible for "weeding out meritless claims,"⁶⁷ but the process is obviously flawed. This is not intended to disparage the courts' efforts, for screening cases is but one of the courts' many tasks, all of which must be performed with limited resources. Lawyers file both frivolous and le-

⁶⁴ *Id.*

⁶⁵ Schanzenbach & Dana, *supra* note 45, at 11-12; Kobayashi & Ribstein, *supra* note 49, at 1213-15.

⁶⁶ Todd J. Zywicki, *Spontaneous Order and the Common Law: Gordon Tullock's Critique*, 135 *PUB. CHOICE* 35 (2008).

⁶⁷ *In re Silica Prod. Liab. Litig.*, 398 F. Supp. 2d 563, 636 (S.D. Tex. 2005).

gitimate claims, and the two classes of cases compete for those limited resources. Sorting through the cases takes time and resources. If litigation finance results in an increase in case filings without a corresponding increase in judicial funding, the screening process will become more prone to mistakes, permitting more frivolous cases and potentially denying more legitimate claims. The greater the amount of financing, the greater the likely increase in litigation, and the greater the chances that the courts' screening procedures would be swamped and fail.

Screening procedures could fail even if financiers change nothing about the way cases are selected and prosecuted. The true danger of litigation finance, however, is that financiers are likely to engage in a pattern of behavior that could create costs and distortions that would far outweigh any potential benefits from litigation. The most pressing danger of litigation finance is path manipulation.

2. The Danger of Path Manipulation

Path manipulation is the conscious effort to impact the evolution of precedent in order to achieve some goal.⁶⁸ With the development of *stare decisis* in the late nineteenth century, it became possible for an entrepreneurial lawyer to invest in future lawsuits.⁶⁹ Prior to that point, each case was an isolated event on the judicial landscape and had minimal impact on the disposition of future cases. Even if a litigant was likely to be a repeat player, there was little benefit from efforts to change the dominant rule because precedent was seen as the combined wisdom of judges rather than a binding rule.⁷⁰ That all changed as common law courts began to adhere to *stare decisis*, and judges were seen as having the ability to declare binding legal rules.⁷¹ From that point on, legal decisions became a capital good, with a stream of future benefits, and an incentive arose for lawyers to engage in rent-seeking behavior in order to nudge the common law toward favorable rules.⁷²

⁶⁸ Lederman, *supra* note 35, at 235.

⁶⁹ Todd J. Zywicki, *The Rise and Fall of Efficiency in the Common Law: A Supply-Side Analysis*, 97 NW U. L. REV. 1551, 1556 (2003). *See also* Stearns, *supra* note 62, at 1351-53 (arguing that precedent, rather than *stare decisis*, creates path dependence in the law).

⁷⁰ Zywicki, *supra* note 69, at 1578-79.

⁷¹ *Id.* at 1576-78.

⁷² *See id.* at 1579. As with legislative rent-seeking, judicial rent-seeking is likely not limited to pursuing benefits from those currently in a position to bestow them, but will extend to pursuing the appointment of those who are more likely to look favorably on the bestowal of benefits. In the legislative realm, rent-seeking therefore takes the form of both lobbying and campaign contributions. *See id.* at 1555-56. In the judicial realm, rent-seeking will take the form of path manipulation and either electioneering for sympathetic judicial candidates or pressuring elected executives during the judicial appointment or merit-selection processes. *Id.* at 1579.

The emergence of contingency fee arrangements served to strengthen those incentives by allowing lawyers to capture a percentage share of each present and future lawsuit. In other words, each binding legal decision became an even more valuable capital good to the lawyers who prosecuted the cases. As contingency fee lawyers became more sophisticated, they developed ways to capture more of the future benefits by specializing in certain types of litigation, allowing them to generate reputational capital. That is, the lawyer who is able to convince a judge, a jury, or both, to create new liability becomes associated in potential litigants' minds with that particular type of case. In essence, the savvy lawyer can establish brand recognition for the new area of litigation and can thereby capture a large portion of the future damages awarded under the new theory of liability. Even the process of rent-seeking would have generated certain economies of scale within firms, so that a firm could more cheaply process large numbers of claims, giving it an advantage over competing firms.

All of these effects served to increase the potential rewards to lawyers from pushing the boundaries of litigation. After all, the greatest rewards were available to those firms that were able to generate novel areas of liability not previously contemplated. Presently, a contingency fee lawyer may be willing to bring a series of claims known to be non-meritorious, knowing that one favorable decision can create precedent that instantly opens the door to new avenues for recovery.⁷³ For example, prior to their eventual acceptance, the courts repeatedly rejected tobacco and asbestos claims, but the size of the payout more than compensated those attorneys who pursued the long-term strategy.⁷⁴ In other words, the plaintiffs' bar has strong monetary incentives to *create* liability through repeated litigation of presently non-meritorious claims.

The same incentives will drive third-party financiers, whose long-term investment strategy will allow for initial losses in order to achieve greater returns in the future. In fact, assuming financiers follow traditional investment practices and diversify their risk, they may be far more willing than contingency fee lawyers to accept the financial risks of path manipulation. Similarly, because financiers, such as hedge fund managers, will be able to tap into far more funding than is currently available to contingency fee lawyers, they will be able to increase the number of cases brought—in quick succession in the same jurisdiction or simultaneously across multiple jurisdictions—in efforts to speed up the process of path manipulation. To the extent that contingency fee lawyers compete in the litigation finance market, all of the rent-seeking by financiers would be on top of efforts that cur-

⁷³ Paul H. Rubin & Martin J. Bailey, *The Role of Lawyers in Changing the Law*, 23 J. LEGAL STUD. 807, 814-21 (1994). See also Martin J. Bailey & Paul H. Rubin, *A Positive Theory of Legal Change*, 14 INT'L REV. L. & ECON. 467, 467-77 (1994).

⁷⁴ WALTER K. OLSON, *THE RULE OF LAWYERS: HOW THE NEW LITIGATION ELITE THREATENS AMERICA'S RULE OF LAW* 13-21 (2003).

rently push at the boundaries of tort law. At the very least, lawyers would not be expected to oppose expanded liability, as it would increase the demand for lawyers' services.

Each of these first-best solutions will likely cause not only an increase in the total amount of litigation and an increase in the percentage of frivolous lawsuits that make it through screening procedures, but also an increase in frivolous lawsuits filed with the purpose of changing precedent. Of course, as the examples below illustrate, change is not inherently unfair or unjust; our legal history is replete with examples of doctrinal changes that made society more just or improved economic efficiency. In fact, some amount of path manipulation is probably inevitable under a system such as ours, and some scholars have argued that justiciability doctrines such as standing have arisen in an attempt to minimize path manipulation.⁷⁵ What makes path manipulation troublesome under a litigation financing regime is the dramatic increase in cases it makes possible and the impact it has on the goals pursued.

As described above, increases in quantity will arise out of the ability of financiers to marshal far larger quantities of resources and to diversify risk. Each frivolous case represents wasted resources because no remedial or deterrence benefits are recouped by society; increasing the quantity of frivolous lawsuits serves only to further burden society and innocent defendants.

The goals that drive path manipulation under a financing regime will not be the noble and just goals that have been used in the past by public interest groups like the National Association for the Advancement of Colored People (NAACP) and the Women's Rights Project.⁷⁶ Financiers' goals will not even be the sympathetic goals of a lawyer who knows her client has no valid claim under current law, but pushes ahead with the case because she believes strongly that justice requires liability. Instead of these laudable goals, path manipulation under a financing regime will be motivated by a pursuit of investment returns and risk diversification. In the words of one litigation financier:

We're fundamentally a capital provider. We take a share of the ultimate recovery, having taken the risk of funding the case. Forget this being about the law or litigation—we're providing risk funding for an investment in the same way as in any other sector of the market. If the investment pays off we make a return on the capital we're investing.⁷⁷

⁷⁵ Stearns, *supra* note 62, at 1350-52.

⁷⁶ Lederman, *supra* note 35, at 239-41 (discussing how the NAACP used path manipulation to defeat segregation and the Women's Rights Project used path manipulation in seeking heightened protection for women under the Equal Protection Clause of the Fourteenth Amendment).

⁷⁷ Matt Byrne, *World's Largest Dispute Financier Targets US Litigation Market Uptick*, THE LAWYER (Nov. 29, 2010), <http://www.thelawyer.com/%E2%80%98world%E2%80%99s-largestdispute->

This is not intended as a disparagement of profit, generally, or even the pursuit of profit. So long as profits include all of the costs and benefits, profits are socially beneficial and provide a useful motivation for activities that benefit others. If pursuit of profit leads to tortious injuries, however, then costs result that, if internalized, might have made the endeavor unprofitable. By requiring that the tortfeasor correct whatever wrongs it has inflicted, those costs are internalized. Even in a perfectly free market, therefore, tort damages provide a valuable check on the actions of profit-motivated individuals and companies. Because financiers could become dominant players in the tort system, profit motive would drive case selection, a result that seems incongruous with tort law's role as a check on profit motive.

Allowing profit, or investment returns, to influence case selection and prosecution could have harmful consequences to the system and society. At the very least, the promised benefits of litigation financing will be less than advertised. For example, the deterrent effect of litigation will be distorted as financiers demand compensation based on an external evaluation of the case rather than on the actual harm the victim suffers. Abramowicz argues that in an assignment regime, fears that assignment will corrupt the process are exaggerated because the adversarial process assures that each litigant "adequately represent[s] their own interests."⁷⁸ However, the fact that the financier is *not* the victim weakens this claim, so adequately representing the interest of the victim will be far more difficult, even if the assignee were predisposed to ignore his own self-interest and bow completely to the victim's interests in seeking compensation. A financier will have only imperfect information regarding the true damages, which could lead to insufficient compensation and under-deterrence, but will more likely result in excess compensation and over-deterrence.⁷⁹

It may also be that the profit motive also limits the willingness of financiers to fund lawsuits brought by the poor and middle class. Motivated by profit, financiers may limit the number of low-value claims they are

financier%E2%80%99-targets-us-litigation-market-uptick/1006248.article (internal quotation marks omitted). Some scholars have argued that our current system of justice is the result of consistent path manipulation in favor of the "haves," who have not faced financial barriers to justice. Maya Steinitz, *Whose Claim is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1299-1301 (2011). If true, litigation financing—to the extent it allows the poor and middle class to access the courts—could provide long-overdue path manipulation in favor of the poor, or "have-nots." *Id.* However, it is unclear why litigation financiers would systematically choose to finance the claims of the poor and middle-class.

⁷⁸ Abramowicz, *supra* note 4, at 734. Of course, path manipulation means that the assignee (or other financier) may be using the case strategically, with the interests of the present victim only partially considered.

⁷⁹ See Stephen Gillers, *Waiting for Good Dough: Litigation Funding Comes to Law*, 43 AKRON L. REV. 677, 692-94 (2010) (describing how the fear of financed litigation may induce defendant's to make higher offers during settlement negotiations).

willing to fund, in order to focus more on high-value claims. The wealthy will bring some low-value claims and the poor and middle class will bring some high-value claims. It will be much easier, however, to calculate a high dollar value for lost wages and related damages if the victim is wealthy. Wealthy individuals are also far less likely to require assistance with living and recuperation expenses. The combination of lower upfront expenditures and higher damage awards will be appealing to many financiers, and wealthy individuals could make up a larger percentage of funded cases than would otherwise be predicted based on their ability to finance their own lawsuit. If so, it could lead to a form of path manipulation that skews in favor of the wealthy. Skewing the justice system to the advantage of the wealthy not only seems highly questionable from a moral standpoint, but also betrays the promise that third-party financing will assist the poor and middle class.

One might argue that any distortions connected with the profit motive might be diminished by the presence of lawyers in the financing process. Lawyers are bound not only to their clients by fiduciary duties but are also obligated to abide by the legal profession's ethical standards. Neither of these constraints would bind financiers, however.⁸⁰ Moreover, it is not clear what the ethical obligations would be for lawyers in a financing regime,⁸¹ and it may be that the additional rewards from increased litigation and path manipulation would be too much for some lawyers to withstand.⁸² Counsel will also have an incentive to develop a good working relationship with financiers, with the expectation that those financiers will provide the lawyer with more work in the future. In fact, one possible form of litigation financing would be a legal version of a health maintenance organization (HMO), with financiers essentially obtaining exclusive rights to a group of lawyers' services for the purpose of prosecuting the cases invested in by the financier.

⁸⁰ JOHN BEISNER, JESSICA MILLER & GARY RUBIN, *SELLING LAWSUITS, BUYING TROUBLE: THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES* at 7-8 (2009), available at <http://www.instituteforlegalreform.com/sites/default/files/thirdpartylitigationfinancing.pdf>.

⁸¹ See Molot, *supra* note 5, at 436-37 (“[T]he lawyer who actually starts a risk-transfer business is more likely to test prevailing professional norms and provoke a broader reevaluation of the legal profession's self-conception. These lawyers would find themselves in the uncharted territory of forging relationships with capital providers and counterparties, rather than with clients.”); Molot, *supra* note 14, at 110-11 (“We rely on a lawyer's deep-seated professional obligations and strict compliance with codes of professional responsibility to help him navigate difficult ethical dilemmas. If, however, the lawyer were beholden to a nonlawyer capital provider—for example, the management committee of a nonlawyer-controlled law firm—this might make it more difficult for the lawyer to protect the interests of the client and the court as vehemently.”).

⁸² Abramowicz, *supra* note 4, at 720 (“The ethical rules provide incentives for lawyers to act honestly, but these incentives are balanced by opportunities for financial and reputational gain. Increasing the amount at stake for attorneys in a given suit may well increase their incentives to perform well . . . but it may induce them to go too far. Greater rewards could make the potential risks less weighty in the moral decisionmaking process.”).

3. Principal–Agent Problems

Litigation finance could also exacerbate the principal–agent problems already present in the legal profession. The specialized nature of the legal profession, as well as the asymmetric information that arises from the fact that lawyers are highly trained and clients are not, has long made principal–agent problems a concern. Under a traditional hourly fee arrangement, there is little that the average client, who has no experience filing or maintaining a lawsuit, is capable of doing to adequately monitor her lawyer's efforts. Even receiving an itemized statement of fees would be of little help to all but the most sophisticated clients. Lawyers, therefore, would be incentivized to maximize profits by inflating hours worked. Of course, these incentives are balanced out somewhat by reputational factors; lawyers who are known to win (and win big) for their clients are more likely to receive additional work.⁸³ For the individual plaintiff, these two incentives may balance out, but for society at large, both factors serve to increase the cost of the tort system, increasing the work of lawyers and courts and increasing the amount of damages demanded by plaintiffs' lawyers.

When contingency fee arrangements are in place, the attorney has both reputational and monetary incentives to increase the value of the damages award. He also has an incentive to minimize his own inputs into the production function, as his payout will be a fixed portion of the total damages awarded. Because the lawyer's total allotment of time is fixed, each hour worked must be put to the best use possible. The lawyer's time constraints also serve to discourage bringing claims that have either a low-value payout or a low likelihood of winning a damages award.⁸⁴ This is in contrast to an hourly fee system, where the primary choice variable in the profit maximization function is hours worked and the particulars of the case are secondary considerations.

Shifting to a third-party financing regime appears to promise the worst of both worlds, at least in the short run. The third-party financier now has the financial stake in the damages award and wishes to maximize damages subject to minimizing costs. Unlike the contingency fee lawyer, however, the financier has no direct control over those who are responsible for total costs, as the lawyers are external to the financier's organization. The financier, therefore, will find his ability to rein in costs severely obstructed. In the long run, financiers will likely become sophisticated customers capable of adequately policing their attorneys, but this promises only that, after a transition period, third-party financing will be no worse than under the cur-

⁸³ To be certain, many lawyers feel bound by rules of professional conduct, which would constrain their ability to inflate legal fees. However, it would seem an easy task to amass anecdotal evidence of lawyers who do not feel bound by the rules of professional conduct, leading to very little confidence that professionalism, alone, is an effective counter to the monetary incentives to cheat.

⁸⁴ BEISNER ET AL., *supra* note 80, at 5.

rent contingency fee regime. Financiers will have the ability to police costs and reduce the share of damages required to cover their costs, but there are no binding constraints on the share of damages they will be able to demand if they are otherwise able to increase the damages award they can reasonably promise.

Just as very few traditional producers would be content facing a flat demand curve, as is often depicted in very basic economic discussions of competitive markets,⁸⁵ very few law firms would be content to inhabit the bottom of the contingency fee scale. It is possible that certain classes of cases will become so standardized that competition will occur solely in damages share, but it seems unlikely that this effect will be widespread, so there is little hope that society will be able to avoid increased litigation and the tremendous costs that accompany it.

After considering all of the benefits of litigation financing—improvements to efficiency and increased fairness and justice to poor and middle-class victims—it is hard to escape the conclusion that litigation financing is a first-best solution. However, after considering all of the potential costs arising from litigation financing—increased litigation, increased frivolous litigation, and increased danger of profit-driven path manipulation—it is hard to escape the conclusion that we simply do not live in a first-best world. That does not mean, however, that we need reject entirely the idea of financing tort lawsuits. Instead, we should look for second-best solutions, those which would achieve the highest level of benefits while minimizing the costs. A few possibilities are discussed in the next part.

IV. SECOND-BEST SOLUTIONS

Any second-best solution must be able to promise improvements in efficiency and justice above a zero-finance world. It may seem strange that some of the proposals in this part are currently in practice, but the fact that a doctrine is the status quo would not be sufficient to eliminate it from consideration as a second-best solution. After all, a zero-finance world is inefficient, as described previously, and if achievement of the first-best solution is impossible without severe consequences, the law may have been evolving towards a second-best solution for some time. However, too much weight should not be given to the status quo, either; the fact that a doctrine has evolved is some evidence of its usefulness to society, but each candidate proposal should be carefully considered, based on all its moral, economic, and other costs and benefits.

Two short clarifications are in order before commencing. The first is that a search for second-best solutions should not only encompass proposals

⁸⁵ See, e.g., WILLIAM J. BAUMOL & ALAN S. BLINDER, *MICROECONOMICS: PRINCIPLES & POLICY* 199-200 (11th ed. 2009).

for actual financing of lawsuits, but also possible changes to the underlying structural system that, when achieved, will enable greater levels of financing while minimizing the costs. The following list includes examples of both. Second, these proposals are not intended to comprise an exhaustive set. The range of possibilities for second-best solutions is broad, making it impossible to list them all, much less describe the costs and benefits in detail. Rather, the following proposals are but a sampling of some obvious and non-obvious possibilities, offered to show some common weaknesses of reform proposals and that second-best solutions may come in unexpected packages.

A. *Contingency Fee Arrangements*

Perhaps the most obvious possibility for a second-best litigation financing option is the contingency fee arrangement. Commonly recognized as a partial assignment of a plaintiff's claims,⁸⁶ contingency fee arrangements obligate lawyers to obtain a percentage share in any settlement or damages award in return for financing the litigation expenses of a claimant. Prior to the twentieth century, contingency fee arrangements were thought to violate prohibitions on maintenance and champerty.⁸⁷ By the time Maine approved contingency fee arrangements by statute in 1965,⁸⁸ however, contingency fee arrangements had been approved in every jurisdiction.⁸⁹

A plaintiff who is unable to bear the legal costs of a lawsuit will be able to proceed with her claims if she can find a contingency fee lawyer willing to take her case. The plaintiff is not completely protected from risk in this way, because there is still a chance that the claims will fail, but the risk to the plaintiff is reduced because there is no danger of losing legal fees.⁹⁰ In many cases, the contingency fee collected by the lawyer, if calculated on a per-hour basis, would appear to violate the rules of professional conduct, which require that lawyer fees be reasonable. The contingency fee lawyer, however, is not just being compensated for professional legal services; part of the contingency fee is payment for the risk assumed.⁹¹

⁸⁶ See Max Radin, *Maintenance by Champerty*, 24 CAL. L. REV. 48, 73 (1936) ("Contingent fees of lawyers, supported by a lien on the proceeds of a suit, can scarcely be differentiated from the assignment of a cause of action, or rather part of one.").

⁸⁷ See, e.g., *Key v. Vattier*, 1 Ohio 132, 146 (Ohio 1823).

⁸⁸ 1965 ME. LAWS 333 (codified as amended at ME. REV. STAT. ANN. tit. 17-A, § 516(2) (2006)).

⁸⁹ See Lester Brickman, *Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?*, 37 UCLA L. REV. 29, n.38 (1989). For a discussion of how contingency fees became exempted from restrictions on champerty in the United States, see Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 CHI.-KENT L. REV. 625, 639-40 (1995).

⁹⁰ Abramowicz, *supra* note 4, at 738.

⁹¹ *Id.* at 739 ("[T]he size of contingency fees reflects the risks that their lawyers assume.").

By bearing the legal costs of a lawsuit, contingency fee lawyers provide a way for the poor and middle class to overcome some of the financial barriers to bringing a tort lawsuit. This provides efficiency and fairness benefits above a zero-financing world. However, there are also problems with contingency fee arrangements that are similar to those present in a broad financing regime. First, as with financiers, contingency fee lawyers choose which plaintiffs to fund, not the other way around, so some legitimate claims may be ignored if they do not promise sufficient return on investment. Second, while ethical and professional obligations should act as a means of limiting the drive for profit, it would be unrealistic to assume that contingency fee lawyers are not profit motivated. Therefore, there is a significant danger of path manipulation and an increase in the number of frivolous cases, with the resulting harms to efficiency and fairness.

Even with the potential for harm, contingency fee arrangements may still be beneficial as a second-best solution. There are important differences between a contingency fee lawyer and a financier, differences that make contingency fee arrangements preferable as a form of third-party financing. First, a contingency fee lawyer will have a closer relationship with the client than will be possible if the financier is a hedge fund or other investment firm. Professionalism standards will require that a lawyer have regular contact with the client, know the particulars of the client's injuries, and be involved in the day-to-day decisions of the case.⁹² A lawyer who adheres to these standards will be far less likely to choose pursuit of profit over the interests of the client and the courts. Second, the scope of financing will be far smaller under contingency fee arrangements, as financiers will be able to aggregate financial capital on a scale that is beyond any law firm. Even if a law firm borrowed heavily against its assets to fund litigation, the amount of money would still pale in comparison to the funds available to large hedge funds or other investment firms. As a result, the speed of path manipulation will be far below that which would exist under a broad financing regime. Finally, contingency fee lawyers are prohibited from paying for their clients' living or recuperation expenses,⁹³ which limits their ability to control the agenda in a lawsuit. Because a plaintiff will not be entirely dependent upon the contingency fee lawyer, as would be the case if a single financier was providing all living and legal expenses, the plaintiff's interests are less likely to be subordinated to the lawyer's interests.

⁹² See *supra* note 81 and accompanying text for a discussion of how lawyer ethics could change under a broad financing regime.

⁹³ See Michael R. Koval, *Living Expenses, Litigation Expenses, and Lending Money to Clients*, 7 GEO. J. LEGAL ETHICS 1117, 1126-27 (1994) (discussing how courts have interpreted Section 5-103(B) of the Model Code of Professional Responsibility as prohibiting lawyers from providing living expenses).

These may be only marginal improvements, but they are improvements.⁹⁴ Contingency fee arrangements are an improvement over a zero-finance regime and, at the margin, they are also safer and more efficient than a broad financing regime. Whether the total benefits of contingency fee arrangements outweigh the total costs is a question for more in-depth analysis elsewhere. For now, it is sufficient to point out that they represent one possible second-best solution.

B. *Collateral Source Rule*

While not traditionally thought of as a form of litigation finance, the common law doctrine known as the “collateral source rule” provides some relief to poor and middle-class tort victims as they recuperate and attempt to recover from a tortfeasor. In essence, collateral payments to tort victims can be made without diminishing their ability to recover from the tortfeasor.⁹⁵ In other words, regardless of the source of the collateral payment (e.g., insurance, family and friends, or other philanthropic individuals), poor and middle-class tort victims can receive assistance in meeting their living and medical expenses without impacting the amount of damages that can be recovered from the tortfeasor. While the collateral source rule likely emerged to serve other purposes,⁹⁶ it also serves to lower the financial barriers to bringing a suit.

What is especially interesting about the collateral source rule is that it extends as far back in time as the maintenance and champerty rules that motivate this entire discussion. Because the collateral source does not obtain an interest in the litigation, it would not be considered a form of champerty, but if a collateral source provides living expenses or recuperation expenses that allow the victim to pursue litigation, it would qualify as maintenance.⁹⁷ Because the collateral source rule is only relevant when a lawsuit is pending, courts could regularly dismiss cases when collateral sources are

⁹⁴ It has been argued that prohibitions on maintenance and champerty arise from an untenable distinction between “authentic” claims brought by the victim and “inauthentic” claims brought by a third party. Sebok, *supra* note 33, at 62-63. This distinction between contingency fee lawyers and litigation financiers may appear to be a similar distinction based on a “mistaken interpretation of corrective justice.” *Id.* at 67. However, the arguments advanced here are consequentialist arguments, based on the incentives of the relevant parties. In that way, this research attempts the very “complex consequentialist argument . . . that ‘inauthentic claims’ must be prohibited, or, at the very least, limited,” which Professor Sebok invites. *Id.* at 63.

⁹⁵ See RESTATEMENT (SECOND) OF TORTS § 920(A)(2) (1979).

⁹⁶ See generally Michael I. Krauss & Jeremy Kidd, *Collateral Source and Tort’s Soul Rule*, 48 U. LOUISVILLE L. REV. 1 (2009) (tracing the history of the collateral source rule and its emergence in the United States, England, and Canada).

⁹⁷ See Sebok, *supra* note 33, at 100-08 (discussing the spectrum of maintenance rules across various states).

present, based on rules against maintenance. However, this is rarely done, especially when the motivation of the collateral source is philanthropic or humanitarian. In these cases of “selfless maintenance,”⁹⁸ courts have long been unwilling to reject claims that have attracted collateral sources. Courts may not be as forgiving, however, in cases of “malice maintenance,”⁹⁹ where the collateral source contributes with the intent of harming the defendant by allowing the case to proceed. In malice maintenance cases, courts are far more likely to invoke anti-maintenance rules and dismiss the claims.

Whether the motivations behind the collateral source arise from philanthropy or revenge, the collateral source rule is still preferable to a broad financing regime. Some additional litigation will arise as the poor and middle class are able to partially overcome financial barriers to litigation with the help of collateral sources, but there is little danger of collateral sources attempting to engage in path manipulation. Even if a collateral source is motivated by revenge, those negative attitudes are likely very focused on a particular defendant. That, combined with the collateral source’s inability to profit from the present case or any future cases means that collateral sources will not be significant forces for the evolution of law in any direction, much less a profit-centered one.

By mustering positive forces in society, the collateral source rule brings many poor and middle-class tort victims one step closer to obtaining redress for their injuries. It is therefore an improvement on a zero-financing regime and a candidate as a second-best solution.

C. *Regulation of Financing Contracts*

One possible avenue to explore is the use of regulations to minimize the potential for harm from a broad financing regime. For example, in a non-assignment regime, states could require all financing contracts to contain language limiting the influence of financiers on all legal decisions. This could increase the tort victim’s ability to manage such issues as the timing of settlement and the amount of damages demanded. That, in turn, could minimize the amount of path manipulation attempted by financiers because it would be harder to plan future strategies when control of each individual case is more difficult.

Unfortunately, this solution seems unlikely to work without significant enforcement costs. Financiers will not willingly surrender control and the potential for gain that accompanies it. As a result, they will find ways to circumvent the law, possibly by cultivating relationships with law firms that will agree to take the steps preferred by the financier. These agreements

⁹⁸ *Id.* at 100-102.

⁹⁹ *Id.* at 102-107.

could never be written, but informal agreements would almost certainly arise. Informal agreements would necessitate increased government enforcement costs if the regulations were to be effective. Financiers would also have to expend resources maintaining relationships with law firms and assuring themselves that their wishes are truly being followed. As an example of the latter concern, consider that any action by the financier to police legal fees could be construed as violative of the regulations. Knowing this, the lawyers would have additional incentives to inflate the hours worked.

It is tempting to conclude that the increased cost to financiers is an improvement, as it will make it more difficult for them to engage in path manipulation. However, the search for second-best solutions should be motivated by a desire to see society achieve the highest possible level of efficiency, fairness, and justice, not by a desire to obstruct the functioning of any individual or entity. Were it not for the dominant incentives presented by our present system, litigation finance would be the optimal solution, so litigation financing, considered in a vacuum, is a beneficial service. The optimal second-best solution would likely be one that would allow financiers to operate efficiently, but in a way that minimized the harmful costs of path manipulation and frivolous lawsuits.

The particular regulation described here has sufficient costs that it is not a likely candidate as a second-best solution. Other regulations, however, might be more successful.

D. *Better Case Management by Judges, Made Possible by More Funding*

Perhaps it would be possible to salvage litigation financing by strengthening the courts' screening procedures. Judges have a difficult task—they and their chambers are asked to process an increasing number of claims and sort the meritorious from the frivolous, all on relatively stable budgets. They have it in their power to curb any increase in frivolous lawsuits by simply holding the line on new liability. Doing so requires two things: a willingness to act conservatively regarding tort liability and enough funding that proper analysis of each case is possible. Without sufficient funding, even the most dedicated judge may find herself unable to accurately diagnose and reject every frivolous lawsuit. Once it became common knowledge that frivolous lawsuits would always be rejected, the allure of path manipulation would significantly decrease and any remaining litigation financing would be largely beneficial.

Unfortunately, even if it were politically feasible to increase the budgets for state and federal judiciaries to a level that would allow perfect screening of cases, there is no indication that judges would be inclined to hold the line on new litigation and frivolous claims. The fact that judges

are drawn from the ranks of lawyers¹⁰⁰ makes it more likely that, like their colleagues in the law, they favor expansion. Even without any sympathies for their colleagues in the law, judges favor expansion of liability and complexity for the same reason lawyers do—it provides them with continued employment. This principle has been understood since the time of Charles Dickens, who stated that “[t]he one great principle of the English law is, to make business for itself.”¹⁰¹ At the very least, the fact that judges have accepted and aided in the tremendous expansion of liability and complexity in the past century makes it highly unlikely that they can be trusted to act as a bulwark against any future expansion.

E. *Abolish Stare Decisis*

The opportunity for path manipulation would not have been present prior to the establishment of the doctrine of stare decisis. As described above, it is stare decisis that transforms precedent into a capital good with a future stream of benefits.¹⁰² Without that future stream of benefits, the incentive to invest in path manipulation would disappear almost entirely and the costs of litigation finance would be severely reduced. A retreat from stare decisis would not reverse the past century’s expansion of tort liability, but it could limit future expansion. However, there is virtually no judicial, political, or popular support for such a proposal, and it would appear to be a non-starter as a second-best candidate.

F. *Caps on Financiers’ Rate of Return*

If it is the profit motive that makes litigation finance especially dangerous, perhaps an efficient financing regime would be possible if caps were placed on the percentage of any damages award that financiers could demand in return for financing a lawsuit. This would not entirely eliminate financiers’ incentives to engage in path manipulation, but it is at least theoretically possible to set a limit on rates of return that would minimize the increase in total litigation, the increase in frivolous lawsuits, and the amount of path manipulation. However, lawyers would still favor expansion of tort liability as a means of increasing their own employment, so the reduction in the costs of litigation finance might be limited.

Lawyers would also be presented with perverse incentives, as their lucrative monopoly on plaintiffs’ lawsuits would be at risk from the new en-

¹⁰⁰ Todd J. Zywicki, *Environmental Externalities and Political Externalities: The Political Economy of Environmental Regulation and Reform*, 73 TUL. L. REV. 845, 905-06 (1999).

¹⁰¹ CHARLES DICKENS, BLEAK HOUSE 553 (A.L. Burt Co. 1900) (1853).

¹⁰² See *supra* note 69 and accompanying text.

trants into the market.¹⁰³ If we adopt the reasonable assumption that there is a limit to the amount potential plaintiffs will be willing to surrender to financiers, lawyers facing a relegation to hourly fees would have the incentive to expand the hours billed in order to make financing unprofitable.

Finally, there is an inherent danger in empowering government to determine what the appropriate rate of return is. Not only could this lead to rent-seeking behavior, making it highly unlikely that the rate set by the government would contribute to efficiency, but once government has been given the power to determine the appropriate rate of return for third-party financing, expansion of that power into other areas of investment cannot be far behind.

G. *Caps on Damages Awards*

One reform popular with the tort reform movement is a cap on non-economic and punitive damages. These caps are designed to reduce the number of lawsuits brought by making them less profitable.¹⁰⁴ By limiting damages awards, a maximum return per lawsuit would be effectively established. Even if the financier is able to generate new liability, it will have a much smaller stream of future benefits. As a result, the total amount of money invested in seeking that new liability should decrease. If the damages caps are limited to non-economic damages and punitive damages, financiers might shift their attentions more heavily towards those cases where economic damages are likely to be highest. If these tend to be claims brought by the wealthy—due to higher lost wages—the law could potentially become distorted in favor of the wealthy, which could worsen current inequities.

Limits on damages awards also decrease overall deterrence of wrongful conduct and may limit an individual victim's ability to be fully compensated for real harms. It is impossible to know, *ex ante*, whether the improvements in deterrence arising from litigation finance, would be sufficient to outweigh the reductions in deterrence resulting from caps on damages awards. Because damages caps are imposed by legislation, the likelihood of rent-seeking makes it unlikely that the optimal level of deterrence would be achieved.

¹⁰³ See Painter, *supra* note 89, at 631 (suggesting that English rules against champerty give contingency fee lawyers market power); Coharis, *supra* note 4, at 480 ("Under contingency fee arrangements . . . plaintiffs' attorneys, as oligopsonists, do not offer competitive rates.").

¹⁰⁴ Coharis, *supra* note 4, at 451.

CONCLUSION

Every candidate for second-best solution status is likely to share some or all of the shortcomings identified in the solutions discussed above. However, the very nature of a second-best solution is that it need not be perfect—it only needs to be better. What this article shows is that the first-best solution, litigation finance, is likely unobtainable without significant harm to our judicial system. There should be greater effort made towards identifying appropriate second-best solutions. The options described in the previous Part are merely a beginning.

As the litigation financing discussion progresses, certain avenues of related research present themselves. One such avenue is the question of whether litigation finance might be appropriate on a more limited scope. If there are areas of tort law where the dangers of frivolous lawsuits and path manipulation are lessened, litigation finance could be tried in those areas. Doing so would allow for empirical testing of the hypotheses of this and other litigation financing research. Another such avenue is to investigate the impact of litigation financing on the legal profession. Litigation financing might level the playing field, allowing smaller plaintiffs' firms to compete with larger, more established, and more famous firms. If so, would the advent of litigation financing lead to wholesale restructuring of the litigation marketplace? Hopefully, the limited discussion regarding the advisability of litigation financing is only the beginning.



ECONOMIC IMPLICATIONS OF THIRD-PARTY LITIGATION
FINANCING ON THE U.S. CIVIL JUSTICE SYSTEM

Geoffrey J. Lysaught and D. Scott Hazelgrove***

Economics is the science of incentives. By observing how people act in response to incentives, we can attempt to understand and predict the behavior of individuals and organizations. Economic analysis concerns itself with decisions made in response to incremental changes in incentives. In other words, economics is concerned with decisions made on the margin. A marginal change in the incentive structure induces a marginal change in behavior. For example, slightly lowering the interest rate for a particular loan will not cause *everyone* in the market to seek a loan at the new rate, but that marginal change will likely induce *someone*, at the margin, to seek a new loan.

A particular set of institutional rules that can benefit enormously from the analysis of incentives and behavior at the margin are those that frame the U.S. civil justice system. The U.S. civil justice system contains many procedural and substantive mechanisms that motivate the pursuit of legal claims. For example, contingent fee arrangements encourage the pursuit of claims that a plaintiff might not otherwise pursue due to limited financial resources. Statutory provisions for aggregating claims reduce transaction costs and likewise motivate the vindication of perceived legal grievances. Generous discovery rules, including a responder-pays cost-allocation rule and opportunities for enhanced, treble, or punitive damages are other mechanisms that incentivize litigation.

Third-party financing of litigation appears to be yet another mechanism for incentivizing the pursuit of legal claims. The third-party litigation finance model is thriving: industry members estimate an excess of \$1 billion in direct funding to plaintiffs' firms alone.¹ The industry even has its own trade association to lobby for its financial interests.² These financial interests appear to be the strongest motivator for the industry. As the managing partner of a major litigation funder states, "We're certainly not white

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¹ See Kirby Griffis, *Follow the Money: Litigation Funders Back Your Foes*, METROPOLITAN CORP. COUNS., July, 2011, at 1, 6, available at <http://www.metrocorpocounsel.com/pdf/2011/July/01.pdf>.

² *Id.* The American Legal Finance Association was founded in 2004 and is located in New York City.

knights. We're not in this to right any wrongs or punish people. It's just a business for us."³

Some commentators view the introduction of third-party litigation financing into the U.S. legal system as beneficial.⁴ The common argument is that despite other mechanisms that motivate claims, many legitimate claims still never reach the legal system due to a lack of economic resources. Others view third-party financing much more skeptically, sounding warnings of abusive litigation, disincentives to accept reasonable settlement offers, consumer protection and usury problems, and ethics, conflicts of interest, and privilege and confidentiality concerns. Each of these potential problems may yield deleterious consequences on economic systems throughout the world.⁵

In this paper, we address two critical research questions: (1) whether third-party financing of litigation, *ceteris paribus*, will increase the aggregate amount of litigation, and (2) whether third-party financing, *ceteris paribus*, will increase speculative litigation and strike suits. We define third-party financing as capital from an independent, outside investor that funds a plaintiff's litigation expenses in exchange for a share of either the settlement amount or damages in the event of success at trial. The focus of the paper is on the economic and financial implications of third-party financing, rather than on ethical or professional responsibility considerations.

In the context of our financial economic analysis, we argue that third-party financing will likely increase the supply of capital available to fund litigation and thereby reduce the cost of filing a lawsuit. As a result, we would reasonably anticipate an increase in litigation at the margin. Whether an increase in litigation is a good thing, in and of itself, would require a normative judgment. The key question is what type of litigation is likely to benefit from such funding. To the extent truly meritorious claims are not being pursued, despite the many incentives to litigate already embedded in our civil justice system, an increase in litigation due to third-party financing might be viewed as a positive.

³ See Anthony Lin, *The Smart Money: Australia's Litigation Funding Giant Looks Abroad*, AM. LAW., July, 1, 2011, at 3, available at <http://www.law.com/jsp/tal/PubArticleFriendlyAL.jsp?id=1202498856903> (quoting Hugh McLernon, IMF (Australia) Ltd.'s cofounder and managing director).

⁴ See, e.g., Susan Lorde Martin, *The Litigation Finance Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 FORDHAM J. CORP. & FIN. L. 55, 56-57 (2004); Terry Carter, *Cash Up Front: New Funding Sources Ease Financial Strains on Plaintiffs Lawyers*, A.B.A. J., Oct. 2004, at 34.

⁵ See, e.g., JOHN BEISNER, JESSICA MILLER & GARY RUBIN, SELLING LAWSUITS, BUYING TROUBLE: THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES 4-11 (2009), available at <http://www.instituteforlegalreform.com/sites/default/files/thirdpartylitigationfinancing.pdf>; Roger Parloff, *Have you got a piece of this lawsuit?*, CNNMONEY, <http://features.blogs.fortune.cnn.com/2011/06/28/have-you-got-a-piece-of-this-lawsuit-2/> (June 28, 2011, 2:06 PM); Griffis, *supra* note 1.

Our analysis suggests, however, that the types of litigation most likely to benefit from third-party financing are speculative cases and strike suits—two types of litigation the U.S. civil justice system would do well to limit. All litigation is, in essence, speculative, due to the myriad of variables that might affect the outcome of a judgment or settlement. However, substantive, procedural, and jurisdictional elements, as well as case-specific facts and circumstances, make some claims more speculative than others. For example, strike suits are suits brought solely to extract settlement offers from defendants rather than for adjudication on the merits.

We argue that the introduction of sophisticated and diversified investors into the litigation financing market facilitates more efficient risk sharing. Moreover, to the extent attractive risk-adjusted returns can be generated from litigation investments, additional capital will flow to this investment asset class. This has the effect of further reducing the cost of capital for litigation investments and pushing investment funds to take more risk in order to continue to achieve targeted portfolio returns. Investment funds are highly likely, on the margin, to engage in such heightened risk assumption in a competitive market for investment capital. The lower cost of capital, increased ability to syndicate litigation risk, and a desire to maintain investment fund returns will likely lead to an increase in speculative litigation and strike suits on the margin.

This article recognizes the limited potential benefits of third-party financing but ultimately adopts a critical perspective due to the meaningful risk of an increase in litigation generally and in speculative and strike suits specifically. In essence, such an increase in litigation yields clear costs that outweigh the potential benefits. Nonetheless, we consider whether specific changes to the institutional rules governing civil litigation might allow the limited potential benefits of third-party financing to be realized while mitigating the substantial likely costs.

We recommend the adoption of a one-way fee-shifting rule in favor of defendants in cases where plaintiffs have received third-party funding. In particular, our proposal would require any plaintiff who receives third-party financing to indemnify the defendant for its litigation costs, including attorney's fees, if the defendant prevails or the plaintiff drops the case. The plaintiff would not be entitled to similar indemnification in cases involving third-party financing, even if the underlying statutory or case law generally provides for such indemnification. Our one-way fee-shifting proposal should significantly mitigate the incentives for both plaintiffs and financiers to engage in speculative litigation or strike suits. Importantly, such a shift should not constrain incentives to engage in meritorious litigation. In the absence of this or other meaningful reforms to mitigate the risks associated with third-party financing of litigation, the practice should be strictly banned.

The remainder of the paper is structured as follows. Part I contains a brief background discussion of the origins of third-party financing and its

current status in the United States. Part II conducts a basic cost–benefit analysis of third-party financing. Part III explains how third-party financing will likely lead to a net increase in litigation and includes a discussion of empirical evidence supporting this claim. Part IV explains how third-party financing can cause an increase in speculative litigation on the margin. Part V describes how third-party financing can cause an increase in strike suits on the margin. Part VI then discusses policy implications and recommends that any plaintiff who receives third-party funding be required to indemnify the defendant for its litigation costs, including attorney’s fees, if the defendant ultimately prevails.

I. BACKGROUND

The litigation funding industry has come a long way since its inception “on a small scale . . . with cash advances to individual plaintiffs needing money to keep their lives or their lawsuits going.”⁶ While some third-party financiers provide loans to law firms and lines of credit to plaintiffs’ lawyers to fund the pursuit of legal claims, others are increasingly engaging in more complicated financial strategies.⁷ The industry is now marked by increased professionalization of core investment capabilities and sophisticated institutional investors who are focused primarily on their risk-adjusted rate of return. The composition of third-party financing arrangements vary, with some financiers taking a fee based on a percentage of plaintiff’s recovery⁸ and others charging extremely high interest rates to compensate for the risk of lending on a nonrecourse basis.⁹ The emerging trends suggest that sophisticated financiers will drive continued innovation, increasing the scale of their operations as the market continues to evolve.

Third-party investment in a plaintiff’s claim in exchange for a share of any settlement or award appears to have originated during the 1990s in Australian insolvency litigation. Enjoying a statutory exception from laws designed to prohibit such funding arrangements,¹⁰ the litigation funding

⁶ See Carter, *supra* note 4, at 34.

⁷ See Andrew Hananel & David Staubitz, *The Ethics of Law Loans in the Post-Rancman Era*, 17 GEO. J. LEGAL ETHICS 795, 798 (2004) (explaining the different ways that law loan companies conduct their business).

⁸ Elizabeth Sniegocki, *The Advanced Litigation Funding Industry: Gambling on Justice?*, FLA. UNDERWRITER, May 2003, at 29.

⁹ See Martin, *supra* note 4, at 66.

¹⁰ For example, champerty is defined as “[a] bargain between a stranger and a party to a lawsuit by which the stranger pursues the party’s claim in consideration of receiving part of any judgment proceeds.” BLACK’S LAW DICTIONARY 262-63 (9th ed. 2009). Another notable common law prohibition is on the act of maintenance, “[a]n officious intermeddling in a lawsuit by a non-party by maintaining, supporting or assisting either party, with money or otherwise, to prosecute or defend the litigation.” *Id.*

industry in Australia has been allowed to finance liquidators and company administrators pursuing debts on behalf of a company's creditors.¹¹ Despite these humble beginnings, Australian courts soon began allowing financing arrangements in aggregate litigation and large single-plaintiff actions.¹² Plaintiffs in Australia today primarily use third-party financing in various types of commercial cases and class actions.¹³

Australia was a fertile field for the growth of this type of third-party financing because it allowed contingent returns on investment for outside funders while maintaining a prohibition on contingent fees for attorneys. In 2006, the High Court of Australia validated the legality of third-party financing, holding that third-party funders may seek plaintiffs to pursue legal claims, may exert significant control over the litigation, and that such control does not abuse any process or violate any public policy.¹⁴ The incentives present in this institutional dynamic make Australia a strong magnet for third-party litigation capital.

Although third-party financing has not gained much traction in many civil law countries, it has been quickly developing in the United States.¹⁵ Some commentators trace the emergence of third-party financing in the United States to Las Vegas entrepreneur Perry Walton, the "self-proclaimed father of the modern litigation finance industry."¹⁶ Walton founded Future Settlement Funding Corporation in 1997 and began holding seminars teaching others how to develop their own litigation financing ventures.¹⁷ Many companies have adopted the business strategy, creating smaller finance companies that typically fund personal injury actions.

¹¹ See LAW COUNCIL OF AUSTL., REGULATION OF THIRD-PARTY LITIGATION FUNDING IN AUSTRALIA 4 (June 2011), available at http://www.lawcouncil.asn.au/shadomx/apps/fms/fmsdownload.cfm?file_uid=FDE54AA6-C860-A078-ED07-5BB15F2A31E3&siteName=lca.

¹² *Id.*

¹³ *Id.*

¹⁴ *Campbells Cash & Carry Pty. Ltd. v Fostif Pty. Ltd.* (2006) 229 CLR 386, 401 ("In the light of current legislative intervention and the development of the common law, the policy of the law is in favour of litigation funding so long as any tendency to abuse of process is controlled.")

¹⁵ See Marco de Morpurgo, *A Comparative Legal and Economic Approach to Third-Party Litigation Funding*, 19 CARDOZO J. INT'L & COMP. L. 343, 361 (2011) (noting that other common law jurisdictions such as Australia and the United Kingdom are experiencing continued growth of the third-party financing market).

¹⁶ Mariel Rodak, Comment, *It's About Time: A Systems Thinking Analysis of the Litigation Finance Industry and Its Effect on Settlement*, 155 U. PA. L. REV. 503, 505 (2006).

¹⁷ Carter, *supra* note 4, at 36. See also Julia H. McLaughlin, *Litigation Funding: Charting a Legal and Ethical Course*, 31 VT. L. REV. 615, 619, n.11 (2007) (quoting a litigant who sued Walton for tortious interference with contract who stated that "Walton developed a wide ranging business of loaning money in pending lawsuits around the country for huge returns" and that, "to facilitate this scheme he began offering 'courses' which he taught applicants to his school of how to loan money to plaintiffs in lawsuits.").

In the United States, the bulk of third-party investment directly in a plaintiff's claim in exchange for a share of any settlement or award appears to come from companies like Juridica Capital Management. Juridica Capital Management operates a fund called Juridica Investments, which has been traded on the London Stock Exchange's Alternative Investment Market since late 2007 and manages over \$200 million in assets.¹⁸ Such investment vehicles reportedly favor corporate clients with potential payouts larger than those of smaller, individual clients.¹⁹ Richard W. Fields, Juridica Capital Management's chairman and chief executive officer, explains the allure of corporate clients to large investment funds like Juridica: "If you are involved in major litigation, but earnings are dropping and there is pressure on cash flow, funds like ours can fill the financial gap."²⁰ Fields notes that litigation financing is an attractive investment, especially in a depressed economy, and estimates that the U.S. market for third-party financing could be as large as \$33 billion.²¹

Juridica Investments and Burford Capital, also a large London-based investment firm, currently exist to invest primarily in American commercial litigation. Their cases commonly involve contract, intellectual property, and antitrust disputes.²² Juridica, the largest third-party financier of U.S. business litigation, has over 88% of its litigation investments in price-fixing and patent infringement cases.²³ The monetary incentives to engage in this type of litigation funding are compelling. In price-fixing cases, defendants face potential treble damages and rules against contribution, making them easy targets for litigation (and potential settlement). Likewise, defendants in patent infringement cases also face potential treble damages, and the possibility of preliminary injunctions preventing them from selling potentially infringing products during the litigation, which makes them easy targets for third-party-financed litigation (and potential settlement) as well.²⁴

¹⁸ See Jonathan D. Glater, *Investing in Lawsuits, for a Share of the Awards*, N.Y. TIMES, June 3, 2009, at B1.

¹⁹ *Our Public Policy Statement*, JURIDICA INVS. LTD., <http://www.juridicainvestments.com/about-juridica/our-public-policy-statement.aspx> (last visited Jan. 24, 2012) (stating that its "customers are Fortune 1000 companies, FT Global 500 companies, inventors, major universities, and the leading law firms that represent them.").

²⁰ Telis Demos, *Cashing in on Litigation*, FORTUNE, May 4, 2009, available at http://money.cnn.com/2009/05/04/magazines/fortune/demos_litigation.fortune/index.htm.

²¹ Sophia Grene, *Rich Pickings From Legal Cases*, FIN. TIMES, Jan. 25, 2009, available at <http://www.ft.com/cms/s/0/20eb1686-11dd-9535-0000779fd2ac.html>.

²² See STEVEN GARBER, ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWN AND UNKNOWN 13 (RAND Corp. 2010), available at http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf.

²³ See Joanna M. Shepherd, *Ideal Versus Reality in Third-Party Litigation Financing*, 8 J.L. ECON. & POL'Y 593, 601 (2012).

²⁴ *Id.*

It is not unreasonable to assume that Burford, and potentially Juridica and others, will deviate from their traditional focus on commercial litigation in search of profitable litigation investment opportunities. Even if Juridica and Burford stay reasonably true to their current investment strategies, the barriers to entry to the litigation finance business are sufficiently low to attract other funds with different and perhaps more aggressive aspirations. Burford, for example, is currently funding, in part, the personal injury litigation against Chevron in Ecuador.²⁵ Upon investing \$4 million in the Ecuadorians' case against Chevron, in exchange for a 1.5% share in any recovery, Burford acknowledged its goal of increasing its investment to \$15 million with a 5.5% share of any recovery.²⁶

Counsel Financial, backed by Citigroup, has funded other notable personal injury litigation. Counsel Financial provided \$35 million of funding for Ground Zero workers' lawsuits. The lenders earned \$11 million from the settlement amounts of these suits.²⁷ Class action litigation has also increased tremendously in Quebec upon both its legislature's allowance of the practice and the creation of the "Help Fund for Class Actions," financed in part by the Quebec government.²⁸

Finally, it is likely that third-party financing will continue to develop in jurisdictions across the globe. As Hugh McLernon, co-founder and managing director of IMF (Australia) Ltd., the largest third-party litigation finance firm, has stated, "It's now approaching mainstream. Given another decade, I think it will be in the mainstream, not just in Australia but emanating out of here."²⁹ Whether the U.S. civil justice system will benefit from this potential expansion should be informed by thoughtful economic and public policy analysis.

²⁵ See Griffis, *supra* note 1.

²⁶ See Roger Parloff, *Have You Got A Piece of This Lawsuit?*, CNN MONEY, <http://features.blogs.fortune.cnn.com/2011/06/28/have-you-got-a-piece-of-this-lawsuit-2> (June 28, 2011, 2:06 PM) ("Thanks to a complicated funding structure, Burford and other investors become the primary beneficiaries of any settlement reached. In fact, if the settlement comes in low enough, the investors may be the *only* people who get paid.").

²⁷ See Binyamin Appelbaum, *Investors Put Money on Lawsuits to Get Payouts*, N.Y. TIMES, Nov. 15, 2010, at A1, available at <http://www.nytimes.com/2010/11/15/business/15lawsuit.html>. See also Griffis, *supra* note 1 (noting that the lawyers who borrowed from Counsel Financial attempted to shift to the plaintiffs \$6.1 million of the \$11 million they owed Counsel Financial, but the judge ordered the lawyers to absorb these costs because it was not clear that plaintiffs had understood or approved them).

²⁸ See Genevieve Cotnam & Paul Cooper, *The Province of Quebec: The Gateway for Class-Actions*, available at http://www.rmc-agr.com/french/_ui/publications/Quebec%20-%20Gateway%20to%20Class%20Action.pdf (noting that "[s]tatistics reveal that in March 2006, there were 260 class-action claims instituted in the judicial district of Montreal and 25 for the judicial district of Quebec," and that since then, "class-actions are being authorized on a weekly basis.").

²⁹ See Lin, *supra* note 3, at 1.

II. COST-BENEFIT ANALYSIS

There are competing claims regarding the effects of third-party financing on the U.S. civil justice system and on the broader economy. We discuss selected arguments on both sides of the debate in this section. We acknowledge the potential for benefits associated with third-party financing of litigation but conclude that the realities of the U.S. civil justice system are likely to attenuate fruition of these benefits.

A. *Perceived Economic Benefits of Third-Party Financing of Litigation*

The proposition that some good legal claims are not pursued (and are thus never adjudicated) due to a lack of funding may not be entirely unreasonable. A claim with a relatively high probability of success on the merits may not be pursued if the expected payout is too small relative to the costs of litigating the claim. This economic equation may foreclose the use of a contingent fee lawyer. If, in such instances, the plaintiff has no means of direct financing or has insufficient assets to secure a loan, the claim may not be pursued.

It has been argued that medical malpractice claims fit this description and are therefore litigated less often than they should be. However, third-party financing is unlikely to be a viable solution to any potential under-litigation of medical malpractice claims. This is because third-party financiers will face the same economic reality as contingent fee lawyers—the expected payout is too small relative to the required investment.

In certain circumstances, business entities may be potential beneficiaries of third-party litigation financing. For example, smaller, cash-constrained businesses with expensive and time-consuming cases that have large potential payoffs might benefit. Companies of this nature may find third-party financing to be attractive for antitrust or patent infringement claims. Such claims are complex and expensive to maintain but, due to their large potential payoffs, may be worth the time and expense.

Legal departments in large corporations are often viewed as a cost center—they are under enormous pressure to cut costs and are therefore often encouraged to settle rather than litigate. If the corporation is publicly traded, the desire to deliver consistent and predictable earnings growth only exacerbates these pressures. Although the legal department may be well aware of claims the corporation has against others, it may not want to compete internally with other investment projects for capital to fund litigation. Consequently, this means that potentially legitimate claims may not be pursued.

Certainly not all cases that might receive third-party financing fall within the limited number of scenarios described in this section and for which such financing might prove beneficial. The problem is that the cases

falling outside these scenarios—and likely to attract third-party financing—are also most likely to lead to the litigation shenanigans of speculative claims and strike suits.³⁰

Despite the potential for beneficial uses of third-party litigation financing, the practice does not exist in a vacuum. The appropriate introduction of third-party litigation financing into the United States must account for the realities of the U.S. civil justice system. Such realities, including the myriad of extant incentives for pursuing claims, as well as the perverse incentives for bringing frivolous claims, will likely mitigate any perceived benefits.

B. *Perceived Economic Costs of Third-Party Financing of Litigation*

Motivating the analysis in this paper are the perceived economic costs associated with third-party litigation financing for the U.S. civil justice system and the implications of those costs on the economy at large. For purposes of this analysis, we ignore the many legal ethics or professional responsibility problems implicated by third-party financing of litigation.

Legal scholars have long argued that the ever expanding set of litigation incentives, which includes contingent fees for lawyers, procedural mechanisms for aggregating claims, broad discovery capabilities, provisions for enhanced damages and punitive damages, and changes to substantive laws that eliminate requirements to prove reliance or harm, ultimately yields an overabundance of litigation. Our economic argument is straightforward—adding third-party financing to a civil justice system that already contains a multitude of litigation incentives will have a materially adverse effect both on the administration of justice and on economic prosperity in the United States.

There is ample evidence that the current litigation incentive structure has negative implications for the global competitiveness of U.S. companies.³¹ For example, class action litigation under state consumer protection acts divert significant company resources away from productive uses, such as increasing human capital and investing in research and development, despite the fact that class plaintiffs are often not required to demonstrate reliance or harm.³² The current litigation incentive structure also raises general skepticism for potential foreign and domestic investors in U.S. en-

³⁰ See *infra* Parts IV and V. See also Shepherd, *supra* note 23.

³¹ See, e.g., Lisa Rickard, *The Class Action Debate in Europe: Lessons From the U.S. Experience*, THE WORLD FIN. REV., <http://www.worldfinancialreview.com/?p=289>.

³² See, e.g., Henry N. Butler & Jason S. Johnston, *Consumer Harm Acts? An Economic Analysis of Private Actions Under State Consumer Protection Acts*, (Northwestern Law Sch. Faculty Working Papers, Paper No. 184, 2009), available at <http://scholarlycommons.law.northwestern.edu/facultyworkingpapers/184>.

terprises.³³ This diversion of resources and drag on investment has a chilling effect on the entrepreneurial risk-taking that a market economy encourages for the creation of jobs, products, and services that enhance consumer well-being.

Just as the litigation incentives mentioned above operate to increase the supply of litigation in the United States, third-party financing will likely have the same effect. It is important to consider the economic consequences of this potential increase in the volume of litigation *before* third-party financing becomes accepted practice. However, potentially more problematic than the increase in the supply of litigation generally, is an increase in the supply of speculative litigation and strike suits. These suits exacerbate economic inefficiencies inherent in a legal culture that underscores the benefits of litigation, often to the exclusion of potential costs.

III. THIRD-PARTY FINANCING RESULTS IN A NET INCREASE IN LITIGATION

Economic theory predicts that an increase in the supply of capital available to finance litigation can contribute to an increase in litigation on the margin. Some advocates for third-party financing of litigation flatly deny this economic possibility.³⁴ Other proponents of the practice do not deny that third-party financing will increase litigation; instead, they claim that savvy third-party investors or financiers would never fund *unmeritorious* litigation. We discuss this qualifier in a later section. For now, we introduce economic analysis demonstrating that third-party financing can, in fact, increase aggregate litigation.

We rely on three different analyses to demonstrate that third-party financing can increase the aggregate amount of litigation in the civil justice system. First, we utilize traditional supply and demand analysis as applied to the markets for litigation financing and litigation. Second, we consider the impact of third-party financing on the marginal behavior of contingent fee lawyers with varying degrees of risk tolerance. Third, we review the limited existing empirical evidence regarding the impact of third-party funding on aggregate litigation.

Importantly, the normative implications of an increase in litigation depend on one's views of litigation as an efficient and effective means for

³³ See U.S. DEP'T OF COMMERCE, *The U.S. Litigation Environment and Foreign Direct Investment: Supporting U.S. Competitiveness by Reducing Legal Costs and Uncertainty* 2-5 (Oct. 2008), available [at http://2001-2009.commerce.gov/s/groups/public/@doc/@os/@opa/documents/content/prod01_007457.pdf](http://2001-2009.commerce.gov/s/groups/public/@doc/@os/@opa/documents/content/prod01_007457.pdf).

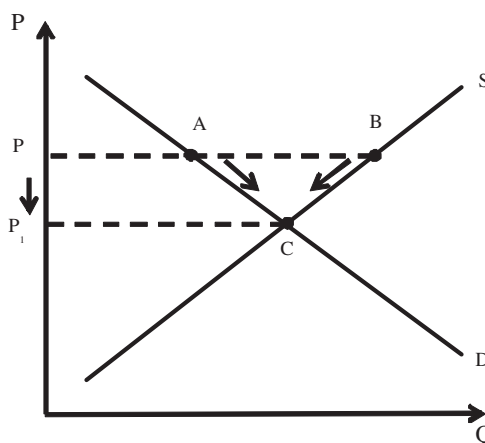
³⁴ We define third-party financing as capital from an independent, outside investor that is used to fund a plaintiff's litigation expenses in exchange for a share of either the settlement amount or damages in the event of success at trial.

resolving disputes. A thorough debate on that issue is beyond the scope of this article. However, insofar as increased litigation hinders the administration of justice and reduces the legal certainty vital to economic progress, the implications of increased litigation stemming from third-party financing presents a concern worthy of thorough consideration.

A. *Supply and Demand Analysis*

The impact of third-party financing on the aggregate amount of litigation is best informed through traditional supply and demand analysis. In any given product or service market, a change in price will cause a change in quantity demanded. As price decreases, quantity demanded increases (and vice versa). Likewise, quantity supplied will increase or decrease based on prevailing market prices, with a greater quantity supplied at higher prices (and vice versa). In Figure 1, at a market price of P , supply exceeds demand (represented by the difference between point B and point A). This excess of supply will cause prices to fall (movement down the supply curve from point B toward point C) and will increase the quantity consumers are willing to purchase (movement down the demand curve from point A to point C). As the price drops from P to P_1 , quantity demanded increases, and quantity supplied decreases until the new market equilibrium is established (point C).

FIGURE 1

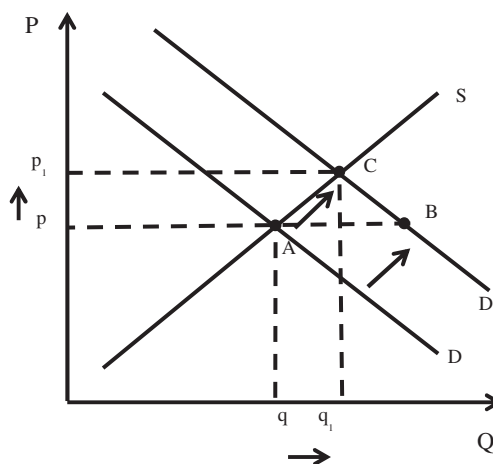


To fully understand how third-party financing has the potential to increase litigation, it is important to distinguish between movements along the demand curve, which are caused by changes in price, and an actual shift in the demand curve, caused by external, non-price determinants. Common non-price determinants that can cause a shift in the demand curve include:

changes in wealth or disposable income, changes in tastes and preferences, changes in expectations, and changes in the prices of related goods or services. For example, an increase in disposable income will cause the demand curve to shift to the right, represented in Figure 2 by a shift from D to D_1 .

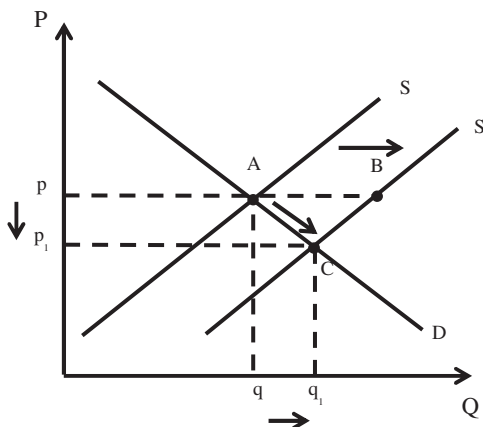
As a result of the extra cash in consumers' pockets, there is an excess of demand over supply at the original market price (p). This excess demand is the difference between points B and A in Figure 2. Seeing that consumers are demanding more of the product and are willing to pay a higher price for it, producers respond by increasing the quantity supplied, represented by movement along the supply curve from point A to point C in Figure 2. As Figure 2 illustrates, an increase in demand causes both the price and quantity supplied to increase.

FIGURE 2



There are also factors that can cause a supply curve to shift. These factors include: a change in the number of suppliers, changes in the prices of product or service inputs, price expectations, and technological advances that enhance production efficiency. For example, an increase in the number of suppliers causes the supply curve to shift to the right, represented in Figure 3 by a shift from S to S_1 . With this shift, there is an excess of supply over demand at the original market price (p); this excess is the difference between points A and B in Figure 3. With excess supply, producers will reduce prices, demonstrated by the movement from B towards C in Figure 3. Falling prices will entice consumers to demand more, represented by the movement from A towards C in Figure 3. Overall, the increased supply results in a greater quantity supplied and demanded at a lower price (point C).

FIGURE 3



For the purpose of this paper, it is important to distinguish between the two markets operating here—the general market for litigation and the capital market for litigation finance—and observe the dynamic relationship between these two markets.

In the market for litigation finance, which includes traditional supplies of capital used to fund lawsuits such as loans to law firms and contingent fee arrangements, the supply curve shifts to the right when third-party financiers enter the market. In our analysis, this rightward shift occurs for at least two reasons. First, the introduction of new financiers into the market increases the absolute number of dollars available to finance litigation in the short-term. Second, third-party financiers bring unique innovations to the litigation financing market.³⁵ These innovations are essentially technological advances that enhance production efficiency and lower the cost of supplying litigation financing, which also increases the absolute number of dollars available to finance litigation.³⁶

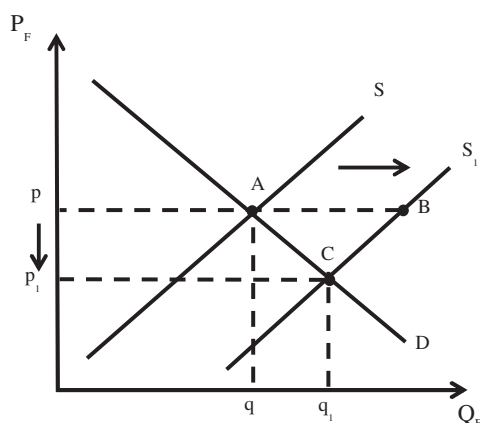
Figure 4 illustrates the impact of innovative new market entrants on the market for litigation financing. As the number of litigation financiers increases, the supply curve shifts to the right. This shift creates an excess supply of litigation financing, or the difference between quantity demanded at point A and the quantity supplied at point B at the original price (p) in

³⁵ Areas of expertise that third-party litigation funders are likely to possess relative to contingent fee lawyers or traditional bank lenders include: professional skills in originating transactions (*i.e.*, sourcing litigation investments), conducting due diligence, underwriting litigation, documentation and contracting, and managing risks across a portfolio of litigation investments. We view the introduction of such skills as market innovations that lower the costs of financing litigation and expand the supply of capital available to fund lawsuits.

³⁶ Our analysis also explicitly assumes that third-party litigation financing and traditional sources of litigation funding, such as contingent fee lawyers and bank loans, are not perfect substitutes. We address this topic in greater detail in Part IV.

Figure 4. This excess supply results in a decline in price and an increase in the quantity of litigation financing demanded, demonstrated by movement from point A to point C on the demand curve in Figure 4. This analysis is identical to the introductory scenario illustrated by Figure 3.

FIGURE 4. IMPACT OF NEW ENTRANTS ON MARKET FOR LITIGATION FINANCING



On the margin, we expect these innovative new market entrants to make certain classes of litigation, that were previously not pursued, economically viable. As money, or investment capital, is an important input to the provision of litigation, it follows that lowering the price of this key input will lower the cost of litigation. If we view litigation finance as a related good to litigation, like a mortgage loan to a home purchase, then our economic analysis would predict that the lower financing costs result in an increase in demand for litigation. If we view litigation finance as an input to the provision of litigation, like lumber in a new home, then our economic analysis would predict that the lower cost of financing would result in an increase in supply of litigation. Regardless of the ultimate dynamic at work, an increase in demand, an increase in supply, or both should yield an increase in the total quantity of litigation in the civil justice system.³⁷

We have argued that an increase in the supply of litigation funding will result in lower prices for such funding. As a key input to litigating, this should ultimately lower the cost of litigation. An economically rational plaintiff will pursue a claim only if the expected damages or settlement

³⁷ The ultimate impact on the price of litigation is indeterminate. An increase in demand for litigation should result in an increase in price in addition to an increase in quantity of litigation. The increased supply of litigation, or more accurately lawyers, in addition to facilitating an increase in quantity of litigation should reduce the price of litigation.

amount equals or exceeds the cost of bringing the suit. This logic can be written as a simple rule where a plaintiff files a lawsuit only if $EV \geq 0$ as measured by the Expected Value equation:

$$EV = (\rho_{\Pi} \times V_{\Pi}) - c$$

Where EV is the expected value of a plaintiff's legal claim, ρ_{Π} is the probability a plaintiff will win at trial, V_{Π} is the potential award or settlement value, and c is the cost of litigating.

In our analysis, third-party financing reduces the cost to the plaintiff of bringing the suit—(c) in the Expected Value equation. Holding all other variables constant, decreasing the value of (c) in this equation increases the number of legal claims that have a positive expected value. This incentivizes the filing of lawsuits that otherwise might not have been pursued at a higher (c). Thus, on the margin, our economic analysis predicts that, holding all else constant, litigation will increase with the presence of third-party financing.

B. *Analysis of the Contingent Fee Model—At the Margin*

While some proponents concede that third-party financing may contribute to an increase in litigation on the margin, others reject this possibility. They contend that other mechanisms, notably contingent fee arrangements, exist to absorb all possible claims that a third-party investor might otherwise finance. In other words, they contend that contingent fee arrangements and third-party financing are perfect substitutes. Following this logic, the introduction of some specific dollar amount of third-party funding would result in an equal reduction in the amount of contingent fee financing. In this section, we consider the impact of the availability of third-party financing on the marginal behavior of contingent fee lawyers with varying degrees of risk tolerance. This analysis further supports the conclusion that third-party financing increases litigation and casts significant doubt on the notion that contingent fee financing and third-party financing are perfect substitutes.

Contingent fee lawyers not only provide legal services, they also arrange for the financing of litigation. This financing can be through a bank line of credit secured by the assets of the firm or a personal guarantee. Alternatively, the contingent fee lawyer could rely on previous winnings to self-finance future litigation. Regardless of the specific transaction structure, the contingent fee lawyer expects to be compensated both for the provision of legal services and the provision of financing for litigation. It is not unreasonable to conclude that a significant component of the contingent fee lawyer's profits is attributable to the provision of financing, or carrying the costs of litigation, as opposed to the provision of legal services.

If an important driver of the contingent fee lawyer's profits is attributable to the provision of financing, or the carrying of litigation costs, we

might expect such lawyers to defend this source of profit rather than abdicate such earnings to third-party investors. Thus, one might expect some contingent fee lawyers to view third-party financiers as competitors for litigation financing. These lawyers may identify benefits, including non-price attributes, to differentiate their financing from third-party financing.³⁸ To the extent such differentiation can be established, it casts doubt on the notion that these two sources of financing are perfect substitutes. Moreover, such competition may further reduce the cost of litigation and, thus, further incentivize an increase in litigation.

The contingent fee lawyer is incentivized to pursue a portfolio of cases, the contents of which are capable of being diversified among varying degrees of stakes and probabilities of success. Consider two plausible scenarios involving the use of third-party financing by a plaintiff's lawyers. First, consider the case of a risk-averse plaintiff's lawyer who wants to increase her earnings. This situation involves a lawyer who engages in a limited amount of contingent fee litigation (or small-stakes litigation) due to risk aversion. She is unwilling to accept the risks associated with self-financing or personal loan guarantees necessary to expand her caseload or underwrite a broad base of contingent fee cases. Such risk aversion limits the type and quantity of contingent fee business that a plaintiff's lawyer may be willing to accept.

The use of third-party financing in the case of the risk-averse lawyer alters the incentive structure so that the third-party investor now bears the risk of loss. The investor can spread that risk by making a host of diversified, uncorrelated investments with a positive expected value. This allows the risk-averse lawyer to expand her case portfolio in order to increase her earnings without sacrificing current profits or taking on additional risk.³⁹ In addition to her existing caseload, the risk shifting the third party facilitates, allows the lawyer to take on a greater number of cases and may incentivize her to pursue more speculative cases. The introduction of third-party financing in this situation will likely yield an increase in case filings at the margin.

The second case involves a risk-preferring, or high-stakes, contingent fee lawyer. This type of lawyer is willing to risk her own wealth, through personal guarantees, for example, to take on a broad base of contingent fee cases, including some with high-risk, high-reward stakes. Having access to

³⁸ Note that the primary advantage of a third-party financier will likely be price—the ability to provide the lowest cost of capital to finance litigation. Because of his expertise, experience, and membership in the bar, the lawyer can offer an integrated legal services and financing option not available from the third-party funder. This option allows the lawyer to compete on non-price attributes such as experience with a certain type of case, knowledge of the defendant and its legal strategy and tactics, relationships with critical experts, and experience with a particular pool of potential jurors or the court.

³⁹ Note that substituting third-party financing for contingent fee financing for a case currently within her portfolio would reduce her earnings as she would pass some profit on to the investor.

capital where a third party bears the risk of loss, this type of lawyer will likely view third-party financing as incremental capital rather than as a substitute for personal-risk capital. In addition to profits earned on current contingent fee business, this lawyer can tap into the earnings stream of third-party financed litigation. The introduction of third-party financing in this situation may incentivize the contingent fee lawyer with a limited, but high-risk portfolio, to accept more cases.⁴⁰ Again, the investor can spread the risk of loss through a diversified investment portfolio. Further, on the margin, the introduction of third-party financing will likely yield an increase in litigation.

This incentive structure may have yet another application. Not only does an increase in the supply of capital incentivize lawyers to accept more cases, the profit-seeking, third-party financier is incentivized to solicit cases for lawyers to accept. The possibility, nefarious as it may seem, even exists for third-party financiers to instigate legitimate controversy (or at least to raise awareness of preexisting controversy) and then offer to fund an action arising therefrom. This hypothetical scenario is at least plausible, given the potency of monetary incentives.

C. *Empirical Evidence*

In addition to the economic analysis presented in the previous two sections, empirical evidence exists to suggest that the introduction of third-party financing leads to an increase in litigation. In 2009, David Abrams and Daniel Chen conducted an empirical study of third-party litigation financing in Australia, where third-party financing began, and has been used most heavily.⁴¹ The authors observed that lawsuit filings increased in those jurisdictions that allowed the practice and decreased in jurisdictions that disallowed the practice.⁴² Moreover, as economic theory predicts (and as we discuss in the following sections), Abrams and Chen find that funded cases appear riskier over time and that investment returns are also increasing.⁴³ “These observations,” they note, “are consistent with a growing litigation funding industry being able to finance riskier projects with higher value, such as class action lawsuits.”⁴⁴

These findings provide some empirical evidence that the incentives described in the previous sections are truly at work. Such a finding is also a

⁴⁰ In this circumstance, the third-party financing could be used to fund cases that act as a “hedge” against the current high-risk caseload.

⁴¹ See David Abrams & Daniel L. Chen, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes* (Duke Law Sch. Working Paper, 2012), available at <http://www.duke.edu/~dlc28/papers/MktJustice.pdf>.

⁴² *Id.*

⁴³ *Id.* at 16.

⁴⁴ *Id.* at 19.

strong indicator that, because monetary incentives matter to third-party financiers, capital will continue to flow to locations whose institutional frameworks allow for the greatest return on investment.

IV. THIRD-PARTY FINANCING RESULTS IN AN INCREASE IN SPECULATIVE LITIGATION

In addition to contributing to an increase in litigation on the margin, an increase in the supply of third-party financing may also contribute specifically to an increase in speculative litigation on the margin. As we use the term here, speculative litigation refers to cases whose expected outcomes are marginally less certain than those of other cases. Perhaps all litigation may be classified as speculative in some sense, for all litigation carries risk. However, some cases are undoubtedly riskier than others, and an increase in third-party financing capital may lead to the pursuit of marginally less certain, or more speculative, cases.

As financiers enjoy strong risk-adjusted returns from funding litigation relative to other asset classes, additional capital and competition will be attracted to the third-party litigation financing market. This increased supply of capital will dilute return on investment for cases occurring in later time periods relative to cases with identical risk occurring in earlier time periods. In other words, risk-adjusted returns will decline as more capital is attracted to the market. Such return dilution will ultimately force litigation financiers to look for riskier cases to fund in order to maintain their original return thresholds.

Consider the following three scenarios. Suppose Case 1 has a 75% probability of success on either final judgment or settlement. Furthermore, suppose that Third-Party Financier A has offered \$1 million in funding and that the potential award or settlement value is \$4 million based on alleged damages at the time of filing, with Financier A negotiating a 50% share of any eventual, actual award or settlement. Financier A expects to gain 50% on his investment, or a total return of \$1.5 million.

$$\$4,000,000 \times 75\% = \$3,000,000 \text{ Expected Award}$$

$$\$3,000,000 \times 50\% = \$1,500,000 \text{ Financier A's Share of Expected Award}$$

$$(\$1,500,000 \div \$1,000,000) - 1 = 50\% \text{ Financier A's Expected Return on Investment}$$

With a high likelihood of success, this investment is relatively secure.

Suppose Financier B, who has not yet entered the market for third-party financing of litigation, observes Financier A's success and decides to enter the market in an attempt to compete away some of Financier A's profits. Financier A now faces competition and must react accordingly. Financier A decides to finance with \$1 million Case 2, which also has a potential \$4 million award or settlement value based on alleged damages

and a 75% probability of success (i.e., identical risk to Case 1). However, due to increased competition, Financier A is able to negotiate only a 45% share of Case 2's actual award or settlement value. Because of the high probability of success, Financier A still makes a relatively secure investment, but he stands to recognize only a 35% expected return on his investment, or a \$1.35 million total return due to the competitive pressure from Financier B.

Now suppose Case 3 also attracts \$1 million of funding but has a potential award or settlement value of \$6 million based on alleged damages with just a 50% probability of success (i.e., more speculative or risky than Case 1 or 2). Before the increase in competition in the third-party litigation financing market, Financier A may not have elected to fund such a risky case. However, as more financiers enter the market, Financier A will be incentivized to pursue more speculative cases in order to maintain his investment returns. Case 3 in this situation presents an attractive option. Despite having only a 50% probability of success, if Financier A can negotiate a 50% share of any eventual, actual award or settlement, he has an opportunity to enjoy the 50% return he made in Case 1 before the increase in competition from Financier B.

$\$6,000,000 \times 50\% = \$3,000,000$ Expected Award

$\$3,000,000 \times 50\% = \$1,500,000$ Financier A's Share of Expected Award

$(\$1,500,000 \div \$1,000,000) - 1 = 50\%$ Financier A's Expected Return on Investment

Over time, this trend will likely continue, with third-party financiers pursuing increasingly speculative cases in an effort to maintain risk-adjusted returns.

At some point, cases may become too speculative to fund: either the plaintiff or the financier will recognize costs that outweigh the potential benefits. On the margin, however, more speculative cases may increasingly be funded as market entrants increase and force incumbents to search for new, riskier investment opportunities. Moreover, as cases are funded as part of a diversified portfolio or shared among several investors, the risks of individual cases can be spread out across more secure investments or many investors. This diversification and syndication of risk could facilitate even further investor speculation in the litigation asset class.

The pursuit of increasingly speculative litigation by third-party investors may be, on balance, more harmful than beneficial to the litigation system and to the broader economy. That being said, it is important to recognize that the pursuit of a very limited subset of speculative cases may not be harmful to the litigation system or to American democratic principles. For example, many civil rights cases may have been speculative in the sense that, despite being completely meritorious, they carried low relative probabilities of success at trial.

V. THIRD-PARTY FINANCING RESULT IN AN INCREASE IN STRIKE SUITS

Our economic analysis suggests that as the market for third-party financing of litigation is introduced and evolves, the marginal cost of bringing lawsuits declines, and plaintiffs have a greater incentive to pursue claims. In addition, third-party litigation financing facilitates more sophisticated risk-sharing arrangements with the client (plaintiff and his or her attorney) bearing less risk. This combination of lower cost and more sophisticated risk-sharing has the potential not only to drive an increase in litigation generally, and more speculative litigation specifically, but also to facilitate an increase in strike suits. Strike suits are defined as claims pursued solely to induce a settlement offer rather than for adjudication on the merits.

For analytical purposes, strike suits are defined as those having a negative expected value to the plaintiff at the outset of litigation *if* the case were pursued to a decision at trial. A negative expected value (NEV) suit is one that possesses a negative expected return to the plaintiff because expected total litigation costs exceed the expected judgment.⁴⁵ Using the expected value formula of “ $EV = (p_{\Pi} \times V_{\Pi}) - c$ ” first introduced in Part III.A., we observe that any of the three variables can be altered to create a negative expected value. For example, a case with a high probability of success and big potential award could be NEV due to exorbitant costs. Our concern lies with cases that have a low probability of success and big potential awards.

Clearly, lowering (c) shifts some NEV cases with low probabilities and large potential awards to positive expected values. We provide analysis of this marginal effect and its likely impact on the aggregate volume of litigation in previous sections. However, there are several situations where a plaintiff might file a NEV suit in an attempt to extract a settlement offer from a defendant. Our analysis in this section suggests that third-party litigation financing could be used tactically to facilitate successful NEV or strike suits.

First, information asymmetries between the plaintiff and defendant may incentivize the plaintiff to bring a NEV suit. A defendant may not know whether the expected value to the plaintiff of going to trial is positive or negative. In many instances, the plaintiff will have better information regarding the severity of injuries, credibility of witnesses, actual trial expenses, and so forth. If the defendant is sufficiently risk averse, she will make a settlement offer, even if she suspects that plaintiff has a NEV suit.⁴⁶

⁴⁵ See Lucian Bebchuk, *Suits with Negative Expected Value*, 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 551 (1998). Importantly, a NEV is not necessarily a frivolous suit or one in which the plaintiff has little or no probability of winning. A meritorious but low-stakes claim might be NEV insofar as the litigation costs exceed the maximum possible award upon success on the merits.

⁴⁶ *Id.*

Second, the plaintiff may be able to impose large upfront costs on the defendant during the initial stages of litigation. These costs may be sufficiently large to induce a settlement offer from the defendant, as settlement may be more cost effective than responding to the suit. The plaintiff has a credible threat insofar as the defendant's expected costs of protracted litigation, as well as pretrial work (e.g., discovery), are sufficiently high relative to the proposed settlement offer. The defendant may make such an offer even if she suspects that she would win on a motion to dismiss after discovery or that the plaintiff would drop the case after these initial stages of litigation.

Third, a contingent fee rather than an hourly fee arrangement may incentivize a plaintiff to bring a NEV suit. If the plaintiff's lawyer spends enough hours on the claim (including pre-trial preparation and the trial in absence of settlement) under an hourly fee arrangement, the plaintiff's suit may quickly become a NEV. But if the plaintiff hires her lawyer on a contingent fee basis, she may have a credible threat to go to trial if the defendant refuses to settle for more than what the plaintiff's discovery and litigation costs would be.

Fourth, a plaintiff with a NEV suit might be able to induce a settlement offer if the plaintiff is a repeat player with a reputation of going to trial if no favorable settlement is reached. The credibility of the plaintiff's threat is stronger from a repeat player than from a plaintiff engaged in single-instance litigation. Although some defendants may invest in litigating both NEV claims and claims with a positive expected value to plaintiffs in order to deter future lawsuits, other defendants will have incentives to settle plaintiffs' NEV suits quickly and efficiently. This latter group may be particularly susceptible to third-party financed strike suits. The credibility of a plaintiff's threat is also enhanced when the defendant is not a repeat player or does not have a reputation of litigating on principle.⁴⁷

Increased supply of third-party litigation financing might increase the credibility of threats by plaintiffs pursuing strike suits. Defendants who know that plaintiffs are well-armed with the financial resources necessary to fund their NEV suits may be pressured into making the economically rational choice of settling rather than engaging in protracted litigation. Clearly, the filing of strike suits and the successful extortion of settlement offers would harm the U.S. civil justice system and American economic well-being.

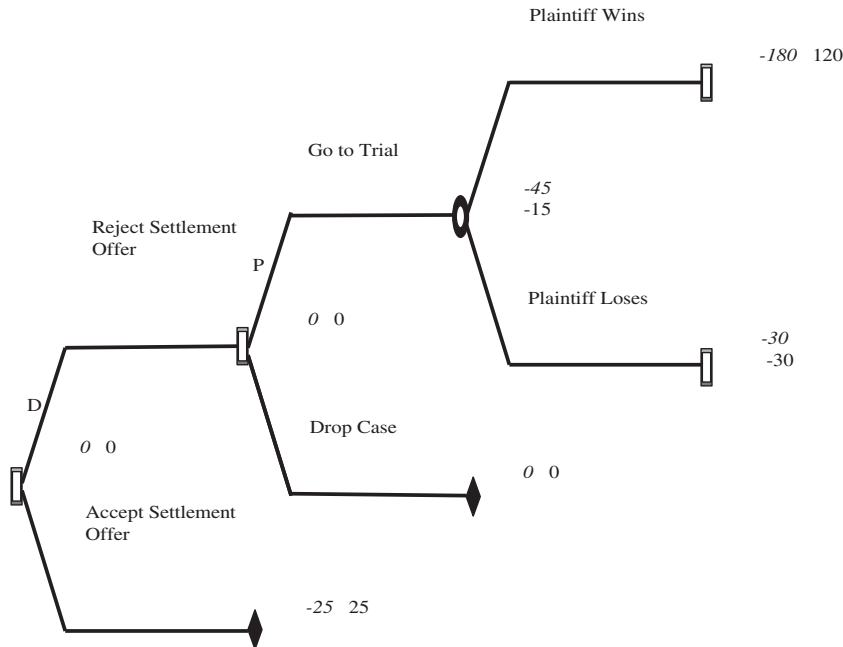
⁴⁷ See Joe Speelman, *Litigation Strategy Has to Be Grounded in Principle*, TEX. LAW., July 7, 2008, available at <http://www.law.com/jsp/tx/PubArticleTX.jsp?id=1202422726268> (arguing that litigation must be based on principles, rather than on economics alone).

A. Game Theory Model

A simple game theory model is useful to demonstrate how an increase in supply of third-party litigation financing might contribute to an increase in speculative litigation and strike suits. The following decision trees illustrate how a defendant may perceive a change in the plaintiff's incentives, at the margin, due to an increase in third-party financing. This perceived change in the plaintiff's likely behavior may increase settlement pressure on the defendant.⁴⁸

In Figure 5 below, the defendant's payout is in italics and the plaintiff's payout is in regular typeface. Absolute total payouts to each party appear at the end of each branch and probability-based expected payouts are reflected at relevant decision points or game nodes. Suppose the following conditions: (a) the plaintiff makes a \$25,000 settlement offer; (b) each party will incur \$30,000 of trial costs; (c) potential monetary damages are \$150,000; and (d) the plaintiff has a 10% probability of prevailing at trial. Note that the plaintiff's \$25,000 settlement offer is less than the defendant's expected trial costs of \$30,000. The key question, based on these facts, is whether the defendant should accept the plaintiff's \$25,000 settlement offer.

FIGURE 5



⁴⁸ HOWELL E. JACKSON ET AL., ANALYTICAL METHODS FOR LAWYERS 34 (2003).

At the outset, the plaintiff has a negative expected value associated with going to trial; this is a strike suit. If the plaintiff were to proceed to trial, she has a 10% probability of winning \$120,000 (\$150,000 monetary damages – \$30,000 trial costs) and a 90% probability of losing \$30,000 of trial costs. So at the outset, the plaintiff's case yields a negative expected value of \$15,000 ($(10\% \times \$120,000) + (90\% \times -\$30,000)$). Based on these facts, the defendant, seeing that the plaintiff expects to lose \$15,000 by going to trial, would reject the plaintiff's \$25,000 settlement offer. In other words, the defendant calls the plaintiff's bluff. If the plaintiff is economically rational, she will drop the suit, in which case she would lose nothing.

The critical strategic question for the plaintiff in this scenario is how she could enhance the credibility of her threat of litigation. This is illustrated in Figure 6 where the conditions are the same as in Figure 5, except that plaintiff secures \$25,000 of third-party financing and incurs an equal amount of trial costs, or some other similar obligation, *prior* to making a settlement offer.⁴⁹ The plaintiff calls the defendant and this time *increases* her settlement offer to \$35,000. If the plaintiff and her financier are successful in extracting a \$35,000 settlement, they will receive a 40% return on investment ($(\$35,000 \div \$25,000) - 1$). The defendant can either accept the increased settlement offer or call the plaintiff's bluff as before.

Nothing about the facts of the case, the costs that will be incurred, or the probabilities of success at trial have changed. This is still the same strike suit. However, the defendant's perception of what an economically rational plaintiff would do under these facts might have been fundamentally altered by the introduction of a third-party investor. The defendant may reasonably anticipate that an economically rational plaintiff would proceed to trial under these facts because to do so would mitigate her losses—the plaintiff loses \$25,000 by dropping the case but expects total losses of only \$15,000 by going to trial.⁵⁰ Given this assumption about the plaintiff's behavior, the defendant must now choose between an expected loss of \$45,000 ($-(10\% \times \$150,000 \text{ monetary damages}) - \$30,000 \text{ trial costs}$) by going to trial or a \$35,000 loss due to settlement.

If the plaintiff drops the case in this example, she would lose \$25,000, whereas in the previous example she lost nothing if she dropped the case.⁵¹

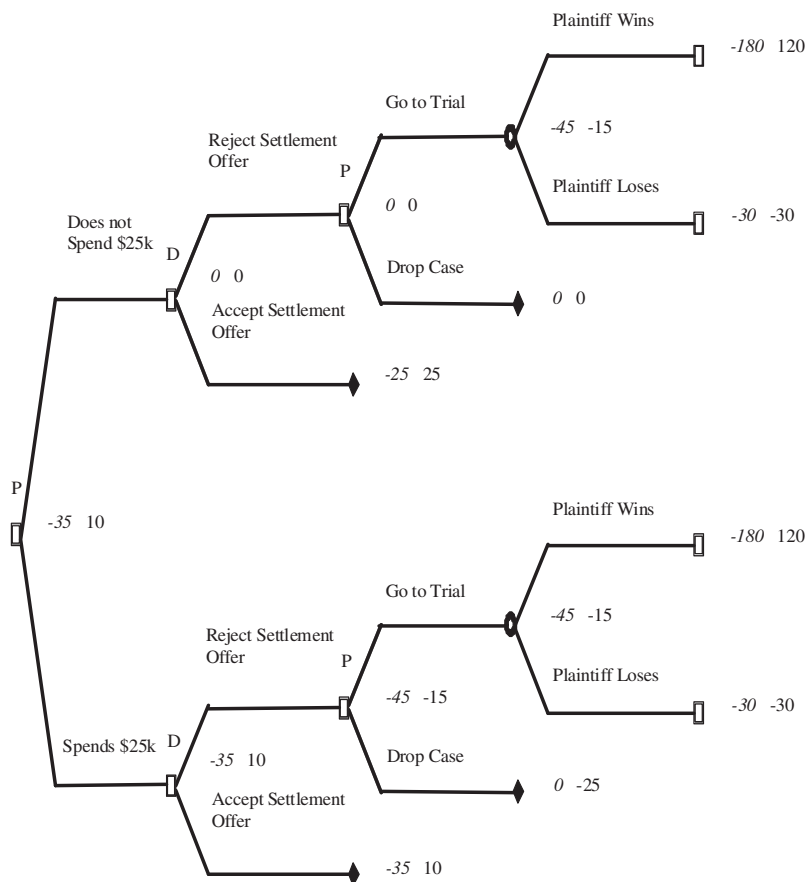
⁴⁹ From an economics perspective, the plaintiff is simply transforming marginal costs into fixed costs. This is a well-established strategy for establishing credibility with bargaining partners or otherwise binding oneself to a particular course of action.

⁵⁰ It can be demonstrated that the plaintiff's expected value of proceeding to trial after the initial investment is positive. Treating the \$25,000 as a sunk cost, the marginal benefit of going to trial is greater than the marginal cost. Specifically, the marginal expected value of going to trial is \$10,000 ($(10\% \times \$145,000) + (90\% \times -\$5,000)$). In other words, the plaintiff spends an extra \$5,000 for anticipated loss mitigation (i.e., benefit) of \$10,000.

⁵¹ One might argue that the non-recourse nature of the potential loan eliminates the prospects of a \$25,000 loss to the plaintiff thereby putting the defendant back in the original scenario. The reality, however, is that between the plaintiff, the plaintiff's lawyer, and the third-party investor, someone with

If the plaintiff proceeds to trial, she would, at worst, expect to lose \$15,000—the same negative expected value as before. Recognizing that the plaintiff might proceed to trial under these facts, if the defendant rejects the settlement offer, the defendant will choose to accept the settlement offer. The plaintiff and her financier will receive a check for \$35,000 for a gain of \$10,000. Not only was the plaintiff able to make her strike suit pay off by using third-party financing, she actually increased the monetary value of her settlement demand.

FIGURE 6



An increase in expended capital or financial obligations up front can increase the credibility of a plaintiff's threat, increasing settlement pressure on the defendant. With an increase in the supply of third-party litigation financing, plaintiffs may be incentivized to bring actions, despite their low

the perceived ability to influence litigation strategy is on the hook for the \$25,000 loss. This perception will be what influences the defendant's settlement decision.

expected probability of success, in order to force the defendant into settlement offers. Defendants with reputations for being risk-averse and consistent settlers may be particularly attractive targets for third-party investor financed strike suits.

VI. POLICY ANALYSIS AND RECOMMENDATIONS

Although our legal culture is well imbued with a desire for increased access to justice, we may have reached the point of diminishing marginal returns for resolving disputes through the litigation system. Thoughtful economic analysis demonstrates that third-party financing can lead to an increase in litigation. An increase in litigation may or may not be a negative for the economy and the U.S. civil justice system.⁵² The critical policy question is what types of cases are likely to be attractive to third-party investors. Third-party litigation financing presents a meaningful risk of an increase in speculative litigation and, more importantly, strike suits.

While third-party litigation financing might benefit some claims that are not being pursued due to a lack of funding, our economic analysis demonstrates that investors are likely to be attracted to the most troublesome and economically deleterious cases—speculative cases and strike suits.⁵³ In the absence of meaningful reform to the multifaceted incentive system designed to spur litigation in the interest of access to justice, we recommend a strict and complete ban on third-party litigation financing. In the alternative, we need to identify and implement institutional reforms that maximize the positive attributes of an increased supply of capital and mitigate (if not eliminate) the risk of speculative litigation and strike suits.

One potential reform worthy of consideration is to require any plaintiff who receives third-party financing to indemnify the defendant for its litigation costs, including attorney's fees, if the defendant ultimately prevails or the plaintiff drops the case.⁵⁴ This indemnification rule would not work in

⁵² See generally PAUL H. RUBIN, PUBLIC POLICY ROUNDTABLE ON THIRD PARTY FINANCING OF LITIGATION, ON THE EFFICIENCY OF INCREASING LITIGATION (2009) available at <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf> (arguing that any benefits of increased litigation are likely to be outweighed by the costs).

⁵³ A recent study estimates that the U.S. tort litigation system cost \$252 billion in 2007, amounting to 1.83% of U.S. GDP compared to just 0.5%-0.7% in other OECD countries. See TOWERS PERRIN, 2008 UPDATE ON U.S. TORT COST TRENDS 3-5 (2008). Strike suits are not entirely to blame for this economic strain; however, they contribute to a tort litigation system whose administrative costs comprise a substantial portion of the direct costs incurred in operating the system. See *id.* at 8. Insofar as strike suits contribute to the net increase in litigation, third-party financing will likely operate to exacerbate this inefficiency.

⁵⁴ Recall that for purposes of our analysis, we define third-party financing as capital from an independent, outside investor that is used to fund a plaintiff's litigation expenses in exchange for a share of either the settlement amount or damages in the event of success at trial. This definition also limits,

reverse. In other words, if a third-party financed plaintiff prevails, then the plaintiff would not be entitled to indemnification for its attorney's fees and legal expenses. This would be true even if the underlying statutory or case law generally allowed such indemnification in favor of the plaintiff. Our proposed one-way fee-shifting rule is highly likely to mitigate the risk of third-party financed speculative litigation or strike suits while preserving the potential benefits of such financing.

Our proposal contemplates a shift away from the so-called American rule, under which each party pays its own attorney's fees, to a modified version of the English rule. Under a "pure" English rule, the losing party would pay the other side's attorney's fees. Our modified version of the English rule requires a third-party financed plaintiff to pay the defendant's attorney fees if that plaintiff ultimately loses or drops the case. However, the defendant does not pay the plaintiff's attorney fees should the third-party financed plaintiff prevail. Our proposal is a modified, one-way "loser pays" rule.

A full discussion of the relative merits and challenges associated with a shift to a loser pays rule, or modified version of such, is beyond the scope of this paper. Nonetheless, some attributes of the loser pays model would apply to our one-way fee-shifting proposal.

Without a loser pays rule, risky, potentially low-probability claims are much more likely to be filed in the United States than in civil justice systems that incorporate the English rule. Under the American rule, there is very little cost for a plaintiff, who can simply externalize costs onto defendants and taxpayers, to file a risky claim. As one industry leader argues, "[t]here is no doubt in my mind that the biggest mistake they made in America was not having [loser pays]."⁵⁵ He notes the advantage of increased access to the courts but laments the "terrible price you pay for it."⁵⁶ For example, he argues, "[y]ou pay for it in [lousy] claims, in claims that go forever, and lawyers signing off on things that they shouldn't sign off on."⁵⁷

Nearly every Western democracy, except the United States, follows the English rule. And those jurisdictions generally do not have as many litigation incentives as the United States. Although the name connects it to England, the loser pays rule has existed in Europe for millennia, emerging in Roman law and developing over time in civil law systems, and even in church courts throughout the continent. Even Scandinavian countries, de-

for purposes of this analysis, the reach of our one-way fee-shifting proposal in favor of defendants. Whether this proposal or some other reforms are required to address other sources of outside money (e.g., loans to plaintiffs to cover living expenses) is beyond the scope of our analysis.

⁵⁵ See Lin, *supra* note 3.

⁵⁶ *Id.*

⁵⁷ *Id.*

void of Roman civil justice roots, embrace a loser pays regime.⁵⁸ Legal scholar Walter Olson explains the practical virtues of a loser pays rule:

Litigants naturally think too well of their cases; loser-pays pushes them to size up their prospects more realistically. It also curbs the brand of extortion . . . by which lawyers use the costs of the process itself, or the risk of a fluke outcome found in any trial, to strong-arm their opponents into settlement. Such abuse runs in both directions: [m]any plaintiffs with shoddy claims get paid off, while many defendants who are liable as charged get off with paying less than full freight by threatening to inflict the cost of trial. Thus valid legal claims are often paid earlier and more fully in Europe than here.⁵⁹

We are not advocating a one-way fee-shifting rule in favor of defendants for *all* civil litigation—just for third-party financed litigation. Nor are we arguing that the United States implement litigation safeguards currently in place in other jurisdictions around the world.⁶⁰ A shift from the so-called American rule to our modified English rule for third-party financed cases is a modest and prudent attempt to balance the anticipated costs and benefits of third-party litigation financing.

Moreover, third-party financiers should accept this cost-allocation rule shift based on their claim to pursue only cases with a high likelihood of success and to never pursue speculative claims in order to induce settlement offers. Upon thorough investigation into the merits of each case, third-party financiers should not be dissuaded from bringing meritorious claims, and a one-way fee-shifting rule in favor of defendants should not be a disincentive for the third-party financing enterprise. In fact, IMF Australia's cofounder and managing partner Hugh McLernon views the procedural hurdles in the Australian civil justice system, including the loser pays rule, as instrumental in promoting a disciplined IMF case funding strategy that will allow his business to thrive in any jurisdiction.⁶¹

Some critics argue that the disincentive for litigation under the English rule is too harsh and that the rule's adoption would prevent groundbreaking litigation in the public interest, notably in the civil rights arena.⁶² However, the use of our modified English rule for third-party financed cases is not likely to deter such groundbreaking cases because they may still be pursued on a contingent fee or self-financing basis. As argued above, there is no

⁵⁸ See Walter Olson, *Civil Suits: Loser-Pays makes lawsuits fairer in Europe. It could work here, too*, REASON MAG., June 1995, at 1, available at <http://reason.com/archives/1995/06/01/civil-suits>.

⁵⁹ *Id.*

⁶⁰ For example, we are not arguing for a prohibition on the use of contingent fees.

⁶¹ See Lin, *supra* note 3.

⁶² For example, the Honorable Robert L. Carter, United States District Court Judge for the Southern District of New York, stated that he has “no doubt that the Supreme Court’s opportunity to pronounce separate schools inherently unequal [in *Brown v. Board of Education*] would have been delayed for a decade had my colleagues and I been required, upon pain of potential sanctions, to plead our legal theory explicitly from the start.” Robert L. Carter, *The Federal Rules of Civil Procedure as a Vindicator of Civil Rights*, 137 U. PA. L. REV. 2179, 2192-93 (1989).

reason not to expect zealous pursuit of meritorious public interest cases, such as religious freedom, free speech, or civil rights. These classes of litigation should not be dissuaded by a modified loser pays rule if financed by third-party capital.⁶³

CONCLUSION

Economics purports to observe and explain how people respond to incentives. Monetary incentives are especially powerful, and there is a lot of money to be made through litigation, especially in the United States. The U.S. civil justice system contains a plethora of mechanisms to incentivize litigation in pursuit of the administration of justice. Contingent fee arrangements, class action and aggregate claims provisions, broad discovery capabilities, and the American rule of cost allocation, among others, all contribute to a litigation system that provides great benefits, but not without substantial costs.

The powerful monetary incentives behind third-party financing of litigation will very likely operate to increase litigation on the margin, including an increase in more-speculative litigation and strike suits. After all, it is “just a business.”⁶⁴

The benefits associated with increasing access to justice come with substantial costs. The civil justice system seeks to remedy legal imbalances and reduce economic inefficiencies along the way; some cost associated with this process is therefore justified. However, there is a point at which the costs outweigh the benefits. Because many of the administrative resources of the civil justice system are fixed in the short term, increased litigation likely yields substantial increases to the marginal cost of justice. As third-party financing will likely cause an increase in litigation, as well as an increase in speculative litigation and strike suits, this practice will accelerate the arrival of that point at which the costs of justice outweigh the benefits.

In order to thwart further incentives to increasing lawsuit filings and to counteract the resulting negative economic effects, we propose the adoption of a one-way fee-shifting rule in favor of defendants in cases financed by third-party capital. This one-way fee-shifting rule aims to reduce the value of speculative litigation, while increasing the value of those cases with a high probability of prevailing. Such a rule would go a long way toward mitigating the powerful incentive of third-party financiers and their clients to engage in speculative litigation and strike suits, without precluding socially advantageous public interest litigation and other meritorious claims.

⁶³ If civil rights or other notable public interest cases prove to be dissuaded by our modified “loser pays” rule, an exception for such cases might be warranted.

⁶⁴ See Lin, *supra* note 3.

INSURERS DEFEND AND THIRD PARTIES FUND: A COMPARISON OF LITIGATION PARTICIPATION

*Michelle Boardman**

Insurance companies provide a legal defense for their liability policyholders who have been sued. This defense commonly takes the form of the insurer selecting, paying, and directing the lawyer. This lawyer has two co-clients—the insurer and the policyholder-defendant.¹ While this arrangement has downsides, its value is well known and accepted.

Proponents of expanding third-party litigation funding in the United States argue that the insurer defense model supports and even necessitates expansion. A comparison between these relationships is strained; the occasional similarity is overwhelmed by the differences. This article is the first to fully consider the value of the comparison between the two forms of litigation funding. It concludes that the insurer defense model can provide some insight but that several of the more causal, common analogies between the two funding forms should be put aside. It does not take a stance on the larger question of whether or how third-party litigation funding should be expanded in the United States.

Why compare third-party litigation funding with insurer litigation defense? Before evaluating the more specific claims that are being made about the two, there are several general reasons to explore insurer defense funding. First, an insurer's defense of its policyholder can be considered a form of third-party litigation funding, one that is already prevalent in the United States.² We might hope to see the future of the new funding forms by looking at the present insurer defense model. Second, insurance compa-

* Assistant Professor of Law, George Mason University School of Law. Thank you to Henry Butler and the Searle Civil Justice Institute at George Mason's Law & Economics Center, participants at the New York conference on "Third-Party Financing of Litigation: Civil Justice Friend or Foe?," and participants at the Brussels "Global Conference on Third-Party Financing of Litigation," particularly Joanna Shepherd Bailey, George Barker, Jeremy Kidd, Alan Morrison, and Anthony Sebok.

¹ See *infra* Part II.D. for a discussion of this co-client relationship. In the rare cases where a conflict between the insurer and policyholder makes this relationship impossible, the insurer withdraws from all but the obligation to pay for the policyholder's defense of a claim.

² See, e.g., GEOFFREY MCGOVERN ET AL., RAND INSTITUTE FOR CIVIL JUSTICE PROGRAM, CONFERENCE PROCEEDINGS, THIRD-PARTY LITIGATION FUNDING AND CLAIM TRANSFER: TRENDS AND IMPLICATIONS FOR THE CIVIL JUSTICE SYSTEM 2 n.2 (2010), available at http://www.rand.org/pubs/conf_proceedings/CF272 [hereinafter RAND CONFERENCE 2009]. In the United States insurers typically pay on the claims of their policyholders and then sue to recover damages from the third parties that caused the damage covered under the insurers' policies, a procedure called "subrogation." *Id.* at 8. "Before-the-event and after-the-event legal insurance policies are not common in the United States . . ." *Id.*

nies play a larger role in European litigation financing.³ Litigation expense insurance is not yet an American phenomenon, however. Third, the large litigation investor funds like Juridica “partner[] and co-invest[] with other leading financial institutions and *insurers* in London and New York.”⁴

In addition to the more general argument that insurers already are litigation funders, this article will flesh out and examine two additional specific claims. First, there is the possible unfairness “of the defendant’s ability to transfer risk to an insurance company before the event, while plaintiffs are left to absorb all the risk of returns on their claims until the eventual outcome.”⁵ The lack of parity between the plaintiff’s and defendant’s positions also has consequences beyond fairness concerns. The next claim assumes the greater including the lesser: If an insurer’s *control* of a defendant’s litigation is palatable, then mere investor *involvement* must be even more so. In other words, insurers interject themselves into settlement decisions in defense actions; litigation funding will be less intrusive and thus we need not worry about interfering with either the lawyer’s or the client’s legal judgment. To evaluate both of these claims, we will continue to return to the first general claim that insurers are litigation funders in the same relevant sense as that term is used to apply to third-party litigation funders.⁶

For purposes of this article, third-party litigation funding will (a) often be shortened to “litigation funding” and (b) refer to investments in commercial plaintiffs’ suits by funds and, at times, nonrecourse loans made to individual plaintiffs in tort suits. This paper does not fully address other forms of litigation funding such as lawyer–client contingency fee arrangements or outright claim transfer in which a legal claim is sold to and pursued by a party outside the original dispute. This division serves several functions. First, it is in keeping with “third-party litigation funding” becoming a term of art, not a bare description. Second, the analogies that are drawn from insurer defense funding are focused on analyzing this subset of

³ See Anthony Heyes, Neil Rickman, & Dionisia Tzavara, *Legal Expenses Insurance, Risk Aversion and Litigation*, 24 INT’L REV. L. & ECON. 107, 108 (2004). However, as other articles cited in this volume explore, the role of insurers in European litigation funding seems to have been overstated.

⁴ JURIDICA CAPITAL MGMT. LTD., <http://www.juridica.co.uk/about.php> (last visited Mar. 1, 2012) (emphasis added).

⁵ RAND CONFERENCE 2009, *supra* note 2, at 52 (Appendix B: Presenter Materials, from Keynote Speech by Lord Daniel Brennan).

⁶ There is another claim that merits discussion but falls outside the scope of this piece. Lord Daniel Brennan, Chairman of Juridica Capital Management, asks, “Why should an insurance company be able to take direct control of a claim through the contract right of subrogation, while a financial institution is restricted from purchasing an interest in a legitimate legal claim held by a business?” *Id.* This claim addresses the fitness of certain institutions to pursue claim transfer, which is not third-party litigation funding. Litigation funding and claim transfer may be substitutes in certain circumstances; for example, both allow for a market in litigation investment. Nonetheless, the legal and ethical restrictions on claim transfer are a substantial topic unto itself. The dynamics and incentives of insurer plaintiff subrogation suits likewise merit a comprehensive, separate discussion.

litigation funding. A comparison between insurer defense and contingency fees might well prove interesting another day. Third, sloppy thinking can result, and has resulted, from simultaneously using the phrase “litigation funding” in both the narrow and the broader sense in one breath.

Part I describes the type of third-party litigation funding at issue in this article. Part II sets forth the nature of the relationship between defendant policyholders and their third-party liability insurer. This part begins the comparison between litigation funding and insurer defense. Readers with a working knowledge of litigation funding and liability insurance may want to skim these sections but should not skip them. Part III delves into the three comparison claims described above.

I. THIRD-PARTY LITIGATION FUNDERS

In this article, “third-party litigation funding” refers to either investment in commercial plaintiffs’ suits by litigation investment funds or non-recourse loans made to individual plaintiffs in tort suits, known as lawsuit lending.⁷ These forms of litigation funding involve a potential plaintiff and a party who is not otherwise related to the litigation. The borrower-plaintiff may already be engaged in litigation, but it is more likely that the borrower is a person or entity holding a legal claim. The third-party funder agrees to pay all or part of the plaintiff’s legal costs in exchange for payment, usually a percentage of the plaintiff’s recovery.⁸

The purpose of litigation funding depends upon the plaintiff. For commercial plaintiffs, we can generally assume that the purpose is to transfer some or all of the litigation risk to a third party. A business can increase the expected value of a suit by shifting the litigation risk to a party who values the expected reward more than the expected risk.⁹ For individual tort plaintiffs, we may generally assume the purpose is to make the litigation possible because the plaintiff does not otherwise have the resources to sustain the case even though the plaintiff’s lawyer is operating on contingency. Perhaps because contingency fee arrangements are permissible in

⁷ This article does not address the rare cases in which a *defendant* receives third-party funding from sources other than its insurer.

⁸ See *infra* Part II.B. for a discussion of the various stakes that parties providing litigation support may have in the outcome of the litigation.

⁹ On the defense side, Jonathan Molot has set forth a three-tiered structure of litigation risks based upon Guido Calabresi’s primary, secondary, and tertiary costs of accidents. See Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367, 372-75 (2009) (citing GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* (1970)). Molot’s goal is “to develop a risk-transfer and risk-pooling mechanism that could reduce the secondary and tertiary costs of litigation. . . . [T]he hypothetical defendant . . . would not have to retain litigation risk for the duration of a lawsuit. Instead, it could choose to pay the ‘expected value’ of its lawsuit plus a premium to protect against a higher-than-expected loss.” *Id.* at 375.

the United States, unlike in many other countries, the loans available to individual plaintiffs seem to be limited to living while litigating and not to lawyers' fees directly.¹⁰ Of course, in either the individual or the commercial case, litigation funding may make the difference between a suit being brought or not brought; a commercial entity can have the resources to bring a suit but believe the suit is not worth the litigation risk.

The two primary investor funds in the United States are Juridica Capital Management (US) Inc., launched in 2007,¹¹ and Burford Capital Limited, launched in 2009.¹² Because the funds are relatively new and their operations are not fully public, there is some uncertainty about how the fund model will develop. Juridica describes itself as "a lawyer-owned financial services company operated in an investment banking tradition and focused exclusively on capital and finance for corporations, law firms, lawyers, and claim-holders worldwide."¹³ It also touts its legal and case expertise, suggesting at least the possibility of its deeper involvement in case decisions after the initial investment decision.¹⁴ It arranges various forms of funding for both law firms and claim owners but "does not arrange finance for personal injury claims or for mass tort claims, except in special circumstances."¹⁵ Juridica exclusively manages worldwide operations of Juridica Investments Limited, which is listed on the Alternative Investment Market of the London Stock Exchange.¹⁶

¹⁰ Whether plaintiffs unable to secure a contingency fee arrangement could interest a third-party litigation funder to invest in their litigation is a question that merits further investigation. See Marco de Morpurgo, *A Comparative Legal and Economic Approach to Third-Party Litigation Funding*, 19 CARDOZO J. INT'L & COMP. L. 343, 356 (2011).

¹¹ *History*, JURIDICA CAPITAL MGMT. LTD., <http://www.juridica.co.uk/history.php> (last visited Apr. 13, 2012).

¹² *Investor FAQs*, BURFORD, <http://www.burfordfinance.com/en/investor-relations/investor-faqs> (last visited Apr. 13, 2012).

¹³ JURIDICA CAPITAL MGMT. LTD., <http://www.juridica.co.uk/about.php> (last visited Mar. 1, 2012).

¹⁴ *Id.* ("Through over fifty years' combined experience in finance and law product innovations, Juridica's principals have developed an extensive, world-wide network of leading law, legal ethics, finance and consulting experts and scholars. Juridica calls on this network to assist in case and risk analysis, financial modeling and financial product design."). Lord Brennan, Chairman of Juridica Investments Limited, states that Juridica "employs: a cutting edge underwriting system; effective due diligence; full financial analysis of all factors affecting the investment, legal, financial, and overall return on the investment; quality experts on ethics, liability, damages, and enforceability; [and] the best lawyers." RAND CONFERENCE 2009, *supra* note 2, at 55 (Appendix B: Presenter Materials, from Keynote Speech by Lord Daniel Brennan).

¹⁵ *Claim Sectors*, JURIDICA CAPITAL MGMT. LTD., <http://www.juridica.co.uk/claim.php> (last visited Mar. 1, 2012).

¹⁶ *Juridica Investments Limited*, JURIDICA CAPITAL MGMT. LTD., <http://www.juridica.co.uk/investments.php> (last visited Mar. 1, 2012).

The largest investor fund, “Burford Capital Limited[,] is a publicly listed fund that invests in commercial disputes.”¹⁷ Burford considers United States commercial disputes and international arbitration to be its “core business” areas.¹⁸ Like Juridica, many of Burford’s principals are lawyers. After all, legal expertise is central to choosing in which cases to invest and how deeply. “Juridica prefers to examine potential business-related claim investments that have been vetted and accepted by qualified lawyers.”¹⁹ The open question is whether the lawyers remain involved with the borrower’s case after making the initial loan. Burford Capital describes itself as a dispute financier; Burford Group, which describes itself as the investment advisor to Burford Capital, has stated in the past that its goal is “not only to arrange critical funding, but *to improve the odds of a favorable outcome.*”²⁰

A litigation investment fund that has lent a set amount has every incentive to encourage a favorable outcome; payment may be contingent upon a positive settlement or award and it may be in the form of a percentage of the plaintiff’s recovery. A fund that has pledged to lend a variable amount, depending on litigation costs, may reach a point where it prefers to cut its losses and accept a “losing” settlement over investing additional resources in the litigation or settlement negotiations. In both cases the fund mirrors an indemnity insurer, who has an incentive to minimize (maximize) the amount paid out (paid in) under the policy in settlement or award. As discussed elsewhere, their incentives as to litigation *costs* may differ. 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.

Much of the analysis of litigation funding in the United States has assumed a model in which the funds do not attempt to influence the borrower’s litigation or settlement decisions after the initial investment has

¹⁷ Press Release, Burford Capital, Burford Capital Limited Interim Results 2011 (2011), available at http://www.burfordfinance.com/docs/default-document-library/burford_capital_interim_2011_web.pdf [hereinafter Burford Interim Results 2011; see also BURFORD, <http://www.burfordfinance.com/home> (last visited Mar. 1, 2012).

¹⁸ Burford Interim Results 2011, *supra* note 17, at 2. Other funds, most of which do not have an American presence, include Allianz, Credit Suisse, Claims Funding International PLC, Context Capital, Harbour Litigation Funding, and IM Litigation Funding. RAND CONFERENCE 2009, *supra* note 2, at 69-71.

¹⁹ *How We Work*, JURIDICA CAPITAL MGMT. LTD., <http://www.juridica.co.uk/how.php> (last visited Mar. 1, 2012).

²⁰ See BURFORD, <http://www.burfordfinance.com/en> (last visited Mar. 1, 2012); see also Roger Parloff, *Have You Got a Piece of This Suit?*, CNN MONEY (June 28, 2011, 2:06 PM), <http://features.blogs.fortune.cnn.com/2011/06/28/have-you-got-a-piece-of-this-lawsuit-2/> (“Our goal is . . . to improve the odds of a favorable outcome.” (quoting Burford’s website)).

been made. Whether advice or pressure is brought to bear during litigation, a fund could influence the litigation's path by requiring an agreement about approach and settlement stance before making the investment commitment. For purposes of this article, which does not turn on the question, it is reasonable to consider it possible, but not proven, that litigation investment funds would influence strategy before or during litigation.

On the individual tort-plaintiff side, the borrowing structure is a fairly simple non-recourse loan. If the would-be plaintiff's lawyer is the one making the loan, we call it a contingency fee. If an outside lender makes the loan, it is third-party litigation funding.²¹ The "leading provider of litigation financing, plaintiff funding, and lawyer funding," at least according to itself, is LawCash, whose website describes its business model in detail.²² If a plaintiff already engaged in a contingency fee suit borrows money for non-litigation expenses during the suit, there does not seem to be a set name—"third-party litigation support funding" is too long and "lawsuit living lending" is too alliterative. A separate term is called for, although the term "lawsuit lending" is used to apply to the entire tort plaintiff field.

Lawsuit lenders have faced difficulty in some states. Courts have held the contracts void, calling the lenders "intermeddlers" who should not be "permitted to gorge upon the fruits of litigation."²³ In the case of this language from the Supreme Court of Ohio, the state legislature made the contracts legitimate again five years later.²⁴ The American Tort Reform Association (ATRA) has urged state legislatures and the American Bar Association to resist approving or legitimizing this form of litigation funding. ATRA argues that lawsuit lending "generally targets low-income Americans with a convenient if usurious line of credit" and "fundamentally shifts the focus of courts from promoting and administering justice to serving as a forum for investors to wager on lawsuits."²⁵

On the other side, the American Legal Finance Association (ALFA) is a trade association that represents some twenty third-party litigation support funders whose clients are individual plaintiffs in personal injury suits. The association sets forth industry "best practices" and coordinates with state

²¹ See *infra* Chart 1 for a comparison of the two.

²² LAW CASH, <http://www.lawcash.net> (last visited Mar. 2, 2012). LawCash does appear to be one of the largest lawsuit lenders.

²³ Ben Hallman & Caitlin Ginley, *States are Battleground in Drive to Regulate Lawsuit Funding*, IWATCH NEWS (Feb. 2, 2011, 2:50 PM), <http://www.iwatchnews.org/2011/02/02/2160/states-are-battleground-drive-regulate-lawsuit-funding> (quoting the Ohio Supreme Court in 2003).

²⁴ *Id.*

²⁵ Press Release, Am. Tort Reform Ass'n., ATRA Urges ABA to Resist Third-Party Lawsuit Lending (Feb. 16, 2011), available at <http://www.atra.org/newsroom/atra-urges-aba-resist-third-party-lawsuit-lending>. See also Am. Bar Ass'n., *Comments: Issues Paper Concerning Lawyer's Involvement in Alternative Litigation Financing* (Alt. Litig. Fin. Working Group Issues Paper, 2011), available at http://www.americanbar.org/content/dam/aba/migrated/2011_build/ethics_2020/comments_on_alternative_litigation_financing_issues_paper.authcheckdam.pdf.

governments on voluntary agreements, regulations, and legislation.²⁶ According to ALFA, its members provide non-recourse loans to individuals who already have an arrangement with a contingency fee lawyer. The ALFA member funds not the litigation but rather the non-litigation costs of living while awaiting an award of damages.²⁷ These costs include medical bills resulting from the injury and house payments or other payments that have become difficult because the plaintiff is out of work.²⁸

Obviously, money is fungible. Does it make sense to think of ALFA members as funding living while litigating and not funding the litigation itself? Yes, it does, given that the loans for each are nonrecourse. The plaintiff does not give the contingency fee lawyer any money up front. He is not using the money from the ALFA lender to repay his lawyer during or after the suit. If the suit comes to nothing, he owes neither his lawyer nor the lender.

On the other hand, the existence of the ALFA lender will in some cases allow a plaintiff to bring or maintain suit where before he would have abandoned suit or settled earlier. A tort plaintiff with little personal means, whose job is disrupted by injury and whose medical bills are due, will settle for less in order to get payment sooner than a plaintiff who can afford to wait while his bills are paid by a nonrecourse loan. The contingency fee lawyer may direct his clients to lawsuit lenders for this reason; the lawyer sees a winning case but knows it will take more time than the plaintiff has to recover the reward.

II. THE INSURANCE DEFENSE PICTURE

The existing generalizations about the similarities between litigation funding and insurance defense have assumed knowledge of the insurance side. The lack of explicit comparison has resulted in some sloppy conclu-

²⁶ See *Facts About ALFA*, AM. LEGAL FIN. ASS'N., <http://www.americanlegalfin.com/FactsAboutALFA.asp> (last visited Mar. 3, 2012) (describing a voluntary agreement with the Attorney General of New York State and legislation in Maine and Ohio).

²⁷ See *Frequently Asked Questions*, AM. LEGAL FIN. ASSOC., <http://www.americanlegalfin.com/faq.asp> (last visited Mar. 3, 2012) ("An ALFA client can be anyone who has hired an attorney on a contingency fee basis to seek financial compensation for a personal injury suffered in an accident that wasn't their fault. Typically, the injury suffered has left them in financial hardship due to an inability to work. The consumer can contact one of the ALFA member companies directly to apply for legal funding or their Attorney may refer their clients to an ALFA member company when the client is experiencing financial distress during the course of his or her case. The client most often uses the funds received to make mortgage or rent payments, pay medical bills, purchase food, car payments, tuition, or basically anything else they need. Legal funding is used to pay for life's necessities.").

²⁸ *Id.*

sions. Thus, to draw an analogy between litigation funding and insurance defense requires a clearer picture of the insurance defense side.

We can envision two typical defendants. The first, an individual homeowner, purchases a homeowners insurance policy that includes personal liability and medical payments coverage. When a visitor is injured falling from the homeowner's deck, the policy provides coverage for the civil claim of injury and medical expenses. The protection goes beyond the home; if the policyholder unintentionally injures a person or causes property damage while out in the world, there may be coverage. In some sense, the liability sections of homeowners policies operate as liability insurance for individuals.

The second typical defendant is a corporation with a General Commercial Liability (CGL) policy. When a claim or suit is brought against the company, the insurer pays for both the defense and the damages award or settlement, subject to policy limits.²⁹ The relationship between the duty to provide a defense and the duty to pay proceeds in liability can be complex, but in general, the defense payments do not diminish the amount available to pay for damages or settlement.³⁰

This article will spare the reader a treatise on the relationship and pitfalls between policyholder and liability insurer, but a few key elements of the set-up are important. Key aspects of the insurer defense relationship include:

(1) the contractual relationship precedes the litigation.

Thus,

(2) the insurer's involvement in the litigation is *automatic*, not an investment *choice*, and

(3) litigation funding is not the primary purpose of the contract.³¹

Once a legal claim is made,

(4) the policyholder has a duty to cooperate with the insurer, and

(5) the policyholder and the insurer are co-clients of the lawyer.³²

The first three aspects are relevant to the incentives the contractual relationship creates before litigation. The last two are central to the nature of that relationship in the throes of litigation.

²⁹ It is possible to purchase a CGL policy that provides coverage for damage awards against the policyholder but *does not give the insurer either the right or duty to participate in the litigation*. These policies are generally only available to large sophisticated corporations in whose litigation expertise the insurer is confident. Of course, the policy still provides for safeguards of the insurer's interests.

³⁰ See *General Liability Insurance*, TECHINSURANCE, <http://www.techinsurance.com/general-liability-insurance/> (last visited Mar. 3, 2012).

³¹ Litigation funding is the primary or at least equal purpose of some insurance contracts, such as professional liability policies, which include medical malpractice and Directors & Officers insurance.

³² See *infra* Part II.D.

A. (1)-(2) *Insurer Funding is Aleatory and Automatic If Triggered*

The relationship between the policyholder and insurer obviously begins when the policyholder purchases liability insurance. The insurer commits to the policyholder before he becomes a defendant in need of a legal defense. Indeed, the insurer commits before knowing whether the policyholder will ever need a legal defense. Like the insurer's obligation to indemnify, therefore, the insurer's obligation to provide a defense is aleatory. Unlike a third-party litigation funder, neither party to the contract knows at the time the contract is made whether any litigation will in fact be funded.³³

If the policyholder does become a defendant, the insurer is pulled into the litigation by pre-existing contract. In stark contrast to a third-party litigation funder, the insurer does not have a choice whether to fund the defense or not. Having entered into the insurance contract, it is a comparison between the contract and the plaintiff's complaint that determines whether the insurer owes a defense.³⁴

The insurer makes a promise to defend (and asserts the right to defend)³⁵ that is *not* based on the strength of the claimant's case.³⁶ If the act alleged in the complaint is one that falls within the scope of coverage, the insurer has an obligation to defend "even if the suit is groundless, false, or fraudulent."³⁷ The insurer does not first conduct a mini-trial only to join in the policyholder's defense if a finding of liability is likely. The duty to defend against potential liability is thus broader than the duty to compensate for liability.

This makes sense. If the policyholder is found liable after the insurer refuses a defense, the insurer will still be on the hook for the liability; the reasonableness of judging the claim to be groundless will not be a defense. "The duty to defend arises not from the probability of recovery but from its possibility, no matter how remote. Any doubt as to whether the allegations

³³ This is a little simplistic on the commercial insurance side, especially for claims-made policies.

³⁴ This is the eight-corners rule, referring to the four corners of the insurance policy and the four corners of the plaintiff's complaint. See *GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 308 (Tex. 2006). In certain jurisdictions the rule is not this simple. If the insurer has access to facts that show the true nature of the allegation to be under liability coverage, the insurer may have a duty to defend despite a poorly drafted complaint.

³⁵ See generally Douglas R. Richmond, *Liability Insurers' Right to Defend Their Insureds*, 35 CREIGHTON L. REV. 115 (2001).

³⁶ See generally James M. Fischer, *Insurer-Policyholder Interests, Defense Counsel's Professional Duties, and the Allocation of Power To Control the Defense*, 14 CONN. INS. L.J. 21 (2007).

³⁷ ISO, Homeowners 3-Special Form 16 (Homeowners 00 03 10 00) (2006). This language is common.

state a claim covered by the policy must be resolved in favor of the insured as against the insurer.”³⁸

Insurers may have other defenses, such as when a complaint only alleges intentional wrongdoing, which is excluded from coverage under the policy and by public policy.³⁹ An insurer may disclaim the duty to defend on the basis of a policyholder’s breached duty to cooperate, although success will require a substantial and material breach.⁴⁰ But the insurer will not be deciding whether it would prefer to defend the policyholder’s suit or invest the resources elsewhere.

In the ideal case, an insurer does not first learn of a suit when the complaint is filed; in order to investigate and create reserves, the insurer wants to be informed when the policyholder realizes it has committed an act that could lead to liability. Similarly, a plaintiff seeking funding can approach (or be approached by) a litigation funder either before or after the plaintiff has brought suit. The difference, of course, is that the litigation funder must decide whether to take on a contractual obligation to fund. The insurer has no such decision to make; its prior contractual obligation has been triggered by an event outside its control.⁴¹ This difference is relevant to the insurers-as-litigation-funder’s claim and the parity claim.

B. (3) *Litigation Funding Is Not the Primary Purpose of the Contract*

For an individual homeowner, the primary purpose of the contract is indemnification from damage to the home and personal items. Even if we optimistically assign the liability coverage equal billing, the litigation funding of a defense is at most half of the value of the liability coverage. Thus, with generosity, the litigation-funding portion of the contract is one-fourth of the purpose or value of the insurance policy to the policyholder. For a commercial policyholder, the litigation funding function is more valuable. While some homeowners are at best vaguely aware of their liability coverage, businesses purchase liability coverage in part to have protection against the cost of suit. With generosity again, we can even say that the

³⁸ *George Muhlstock & Co. v. Am. Home Assurance Co.*, 502 N.Y.S. 2d 174, 178 (N.Y. App. Div. 1986) (quoting *Sucrest Corp v. Fisher Governor Co.*, 83 Misc. 2d 394, 404, 371 N.Y.S.2d 927, *aff’d*, 56 A.D.2d 564, 391 N.Y.S.2d 987).

³⁹ If the complaint alleges both intentional wrongdoing and, in the alternative, negligence, the duty to defend is usually triggered. *See, e.g., Sharonville v. Am. Emp’rs Ins. Co.*, 846 N.E.2d 833, 837-38 (Ohio 2006).

⁴⁰ *See* ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, *UNDERSTANDING INSURANCE LAW* § 110 (4th ed. 2007).

⁴¹ The same is true of before-the-event litigation expense insurance available in parts of Europe.

CGL policyholder values the litigation-funding portion at up to one-half the function of the policy.⁴²

Nor is litigation funding the primary purpose of the contract for the insurer. Once a liability insurer's policyholder is charged by another party with potential liability, the insurer has a financial stake in the outcome of that dispute—whether the dispute settles or is resolved in litigation. This can be seen most clearly by considering a liability insurance contract in which the insurer takes no part in the litigation.⁴³ In these cases, the insurer retains the same financial stake in the outcome of the underlying litigation but maintains little or no control over the litigation.

With third-party litigation funding, the purpose of the contract is . . . litigation funding. The plaintiff seeks to shift litigation risk and the funder seeks to invest in the litigation; the path to both of these objectives is the financier's funding of the litigation. Burford Capital, and other investment funds, may add the function of increasing the chances of litigation success.

This difference in purpose matters in two ways. First, to the extent that third-party litigation funding has negative externalities that are difficult to measure, one might be inclined to restrict contracts with litigation funding as the goal more readily than contracts that include litigation funding. The most obvious externality of litigation funding will be an increase in litigation. Whether this is a negative externality is a large theoretical and empirical question that will not be answered here; litigation funding may primarily increase legitimate claims being brought and increase efficient settlement.⁴⁴

While this debate plays out, the point to note here is that insurer *defense* funding does *not* obviously increase litigation. This difference between plaintiff litigation funding and defendant litigation funding is simple and powerful but easily overlooked.

With plaintiff litigation funding, an obvious first-line effect of the funding is to increase the number of claims brought. Again, whether it then increases the number of court cases, desirable settlements, or undesirable settlements is an empirical question. Liability insurance also increases the

⁴² For specific types of business that are more likely to be sued than to be liable, the litigation funding portion would be worth *more* than one half.

⁴³ It is possible to purchase a CGL policy that provides coverage for damage awards against the policyholder but does not give the insurer either the right or the duty to participate in the litigation. These policies are generally only available to large sophisticated corporations in whose litigation expertise the insurer is confident. Of course, the policy still provides for safeguards of the insurer's interests.

⁴⁴ See Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 107 (2010); see generally Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367 (2009) (commercial defendant litigation funding); Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61 (2011); Anthony J. Sebok, *Betting on Tort Suits After the Event: From Champerty to Insurance*, 60 DEPAUL L. REV. 453 (2011). *Contra* Catherine M. Sharkey, *The Vicissitudes of Tort: A Response to Professors Rabin, Sebok & Zipursky*, 60 DEPAUL L. REV. 695 (2011).

number of claims brought, but it is the funding of the *damage award*, and not the funding of the litigation, that attracts plaintiffs.⁴⁵

Providing an otherwise judgment-proof tortfeasor with insurance increases substantially the value of bringing a claim against him. The effect of also providing a sophisticated, managed defense is less clear. Insurer management of a defense should please quality plaintiffs, in general, and displease weak plaintiffs or those looking for an easy settlement from a nuisance suit. In other words, the high quality of the defense should lead to more accurate settlements, which is good for those with strong cases and bad for weak ones.

In sum, the first rough effect of the difference in function of insurance and litigation funding contracts is that plaintiff litigation funding increases litigation, and insurance litigation funding does not. Second, the purpose of each contract affects the potential alignment of incentives for the funder. The insurer is more fully and evenly invested in the litigation than the third-party litigation funder. This does not necessarily mean the insurer's incentives are always better aligned than the litigation funder—far from it. It does mean that any claims about the workings of litigation funding based on the workings of insurer defense required detailed scrutiny.

Knocking aside all subtleties for the moment, we can envision a continuum of services for litigation stake and for litigation control. At one end of the spectrum is the lawsuit lender. The lender exerts no litigation control and is indifferent to the cost of litigation; his sole interest is in the fact of and amount of settlement or award. At the other end of the spectrum, imagine a litigation coach who has no stake in the outcome of the case; the coach's job is to help the litigant (plaintiff or defendant) get his desired outcome, which, roughly, will be maximizing the outcome while minimizing the cost of suit. The coach's pay for this job does not vary with the litigant's outcome. It is not a percentage of the damages awarded or saved. There is no premium for success, however defined, as there is in English conditional fee arrangements. Nor does the coach lend money to the litigant. In fact, let us assume the litigant has paid up front, so the coach has no reason to fear payment cannot be made if the suit fails. In other words, the coach has no financial stake whatsoever in the outcome of the litigation.⁴⁶ The lawsuit lender has no litigation control; the coach has total control. The lender's only stake is in the outcome of the litigation, whereas the coach has no stake in the outcome.⁴⁷

The value of the fictitious litigation coach is two-fold. First, it fills the box of litigation stake = zero and litigation control at the high end, say 90%. Second, in the insurance defense context it is not fanciful. The in-

⁴⁵ For a disturbing analysis of how insurance increases litigation, see KENNETH S. ABRAHAM, *THE LIABILITY CENTURY: INSURANCE AND TORT LAW FROM THE PROGRESSIVE ERA TO 9/11* (2008).

⁴⁶ The coach has an obvious reputational stake in his client's view of the outcome.

⁴⁷ See Chart 1 for a visual representation of how these two stakes book-end the spectrum.

surer often controls the entire litigation from a client standpoint; the lawyer still has a role. Of course, the insurer is not a zero for litigation stake, as the coach is.

In contrast to the litigation coach, the lawsuit lender is a zero for control but very high for a stake in the settlement. “Lawsuit lender” here refers to an entity that lends a set amount of money to a plaintiff who already has an arrangement with a contingency fee lawyer. The lender has no control over the litigation. The lender has no stake in the cost of the litigation in that the lawyer is the lender for litigation cost purposes, and the lawsuit lender has lent a set amount that does not vary with litigation costs.

The following chart shows the position of various entities in three categories: how much control the party exercises over litigation and settlement decisions; how much of a stake compared to others involved the party has in the cost of litigation; and how much of a stake the party has in the case outcome, which here is assumed to be settlement. The percentages are not exact, with the exception of the zeroes and a few of the one hundred percentages.

CHART 1

Party providing litigation support	Litigation Control	Stake in Cost of Litigation	Stake in Settlement
“Lawsuit Lender”	0%	0%	20% - 60% ⁴⁸
Litigation Coach	90%	0%	0%
Liability Insurer	80% - 100%	100%	90% - 100%
Litigation Funder	0% - 50%?	80% - 100%	10% - 45% ⁴⁹
Contingency fee Lawyer	90%	100%	30%

The liability insurer could have a lower stake in the settlement depending on the case, of course; the 90-100% stake is more accurate for individual defendants and less accurate for commercial defendants. Likewise, it is not possible to put an exact percentage on the amount of litigation control an insurer exerts, although the control is high. It no doubt reaches full control (100%) for most individual tort plaintiffs. As discussed elsewhere, the

⁴⁸ See Binyamin Applebaum, *Lawsuit Loans Add New Risk for the Injured*, N.Y. TIMES, Jan. 16, 2011, at A1, <http://www.nytimes.com/2011/01/17/business/17lawsuit.html?pagewanted=all> (“Unrestrained by laws that cap interest rates, the rates charged by lawsuit lenders often exceed 100 percent a year, according to a review by The New York Times and the Center for Public Integrity.”).

⁴⁹ LAW 360, THE RISE OF 3RD-PARTY LITIGATION FUNDING (Jan. 21, 2011), available at http://www.jenner.com/system/assets/publications/130/original/The_Rise_Of_3rd-Party_Litigation_Funding.pdf?1312815913

insurer's stake in the settlement depends upon the likelihood of the settlement exceeding the policy limits. The insurer numbers are based on average cases.

The point of the chart stands even if we fill the insurer's numbers based on less common cases. The chart shows that the insurer's incentives are well-aligned. Where (as in most cases) the insurer is heavily invested in both litigation costs and settlement costs, the insurer does not have an incentive to minimize one at the expense of the other. Because the insurer is in control of the litigation, it keeps within its own cost and settlement interests. Unless there is misalignment because the policyholder has a substantial stake in the settlement, the insurer is poised to efficiently litigate and settle.

The policyholder–defendant may exert some litigation decision making in commercial cases and will share more of a stake in the final settlement or court award if the policy limit is reached, requiring the defendant to pay a portion of the costs directly. In a subset of cases, the policyholder's and insurer's interests are significantly misaligned because one bears the litigation costs and the other bears a large share of the settlement costs.⁵⁰ The point here, again, is not that insurer defense has no pitfalls, but that the pitfalls *differ* from those caused by third-party litigation funding.

C. (4) *The Duty to Cooperate in the Defense*

The policyholder's duty to cooperate with his insurer is usually written in the policy, but courts will imply the duty if it is not; the insurer's performance obligation is conditioned on the policyholder's cooperation.⁵¹ Any lack of cooperation must be substantial and material to relieve the insurer of its duties. A key requirement of cooperation is that the policyholder may not settle the claim against it without the insurer's consent.⁵² If the policyholder settles without the insurer's knowledge or against the insurer's will, the policyholder (usually) forfeits the insurer's settlement payment.

⁵⁰ Indeed, Jonathon Molot's most convincing point in two excellent pieces is that commercial defendants may need additional litigation risk insurance. Molot, *A Market in Litigation Risk*, *supra* note 44; Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, *supra* note 44.

⁵¹ See, e.g., *Miller ex rel. Estate of Hott v. Augusta Mut. Ins. Co.*, 335 F. Supp. 2d 727 (W.D. Va. 2004), *aff'd*, 145 Fed. App'x 632, 638 (4th Cir. 2005) ("Under Virginia law, a duty-to-cooperate clause creates a condition precedent to an insurer's liability under the policy. A material breach of the duty to cooperate relieves the insurer of its liability under the policy, even if the insurer is not prejudiced by the lack of cooperation.").

⁵² The requirement to cooperate in settlement comes from both the duty to cooperate and the subrogation clause. The subrogation clause is relevant because an insurer subrogated to its policyholder's claims has only those rights that the policyholder would have had; a policyholder who has settled may have no remaining rights, depending upon the various claims at issue.

In litigation funding, the plaintiff does not have a duty, at least not that we know of, to cooperate with the funder in any way regarding the litigation. In some states, courts “have held that a champerty contract that gives the power to settle to the funder” would permit impermissible intermeddling.⁵³ It is exceedingly likely that the plaintiff has a contractual duty, owed to the funder, to cooperate with the lawyers in pursuing the claim. How the funder incentivizes the plaintiff to accept an appropriate settlement offer is unknown, but such incentives must exist for the funder to be willing to play.

As the relationship between funder, lawyer, and plaintiff evolves, it will become clearer if funded plaintiffs have a duty similar to that of insured defendants. On the other hand, the need for such a duty is surely lower. The plaintiff has every incentive to aid in the winning of the case; certain insured defendants may be recalcitrant to the hassle of involvement if the insurer is the one on the hook for the outcome. In insurance, the duty to cooperate also serves to combat a policyholder attempting to collude with a plaintiff at the insurer’s expense.⁵⁴

D. (5) *Co-Clients: Policyholder and Insurer*

The historic debate over whether insurance defense counsel has one or two clients is not entirely over, but in many ways insurers have won—the policyholder and the insurer are both considered clients.⁵⁵ “Today, absent a contrary agreement as to the identity of the client, the prevailing view appears to be that the lawyer represents both the insured and the insurer, at least for some purposes.”⁵⁶ The insurer is not only integral to the defense decision making, it often runs the defense. Indeed, one of the services the insurer provides is that of repeat-player litigation expert; the insurer is familiar with common claims and has a network of lawyers and experts.

Third-party litigation funders vary in their stated and probable involvement in the underlying litigation. Given the newness of the funding in the United States, it is not clear what the precise relationship between the plaintiff and the funder is meant to be or how it actually manifests. The

⁵³ Sebok, *The Inauthentic Claim*, *supra* note 44, at 110.

⁵⁴ See Lee R. Russ, *Post-Loss Rights & Duties; Adjustment of Loss*, in COUCH ON INSURANCE § 199:4 (2011) (“The main purpose of a cooperation clause is to prevent collusion while making it possible for the insurer to make a proper investigation.”).

⁵⁵ This is not true in all states. For an important part of the debate, and an argument for allowing two clients, see Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583 (1993).

⁵⁶ ABA Standing Comm. on Ethics & Prof’l Responsibility, Formal Op. 96-403 (1996). See also Harry M. Reasoner et al., *Conflicts in Insurance Defense Practice*, in BUSINESS AND COMMERCIAL LITIGATION IN FEDERAL COURTS § 65:53 (Robert L. Haig ed., 3d ed. 2011).

funder and the plaintiff, though, are clearly not co-clients of the plaintiff's lawyer.

At first blush, this difference between the litigation funder and the insurer seems fundamental and intractable. The insurer is a co-client not because it funds the litigation but because it will pay all or part of the defendant's damages owed.⁵⁷ The insurer's money is the money at stake in the litigation. The funder, on the other hand, cannot be a co-client because it has no stake in the underlying litigation. It has lent money to a person or entity who uses that money to bring a suit.

This description reveals the financial similarity between the plaintiff's funder and the defendant's insurer, however. The insurer's money is at stake; if the defendant loses, the insurer pays. The funder's money is at stake; if the plaintiff wins, the funder gains. Is the difference merely that one stands to lose and one stands to gain? One key difference is that in the average defendant's case, the insurer stands to pay nearly all, whereas in the average plaintiff's case, the funder stands to recoup only a portion of the proceeds, usually much less than half.

To further explore the difference between the two, consider each relationship in the absence of litigation funding. A policyholder could purchase a liability insurance policy that provided coverage for damages but not for defense funds. The insurer's funds would still be at stake in the outcome of the litigation. The insurer could still be a co-client of the (now policyholder-paid) lawyer. What differs dramatically in this scenario is the potential conflict between the policyholder and the insurer, in a way that shows the benefit of coupling insurer liability with insurer defense funding.⁵⁸

If the policyholder pays defense costs but not liability, the policyholder will choose to minimize defense costs only, without regard for the final payment as long as it is within policy limits. The policyholder will thus settle as quickly as possible, avoiding defense costs and leaving the liability insurer to pay the settlement award. The liability insurer, on the other hand, who here is paying zero in defense costs, but paying all liability, will choose to minimize liability costs without regard to defense costs; the insurer will prefer an expensive court battle with dismal chances of success to a settlement where the insurer is guaranteed to pay. Joining the defense and liability costs primarily in one party—the insurer—creates a cleaner incentive to minimize the *joint* costs of defense and liability payment.

Returning to the plaintiff's litigation funder, removing the litigation funding alters the relationship beyond recognition. To preserve the investment aspect of the relationship, we can envision a third party who lends

⁵⁷ In many cases, the policyholder (plus insurer) settles with the plaintiff within the policy limits, meaning that the insurer pays the entire amount, minus any deductible.

⁵⁸ More may be said on this point but the obvious observation is that a defendant who bears all the litigation costs and none of the settlement costs within the policy limits will settle at the policy limit as soon as possible, even if the expected value of the claim is much less.

money to the plaintiff. We can even envision that the lender is aware of the plaintiff's potential suit and views it as a potential asset. But the lender has no legal or contractual right to influence the plaintiff's litigation strategy or even to condition the loan upon pursuing the claim. The lender is not a co-client and would never be included in the suit as a party or brought into litigation discussions by the plaintiff's lawyer.

The purpose of this thought experiment, in part, is to reinforce trait (3) above: that litigation funding is not the central purpose of the policyholder-liability insurer contract. We can remove litigation funding from the relationship and retain the other key aspects of the relationship. But the main revelation the co-client status reveals is this: on one level the insurer is not a third party. Of course the insurer is not the party who committed an act triggering a liability suit. In all other ways, however, the insurer is fully involved in the litigation, perhaps with more at stake than the policyholder. Unlike the contingency fee lawyer, fund financier, or lawsuit lender, the insurer's involvement does not stem from the funding of the litigation and its stake precedes the funding decision.

III. THE COMPARISON CLAIMS

Accepting for the moment the value of the comparison between insurance defense and litigation funding, we can examine three claims that have been made on the basis of the comparison.⁵⁹ Do not necessarily blame litigation-funding supporters for any inconsistency among these claims; the claims come from various sources.⁶⁰

First, insurers are third-party litigation funders (as are contingency fee lawyers). Thus, we can see that third-party litigation funding works well in

⁵⁹ There are other claims about the relevance of insurance defense to litigation funding that will not be explored here. In a potential future of litigation funding for *defendants*, for example, the funding would operate as a form of insurance against the possibility of a large judgment.

⁶⁰ For each claim I have cited an individual or group who has supported the specific claim—but these claims are in the ether. Variants on each can be seen in the many recent symposia, conferences, or programs on third-party litigation funding. In addition to the 2009 RAND Civil Justice Institute Conference, RAND hosted "Alternative Litigation Finance in the U.S.: Where Are We and Where Are We Headed with Practice and Policy?," May 20-21, 2010. See STEVEN GARBER, *ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWN, AND UNKNOWN* (2010), available at http://www.rand.org/pubs/occasional_papers/2010/RAND_OP306.pdf. Erasmus University in Rotterdam hosted the conference "New Trends in Financing Civil Litigation in Europe: A Legal, Empirical and Economic Analysis," on April 24, 2009, and published a book based upon this conference. *NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL, EMPIRICAL, AND ECONOMIC ANALYSIS* (Mark Tull & Louis Visscher eds., 2010). Similarly, the Centre for Socio-Legal Studies and the Institute of European and Comparative Law University of Oxford organized an "International Conference on Litigation Costs and Funding," held July 6-7, 2009. *Costs and Mechanisms of Litigation Funding*, UNIV. OXFORD CTR. SOCIO-LEGAL STUDIES, <http://www.csls.ox.ac.uk/FundingandCosts.php> (last visited Apr. 13, 2012).

the United States already and should not cause alarm. Second, litigation funding is necessary on the plaintiff side to restore parity between plaintiffs and insurer-backed defendants. Supporters have not used this language, but one version of the claim is that insurer defense creates an imbalance with negative externalities. Third, insurer control of policyholder litigation is less intrusive than funder involvement will be. Because insurer control is accepted, a lower level of funder involvement should be as well.

A. *Comparison 1: Insurers are Litigation Financiers.*⁶¹

The claim that insurers already are third-party litigation financiers is the most general of the comparisons between litigation funding and insurer defense. Time is better spent on the more detailed versions of this general claim. However, it is worth addressing initially because it has some intuitive appeal and some truth behind it. Moreover, as long as this position holds, casual observations about the insurance defense model will continue to seep into discussions of third-party litigation funding.

The assertion that insurers fund litigation already is true on two different levels. First, in England and some other jurisdictions, litigation expense insurance (LEI) bears a closer relation to third-party litigation financing. LEI comes in two basic forms: before-the-event (BTE) insurance and after-the-event (ATE) insurance, in which “the event” is litigation in want of funding.⁶² LEI is usually purchased by the plaintiff, or plaintiff-to-be, but it can be purchased by a defendant. A plaintiff who purchases ATE litigation insurance has a litigation funder, as that term is used here, who is a third party and an insurer.

Unfortunately, this fact does not advance the discussion of potential third-party litigation funding in the United States. In the United States, litigation expense insurance is not widely available.⁶³ If it were, profitable comparisons could no doubt be drawn between ATE insurer litigation funding and ATE litigation funding by investors. As it is, the available comparison is between European insurers that fund (plaintiff) litigation expenses and American insurers that fund defense expenses as part of liability coverage. The differences between the European litigation context and the

⁶¹ See, e.g., GARBER, *supra* note 60, at 2.

⁶² See Willem H. van Boom, *Financing Civil Litigation by the European Insurance Industry*, in NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE, *supra* note 60, at 92; Morpurgo, *supra* note 10, at 353-54.

⁶³ In the United States, Sonoma Risk Insurance Agency, underwritten by Zurich, sells Contract Litigation Insurance (CLI). See *Contract Litigation Insurance*, SONOMA RISK INS. AGENCY, <http://www.sonomarisk.com/node/4> (last visited Mar. 3, 2012). CLI covers the risk of having to pay the attorneys' fees of one's contracting partner under a “prevailing party” provision—in essence, when the parties have contracted around the American Rule. This coverage can be purchased by either the plaintiff or the defendant before or shortly after the start of litigation.

American one—including our tort system structure, higher litigation costs, and the American Rule—render this comparison difficult.⁶⁴ “Virtually every aspect of financing civil litigation in the United States differs from the European model, at least with regard to formal rules.”⁶⁵ Moreover, as the analysis of the more specific claims below will show, scholars and policy makers are not drawing upon this comparison.

On a second, different level, the claim that insurers fund litigation could refer to subrogation. After an insurer has paid its policyholder for a loss, the insurer may by right or by contract pursue whatever claim the policyholder would have had against the party who caused the loss.⁶⁶ The insurer takes the role of plaintiff and funds what is now its own litigation. (Insurer subrogation thus might shed light on a discussion of expanded claim transfer in the United States). This will be discussed in more detail in a separate part, but for purposes of this claim it is important to note that subrogation is not the type of funding that is a competitor to or a substitute for all the various funding methods described as third-party litigation funding. Moreover, as with insurance defense litigation, the insurer’s interest in the subrogated claim is pre-existing.

In short, the problem with the claim that insurers are litigation financiers is not its inaccuracy but its superficiality. Insurers obviously pay for legal costs in litigation. In the vast majority of cases, insurers do this either as co-clients of the lawyer representing the defendant or as plaintiffs with claims in subrogation. In other words, the insurer is either not a third party or is *the* party as a result of claim transfer. The difference between these relationships and third-party litigation funding does not mean that the two should never be mentioned in the same breath. It does mean that in an analysis of third-party litigation funding, little can be said to automatically follow from the fact that insurers fund litigation.

⁶⁴ Third-party litigation funding has been present in England (over ten years) and Australia (over twenty years) for longer than it has been in the United States. The background in which litigation funding takes place in those countries differs quite dramatically from the United States. In England, for example, the losing party pays the winning party’s litigation costs and contingency fees are prohibited, although conditional fee arrangements have recently been permitted. In addition, until recent cutbacks, publicly provided legal aid allowed many individual plaintiffs to bring suit. There are other relevant differences, but these alone are sufficient to alter the need for and the effect of litigation funding.

⁶⁵ Deborah R. Hensler, *Financing Civil Litigation: The US Perspective*, in *NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE*, *supra* note 60, at 149.

⁶⁶ See generally Spencer L. Kimball & Don A. Davis, *The Extension of Insurance Subrogation*, 60 MICH. L. REV. 841 (1962). Equitable subrogation may be limited as equity requires. The insurance contract can provide the right to “conventional” subrogation, although whether conventional subrogation can apply when equitable subrogation would not is a question of some debate. Subrogation is not limited to insurance, of course. When a surety pays a creditor to satisfy a debtor’s debt, the surety is subrogated to the creditor’s original claim against the debtor.

B. *Comparison 2: Restoring Parity Between Policyholders and Defendants*

Some “question the fairness of the defendant’s ability to transfer risk to an insurance company before the event, while plaintiffs are left to absorb all the risk of returns on their claims until the eventual outcome.”⁶⁷ While fairness may be in the eyes of the beholder, it is useful to examine the potential effects of evening out what may be a lopsided arms race between plaintiff and defendant. First, however, it is worth examining the breadth of the factual claim, both in the commercial and individual context.

In both contexts, there will be defendants who cannot rely on an insurance company to provide a defense. For the individual, the largest set of uninsured suits will be those brought for intentional harms. Whether it is the act, the outcome, or both that must be “expected or intended from the standpoint of the insured” to exclude coverage depends on the policy, but mostly on the jurisdiction.⁶⁸ In the majority of jurisdictions, courts require an intentional act and some level of intent to cause injury, although intent can be inferred and the intent to cause a lesser harm will apply to a worse outcome.⁶⁹ The saving grace for some defendants is not the level of intent required, but the propensity of plaintiffs to bring suits arguing intentional harm and, in the alternative, unintentional harm. Such mixed suits often do trigger an insurer-provided defense.⁷⁰

For the commercial defendant, the largest set of uninsured suits may be those brought for contract disputes and breach of contract. In non-contractual disputes between commercial entities, both parties will likely have CGL insurance and other forms of commercial coverage. In many of these cases the plaintiff is not left to absorb all the risk until the eventual outcome; the plaintiff may recover under its own insurance and then support the insurer in its subrogation claim against the defendant. In this scenario, the plaintiff receives some compensation for the harm before suit and moves some or all of the risk of suit to its insurer. In many circumstances, then, a defendant will not be able to transfer the risk of suit to an insurer and a plaintiff will be able to transfer some risk of suit.

Nonetheless, in plenty of cases the plaintiff will have to bear his own litigation risk while the defendant has been able to transfer some of his risk

⁶⁷ RAND CONFERENCE 2009, *supra* note 2, at 53 (Appendix B: Presenter Materials, from Keynote Speech by Lord Daniel Brennan).

⁶⁸ See *JERRY & RICHMOND*, *supra* note 40, § 63C.

⁶⁹ *Id.* § 63C[a].

⁷⁰ Indeed, plaintiffs may plead in the alternative for the purpose of bringing the tortfeasor’s insurer into the picture. An otherwise judgment-proof defendant may be worth suing if the plaintiff either can convince the insurer that winning on the unintentional claim is likely enough to merit settlement or that settling a mixed claim early on will be less expensive than proving in court that the policyholder’s actions were intentional and not indemnified.

to an insurer. The insurer also brings a trait that proponents of third-party litigation funding wish to extend to plaintiffs: risk neutrality. Without insurance, a risk-averse defendant is not indifferent between a known settlement of \$50,000 and a 50% chance of a \$100,000 damages award even though the expected value is identical; he may settle for \$60,000 to avoid the risk of owing \$100,000.⁷¹ This works to the obvious advantage of the plaintiff.

Having taken this advantage away from the plaintiff through insurance defense, should we restore parity (if that is what it does) by allowing the plaintiff to transfer his litigation risk? For individual plaintiffs, the question is what value litigation funding will add over contingency fee arrangements; lawsuit lending will give some plaintiffs the resources and time necessary to continue a suit he would otherwise be forced to settle "early." For commercial plaintiffs, the question of parity also comes down to efficient settlement. Litigation funding may increase the accuracy of settlements so that they are based on the parties' expectations about the value of the suit and not a reflection of one party's risk preferences.⁷² This is the strongest point that emerges from the comparisons between insurer defense and litigation funding.

Whatever the value of risk neutrality on the part of a plaintiff, the value of coupling litigation cost with liability insurance is high. Assume a scenario in which the plaintiff's payment is expected to be below the policy limits; the policyholder has no fear of an award or settlement going up to that limit. If we imagine a policyholder who has liability insurance coverage for the award or settlement, but *not* for lawyer's fees, he will want to settle as quickly as possible for two reasons. First, going to trial gains him nothing because a damages award of either less than the settlement offer or zero only benefits the insurer. Second, going to trial or any other choice that keeps the lawyer employed is a direct cost borne by the plaintiff alone. This scenario has assumed the possibility of settlement (the most likely outcome) and settlement at or below insurance policy limits (a common

⁷¹ The literature on why and when parties settle is deep. See, e.g., William M. Landes, *An Economic Analysis of the Courts*, 17 J.L. & ECON. 61 (1971); John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279 (1973); Samuel R. Gross & Kent D. Syverud, *Getting to No: A Study of Settlement Negotiations and the Selection of Cases for Trial*, 90 MICH. L. REV. 319 (1991); Bruce L. Hay, *Effort, Information, Settlement, Trial*, 24 J. LEGAL STUD. 29 (1995); Russell Korobkin, *Aspirations and Settlement*, 88 CORNELL L. REV. 1 (2002).

⁷² For a thorough presentation of this argument, see Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, *supra* note 44. Professor Molot is now also the Chief Investment Officer of Burford Group Limited, the largest litigation investment fund in the United States. See *supra* notes 12, 17, 20 and accompanying text. At Burford, Prof. Molot is also a Managing Director and Chairman of the Investment Committee. This is not to question Prof. Molot's belief in the value of third-party litigation funding; indeed, he has put more than his money where his mouth is.

outcome). In short, decoupling the insurer's liability burden from the litigation cost burden results in higher and more inaccurate settlements.⁷³

Professor Stephen Yeazell makes a related parity claim that litigation funding will make "plaintiffs parallel with defendants whose insurers are implicitly vouching for the credibility of the defense."⁷⁴ If insurers do vouch for the credibility of a defense by mounting one, it provides "credibility" in a limited sense. And it pales in comparison to the credibility that a litigation funder provides by agreeing to invest in a plaintiff's case.

The value of credibility here is the ability to bring the other party to a favorable settlement. Insurers have a duty to defend a case, whereas third-party funders have a choice; their choice to invest in a claim sends a strong signal.⁷⁵ (One can imagine, however, a signal that is blurred by hedging. A litigation fund could invest in both sides of an open legal question, perhaps if the legal winds seem to change after the initial investment is made).

The insurer's signal is much more ambiguous. An insurer's decision to be involved in a policyholder's defense is not based on the merits of the case. It is the decision to settle, and at what price, that reveals something of the insurer's opinion of the case. However, the vast majority of civil litigation settles, including the vast majority of civil suits against tortfeasors with liability insurance. Eventual settlement may thus be presumed by both sides. A willingness to delay coming to a settlement may not reveal much either, as the insurer may be working from a belief in the strength of the case or the luxury of taking a negotiating position.

In this sense, an insurer does provide some credibility; it is harder to force a defendant to settle out of the inability to bear litigation risk when a more risk-neutral party is involved. If both the plaintiff and the defendant could pursue and defend a claim without cost, settlement decisions would be more "pure" in that they would reflect more accurately the parties' view of the strength and value of the claim. Instead, each party chooses a settlement point that takes account of litigation costs and negotiation costs, where litigation risk is one of the costs. Stated in this way, the value of credibility parity is the same point as the value of each party making decisions from a point of risk-neutrality.

⁷³ Note that while the policyholder prefers immediate settlement the insurer may prefer a full trial. The closer the expected settlement to the policy limit, the more an insurer has to gain from even a tiny chance of success at trial. The policyholder bears the full burden of the trial's legal costs and the insurer's expected damages payment decreases.

⁷⁴ RAND CONFERENCE 2009, *supra* note 2, at 130 (Appendix B: Presenter Materials, from Stephen C. Yeazell's presentation "Third Party Finance: Legal Risk and Its Implications"). Prof. Yeazell is an expert on civil litigation and one should assume his full view is more nuanced than this sentence, which is taken from a PowerPoint presentation. That said, the idea that litigation funding will equalize the negotiating position of plaintiffs with insurer-backed defendants is a common one.

⁷⁵ One can imagine, however, a signal that is blurred by hedging. A litigation fund could invest in both sides of an open legal question, perhaps if the legal winds seem to change after the initial investment is made.

C. *Comparison 3: In Litigation, If Insurer Control is Acceptable, Mere Investor Involvement Must Be Even More So*

Insurers interject themselves into settlement decisions in defense actions; litigation funding will be less intrusive and thus we need not worry about interfering with either the lawyer's or the client's legal judgment. This comparison speaks to ethical concerns that litigation funding will interfere with the lawyer's duty to his client and legal concerns that funding asymptotically approaches claim transfer, which is permitted but restricted in the United States. This claim has been made about, and makes the most sense with, investor funds, not lawsuit lenders who lend to individual tort plaintiffs.

For example, in discussing the ethical concerns about litigation funding, Nathan Crystal has argued that funders should be allowed the contractual right to *advise* lawyers and clients on settlement, but not the right to decide. In considering the general purpose of the American ethical rule against fee-splitting (lawyers sharing fees with non-lawyers), Crystal's focus is on allowing the lawyer to make independent legal judgments in his client's best interest:

The insurance defense practice is an important model that can be used for comparison here. The insurance company retains the right to decide whether to accept or reject a settlement, except perhaps in medical malpractice cases. If anything, the financing arrangements discussed here are less intrusive on the attorney-client relationship.⁷⁶

This claim is unsatisfactory on both sides of the comparison. On the insurer side, it is not simply that insurers have more control over their policyholder's defense; insurers have more at stake in the litigation and play a more equal role as co-client. On the fund side, it is not at all clear that investor funds do or will maintain the lower level of influence that Crystal and others advocate. Overlaying the comparison is the fact that one side is initiating litigation and one side is responding; it may be that third-party intervention in one raises concerns not raised by the other.

Taking the funder side first: skepticism about the ability of a funder to "advise" but not influence the outcome of a case is natural. This risk seems especially high if the lawyer or law firm and funder are repeat players; the lawyer who does not take advice on when to settle may expect to avoid the advice in the future by having no further dealings with the funder. Some have thus gone farther than Crystal, arguing that a funder should be completely excluded from the legal process so that litigation funding can have

⁷⁶ RAND CONFERENCE 2009, *supra* note 2, at 17-18 (summarizing Crystal's remarks).

“the benefits of champerty without the downside.”⁷⁷ For now, the casual reports of these arrangements place the funder lawyers “in the room” with the plaintiff-borrower and their litigation attorney during discussions, including settlement decisions.

On the insurer defense side of the comparison, it is not as simple as noting that if insurer control of litigation is acceptable, then funder influence that stops short of control is acceptable as well. In a sense, the relationship between insurer and defendant is horizontal integration and the relationship between plaintiff and funder is vertical integration. Thus the potential conflicts that arise in the insurance relationship differ from those in third-party financing. The claims that the ethical considerations are similar have been too quick. In addition to the pre-existing alignment of the policyholder’s and insurer’s interests—as opposed to the prior estrangement of the litigant and third-party financier—both the insurance contract and the common law charge the policyholder and the insurer with cooperation and fiduciary duties toward one another.

Most important, the insurer’s stake is often much higher than the defendant’s while the litigation funder’s stake is always less than the plaintiff’s. Given this, one would expect more and different problems with increased funder control of the litigation. If the funder’s control exceeds its stake in the litigation, it will be tempted to privilege its interests over the plaintiff’s when they diverge.

In addition, unlike the funded plaintiff, the policyholder–defendant has the opportunity to gain at the hands of the insurer. The insurer must be concerned about collusion between their policyholder and the plaintiff. The policyholder’s incentive is not to minimize the amount the plaintiff receives, but rather to minimize the amount the policyholder pays. Thus, the insurer must monitor the policyholder’s behavior. The insurance contract usually states the policyholder’s duties to cooperate in litigation, seek agreement on settlement, etc. Likewise, the insurer’s incentives can easily misalign with the policyholder’s. Unlike the third-party financier, who is on the hook for litigation costs, the insurer is potentially on the hook for litigation costs and the final judgment awarded by a court or jury. It is also possible for the litigation to reveal facts that relieve the insurer of any duty to pay, again, unlike third-party financiers.

Next, the insurer and the financier play different roles in their support and instigation of litigation. As discussed, the insurer’s duty to defend in most policies extends to baseless claims with little chance of success as long as the allegations are within the policy coverage. After the policy coverage is set, insurers do not get to choose which cases to fund. Financiers, on the other hand, select their cases. Furthermore, if the policyholder’s and insurer’s interests diverge, the duty to defend becomes a duty to pay for the

⁷⁷ RAND CONFERENCE 2009, *supra* note 2, at 19 (summarizing remarks by Kathleen Flynn Peterson).

defense; the insurer ceases to control the litigation.⁷⁸ (A common example occurs when a plaintiff alleges both negligent and intentional conduct. The insurer would benefit from a finding of intentional conduct, which in most cases ends insurance coverage. The defendant policyholder obviously prefers a finding of no tort or negligence to intentional conduct.) Third, and perhaps most obviously, an insurer funding the defense of a case will not have the same potential effect on the quantity or type of litigation as funding plaintiffs' instigation of suit.⁷⁹ In short, between insurer involvement in policyholder litigation and third-party litigation financing, there are differences in structure, incentives, ethical rules and questions, and likely effect.

D. *Assignment Versus Investment*

Another difference stems from the level of insurer control over the litigation. At first look, the insurer's domination of their policyholder defendants should be scandalous. The insurer manages to inhabit the small space between claim transfer and champerty without fully committing either of them.⁸⁰ The first reason the insurer is given a pass is that "defense transfer" is not claim transfer. In contrast to the huge judicial and scholarly energy spent on trying to decide if, how, and when to permit the assignment of claims, there is little said about defense transfer.

"[T]he central issue around which the distinction between the practice of selling claims and [third-party litigation funding]—in its 'narrow' sense—is control over the litigation."⁸¹ For individual defendants, insurers exert such a high level of control over the litigation that the law would label it as claim transfer or assignment if it were a claim.⁸² For commercial de-

⁷⁸ A common example occurs when a plaintiff alleges both negligent and intentional conduct. The insurer would benefit from a finding of intentional conduct, which in most cases ends insurance coverage. The defendant policyholder obviously prefers a finding of no tort or negligence to intentional conduct.

⁷⁹ The existence of liability insurance coverage creates strong incentives to sue and to create of new torts. See generally ABRAHAM, *supra* note 45. But this incentive stems from the insurance coverage itself, not from defense funding.

⁸⁰ Champerty is "[a]n agreement between an officious intermeddler in a lawsuit and a litigant by which the intermeddler helps pursue the litigant's claim as consideration for receiving part of any judgment proceeds." BLACK'S LAW DICTIONARY 262 (9th ed. 2009). Three related concepts are well explained here: "[P]ut simply, maintenance is helping another prosecute a suit; champerty is maintaining a suit in return for a financial interest in the outcome; and barratry is a continuing practice of maintenance or champerty." *Osprey, Inc. v. Cabana Ltd.*, 532 S.E. 2d 269, 273 (S.C. 2000) (quoting *In re Primus*, 436 U.S. 412, 424 n.15 (1978)).

⁸¹ Morpurgo, *supra* note 10, at 356.

⁸² Anthony Sebok states that "full control of the lawsuit collapses the distinction between maintenance and assignment." Sebok, *Inauthentic Claim*, *supra* note 44, at 109. This is correct in every way but one: in assignment the assignee internalizes *all* the costs as well as the *benefits* of pursuing the claim, while the litigation funder who controls the litigation still shares the benefit of suit with the

fendants control over the litigation is likely more evenly shared, although insurers retain the *right* to defend and a *veto* over settlement.⁸³

In other words, insurers and policyholders engage in what might be called defense transfer or defense assignment.⁸⁴ Why call it defense transfer instead of defense control? A claim holder can pay a third party to manage its litigation or it can transfer the claim. In transfer, the new owner alone benefits from a positive settlement or award. In insurer defense of individual policyholders, it is largely the insurer alone who pays the settlement or award. The ability to settle a claim against the policyholder's wishes smacks of an insurer with a property right in the claim over the policyholder. In the commercial general liability context, the policyholder is more likely to share some of the burden. On a continuum between claim or defense transfer and litigation support, insurer defense is approaching transfer and third-party litigation funding is not.

This lack of claim transfer is fundamental to litigation funders. Effectuating claim transfer is tricky.⁸⁵ Personal injury claims in tort cannot be assigned at all; given the existence of contingency fee arrangements in the United States, third-party litigation funding for the tort plaintiff might not exist were assignment permitted. Some of the claim areas that investment funds have focused on would be extremely difficult or impossible to achieve in the form of transfer, such as antitrust claims and shareholder disputes.⁸⁶

CONCLUSION

This article rejects the basic claim that if insurer defense is a net social and economic benefit, then litigation funding must be a net benefit as well. Insurer defense funding stems from an existing relationship with a separate aim. Once a policyholder is charged with potential liability, the insurer has a financial stake in the outcome of that dispute, whether it settles or is re-

claim-holder. Perhaps the distinction is trivial because in the first instance the assignee pays the claim-holder for the claim up front and in the second the funder "pays" the claim-holder after a win, with payment in the form of taking only a portion of winnings. Where the timing of payment affects incentives, however, the distinction is not trivial.

⁸³ For an excellent discussion of settlement control in the contingency fee context, see Neil Rickman, *Contingent Fees and Litigation Settlement*, 19 INT'L REV. L. & ECON. 295 (1999).

⁸⁴ The concept of a "defense transfer" is an obvious one, but only one other author has used the phrase. See Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268 (2011).

⁸⁵ Two outstanding articles on property rights in claims and claim transfer generally are Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697 (2005) and Sebok, *Inauthentic Claim*, *supra* note 44.

⁸⁶ See *Claim Sectors—How We Work*, JURIDICA CAPITAL MGMT. LTD, <http://www.juridica.co.uk/claim.php> (last visited Feb. 21, 2012).

solved in litigation. The policyholder and the insurer are co-clients of their lawyer, and the one who controls the litigation spending, the insurer, likely has the largest stake in the litigation outcome.

Third-party litigation financing introduces a new party into the litigation relationship, one that at the margin engenders the litigation. The new party also remains an outsider; the litigation funder does not control the cost of the litigation and may have no hand in litigation decisions. The points of possible tension between funder and client differ from the tension points between insurer and policyholder. At a minimum, this means that the cost-benefit analysis in the two cases must diverge. While tensions and direct conflicts can follow from either third-party financing or insurer litigation, the cost of constraining litigation funding is unknown. Because it is not possible to avoid the conflicts in insurance without banning liability coverage, the cost of fundamentally altering the liability coverage system is unfathomable.⁸⁷

⁸⁷ But see Alan I. Widiss, *Abrogating the Right and Duty of Liability Insurers to Defend Their Insureds: The Case for Separating the Obligation to Indemnify from the Defense of Insureds*, 51 OHIO ST. L.J. 917 (1990).



THE ECONOMICS OF THIRD-PARTY FINANCED LITIGATION

Keith N. Hylton*

This paper examines the law and economics of third-party financed litigation. I explore the conditions under which a system of third-party financiers and litigators can enhance social welfare, and the conditions under which it is likely to reduce social welfare. Among the applications I consider are the sale of legal rights (such as contingent tort claims) to insurers, to patent trolls, and to financiers generally.

INTRODUCTION

Third-party financing of litigation is a practice in which a financier underwrites a lawsuit in exchange for a share of the final judgment. It is a business that appears to be growing. At least two investment funds exist that are dedicated to financing high-stakes commercial litigation.¹ There are numerous funding sources available for low-stakes litigation.²

This is an interesting state of affairs because the legal status of third-party funded litigation is unclear in the U.S. The common law prohibited third-party funding under doctrines proscribing maintenance and champerty. Maintenance refers to the financial participation of a third party in a lawsuit. Champerty is the practice of funding a lawsuit in exchange for a share of the judgment. At present, the common law prohibitions have been

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¹ Juridica Capital Management and Burford Capital Limited are the first litigation funders to raise money through IPOs (on the London Stock Exchange), and they aim their investments largely at the U.S. market. Richard Loyd, *The New, New Thing*, AM. LAW., May 17, 2010, <http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202457711273&slreturn=1>. Juridica and Burford focus on large commercial matters. Juridica invests exclusively in business-to-business related claims where the amount in dispute exceeds \$25 million. *Juridica Investments Limited*, JURIDICA CAPITAL MANAGEMENT, <http://www.juridicainvestments.com/about-juridica/investment-policy.aspx> (last visited Dec. 29, 2011); *Investment Objectives & Policies*, BURFORD CAPITAL LIMITED, <http://www.burfordcapital.com/objectivesandpolicies.html> (last visited June 6, 2011).

² If one types the words *lawsuit loans* into an Internet search engine, hundreds of sources for small-scale litigation funding will appear. “Lawsuit Loans” Search, BING, <http://www.bing.com/search?q=“lawsuit+loans”> (last visited June 6, 2011).

modified or abolished in a majority of American states.³ Still, even though the law on maintenance and champerty is now a patchwork quilt, there remain several American jurisdictions in which champertous agreements are either illegal or unenforceable.⁴ Only a handful of states have abolished the doctrines entirely.⁵

This paper examines the economics of third-party financed litigation.⁶ It explores the conditions under which a system of third-party financiers and litigators can enhance social welfare, and the conditions under which it might reduce social welfare.

I start with a review of the economics of litigation. One fundamental proposition in this literature is that the private and social incentives to litigate diverge.⁷ Because of this incentive divergence, parties may bring suit where litigation reduces welfare, and may not pursue their claims even

³ As of this year, at least twenty-eight out of fifty-one American jurisdictions (including the District of Columbia) explicitly permit maintenance and champerty in some form. Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 98-99 & n.162, 107 & n.190 (2011).

⁴ Sebok identifies fourteen American jurisdictions that explicitly prohibit champerty (*i.e.*, enforce champerty doctrine). *See id.* at 101-02 & n.171.

⁵ Massachusetts, New Jersey, and South Carolina have abolished the doctrines entirely. *See* *Saladini v. Righellis*, 687 N.E.2d 1224, 1224 (Mass. 1997); *Schomp v. Schenck*, 40 N.J.L. 195, 203-04 (N.J. 1878); *Osprey, Inc. v. Cabana Ltd. P'ship*, 532 S.E.2d 269, 277 (S.C. 2000). Courts in several other states have declared the common law prohibitions to be nonexistent, but nevertheless have applied statutory restrictions on champerty. *See, e.g.*, *Strahan v. Haynes*, 262 P. 995, 997 (Ariz. 1928) (declaring doctrines of champerty and maintenance not to be "in force" in Arizona); *cf. In re Stewart*, 589 P.2d 886, 888 (Ariz. 1979) (statute prohibits champertous agreements between attorneys and clients). *See also* *Abbott Ford, Inc. v. Superior Court*, 741 P.2d 124, 141 n.26 (Cal. 1987) ("California . . . has never adopted the common law doctrines of champerty and maintenance . . ."); *cf. Martin v. Freeman*, 31 Cal. Rptr. 217, 219 (1963) (statute prohibits champerty by attorneys). *See also* *Fasteau v. Engel*, 240 P.2d 1173, 1174 (Colo. 1952) (doctrines "no longer exist in Colorado," yet statutes prohibit maintenance involving barratry and officious intermeddling). Finally, courts in Ohio have not yet applied what appears to be a statutory abolition of the doctrines. *See* OHIO REV. CODE ANN. § 1349.55 (West 2008); Stephen Gillers, *Waiting for Good Dough: Litigation Funding Comes to Law*, 43 AKRON L. REV. 677, 688-89 (2010).

⁶ Previous articles on the economics of third-party funding of litigation include Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697 (2005); Robert Cooter, *Towards a Market in Unmatured Tort Claims*, 75 VA. L. REV. 383 (1989); Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J. LEGAL STUD. 329 (1987); Paul H. Rubin, *On the Efficiency of Increasing Litigation* (Public Policy Roundtable on Third-Party Financing of Litigation, Searle Ctr., Nw. Univ. Law Sch. Sept. 24-25, 2009), available at www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf; Daniel L. Chen & David S. Abrams, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes*, available at <http://www.duke.edu/~dlc28/papers/MktJustice.pdf>. There are many articles exploring economic aspects of third-party-funded litigation. The Abramowicz, Chen & Abrams, Cooter, Rubin, and Shukaitis articles are distinguishable because they explore the economic issues in more depth than most. For a recent reexamination of Cooter's argument, see Stephen Marks, *The Market in Unmatured Tort Claims: Twenty Years Later* (Bos. Univ. Sch. of Law, Working Paper No. 11-14, 2011).

⁷ Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333 (1982).

where litigation is socially desirable. However, if transaction costs (i.e., bargaining costs) are low, the incentive divergence problem is unlikely to generate welfare-reducing litigation. The reason is that potential victims and injurers will enter into waiver agreements. Another fundamental proposition, countering the incentive divergence proposition, is that in a low transaction cost setting, parties will sign waiver agreements whenever litigation reduces social welfare.⁸

These fundamental propositions regarding the welfare effects of litigation are used to assess the social benefits and social costs of third-party funding and litigation. I examine the implications of third-party funding in the context of “unmatured” legal claims (i.e., legal rights), and for matured claims. Although markets in unmatured claims are not widespread at present, there are examples such as trade in intellectual property rights (e.g., patent trolls) and subrogation agreements by insurers.

Third-party funding enhances social welfare to the extent it can resolve the incentive divergence problem in the presence of high transaction costs between potential injurers and potential victims. There are two obvious scenarios in which this is beneficial. One is where litigation would be socially desirable, but victims do not sue because the cost exceeds the expected award. Third-party funding permits victims to transfer their claims to more efficient litigators, who would then prosecute these claims. The other scenario is where victims bring suit even though litigation is not socially desirable, such as in a setting in which a no-fault regime would be optimal. If transaction costs prevent waiver agreements from being formed between potential future litigants, the third-party funding mechanism (coupled with third-party control) could achieve the same outcome as waivers. In addition to these benefits, third-party funding can enhance welfare by transferring viable claims to more efficient litigators, thus reducing the resources tied up in the litigation process.

These benefits provide a justification for third-party funding and suggest that a total ban would reduce society’s welfare. However, there are costs associated with third-party funding and litigation. The nature and magnitude of the costs depend on the mechanism by which legal rights or claims are transferred to financiers and to litigators. The value of a particular right or claim may be the private information of the victim, which could be a source of inefficiency in a market in which claims are transferred to third parties. The victim may not know the value of his claim or be aware of personal costs associated with its enforcement. The third-party financier might know the type of litigator who will be assigned to the claim but the victim might not—another scenario that is a plausible source of market failure. If transaction costs prevent trades between third-party litigators and potential injurers, an expanded market in legal claims could reduce welfare

⁸ Keith N. Hylton, *Agreements to Waive or to Arbitrate Legal Claims: An Economic Analysis*, 8 SUP. CT. ECON. REV. 209 (2000).

by generating socially undesirable litigation. External costs associated with third-party control of claims could outweigh the benefits from third-party enforcement. And the fact that third-party enforcers gain as the likelihood of injury increases generates yet another potential source of inefficiency. Because enforcers would have a direct interest in seeing more injuries, they may have incentives to reduce the rate of enforcement or to generate new injuries.

I also examine a market in which contingent claims are auctioned to a financier, who then assigns them to enforcers. The bids the financier offers reflect the type of litigator (i.e., enforcer) to whom the financier will assign the claim. When the auction market is efficient, in the sense that it enhances society's wealth, there are still inefficient transfers of legal rights that could occur. If the auction market is inefficient—e.g., because sellers set the wrong prices for their rights—the problem of inefficient transfers of legal rights is even worse.

The goal of this paper is not to say whether third-party funding of litigation is ultimately good or bad for social welfare; that is an empirical question. What it attempts to do is identify, within a consistent framework, the likely sources of welfare gains and losses in a third-party litigation funding system. Identification of the sources of gains and losses should have implications for empirical research and for regulation. Empirical research on the welfare consequences of third-party litigation funding can be improved by taking advantage of developed frameworks for analyzing potential benefits and costs. The other benefit from a theoretical assessment is its implications for the design of a regulatory system. Because third-party funding of litigation can generate welfare gains, a total ban would be difficult to justify. However, because there are costs, an ideal regulatory system would harness the benefits of third-party funding while minimizing the costs. The framework developed here could inform any such effort.

Part I provides a brief background on the legal prohibitions of third-party funding and the theories that have supported those prohibitions. Part II examines the economics of litigation, focusing on the private and social incentives to litigate and to waive the right to litigate. In Part III, I extend the basic economic model of litigation to examine the welfare consequences of third-party funded litigation. I use the model to identify the sources of social benefit and the sources of social cost of third-party litigation funding.

The key analytical contribution of the model in Part III is to move beyond the literature that focuses on third-party funding as a method of risk reallocation or of overcoming liquidity constraints.⁹ Although this article focuses on a model in which actors are risk neutral and legal rights are traded for a lump-sum fee, it also shows that the model includes as a special case the scenario in which a third party funds litigation under a contract that

⁹ See Chen & Abrams, *supra* note 6; Cooter, *supra* note 6; Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367 (2009); Shukaitis, *supra* note 6.

involves an upfront payment plus a damage-sharing agreement. Thus, although the framework below focuses on outright purchase and sale of legal rights, its results apply with equal force to the standard third-party finance contract.

In Part IV, I extend the model again and apply it to the exchange of realized or “matured” claims. Finally, Part V reviews the implications for welfare effects of third-party funding and discusses regulatory issues.

I. PERSPECTIVES ON THE PROHIBITIONS OF THIRD-PARTY FUNDING AND LITIGATION

Conventional third-party funding agreements would fall under the categories of maintenance and champerty, and any business devoted to such funding might be deemed guilty of barratry. Maintenance is simply providing financial or other support to a lawsuit. Champerty is a special type of maintenance in which the third party collects a portion of the judgment. Barratry is the practice of stirring up litigation, and has been described as “a continuing practice of maintenance or champerty.”¹⁰ It follows that maintenance, champerty, and barratry are closely related, as if maintenance were a single act polluting the litigation environment, champerty pollution for profit, and barratry a nuisance-like process of continuing offenses.

Of these practices, Blackstone had harsh words:

Common barrety is the offence of frequently exciting and stirring up suits and quarrels. . . . The punishment for this offence . . . is by fine and imprisonment: but if the offender . . . belongs to the profession of law, a barretor . . . ought also to be disabled from practicing for the future.

Maintenance is . . . an officious intermeddling in a suit that no way belongs to one, by maintaining and assisting either party with money or otherwise This is an offence against public justice, as it keeps alive strife and contention, and perverts the remedial process of the law into an engine of oppression.

Champerty . . . is a species of maintenance . . . being a bargain with the a plaintiff or defendant . . . to divide the land or other matter sued for between them . . . whereupon the champertor is to carry on the party’s suit at his own expense These pests of civil society, that are perpetually endeavoring to disturb the repose of their neighbours, and officiously interfering in other men’s quarrels . . . the Roman law . . . punished by the forfeiture of a third part of their goods, and perpetual infamy.¹¹

But beyond Blackstone’s condemnation, repeated in many court opinions, it is hard to find a competent explanation of the reasons for prohibiting maintenance and champerty. Max Radin argued that the prohibitions were

¹⁰ *In re Primus*, 436 U.S. 412, 424 n.15 (1978).

¹¹ 4 WILLIAM BLACKSTONE, COMMENTARIES *134-35.

enacted to put an end to the practice, adopted by wealthy landowners in Medieval Europe, of funding property lawsuits on behalf of indigent plaintiffs against their wealthy competitors for status.¹² Through funding these lawsuits in return for a share of the land, a landowner could augment his holdings and status.¹³

The plaintiff in *Key v. Vattier*¹⁴ offered another explanation, noting that the rules prohibiting barratry, maintenance, and champerty were imposed after the Norman Conquest and the resulting redistribution of land into parcels doled out to knights loyal to the new government.¹⁵ Statutes became necessary later as land expropriated by force or assumed by the crown (due to forfeiture and escheat) was given to followers and favorites. The plaintiff's theory, which the court rejected, was that the ancient prohibitions on third-party funding resulted from the forceful taking of land and the consequent need to prevent dispossessed victims from seeking redress through the courts.

Jeremy Bentham suggested that the prohibitions were designed to prevent bullying of courts by feudal barons, which implies that they may have served to reduce corruption.¹⁶ Writing in 1787, Bentham argued that the rules were no longer necessary.

The different historical theories provide contrasting pictures of the prohibitions' functions: the traditional view (held by Radin and Bentham) suggests that the prohibitions were needed at one time to put an end to a wasteful form of rent-seeking, while the alternative view (proffered by the plaintiff in *Key v. Vattier*) suggests that they were, from the start, instruments of oppression.¹⁷ That both theories are plausible indicates the difficulty of making a case for a total ban on third-party funding, or, on the other extreme, a laissez-faire approach toward the practice.

¹² Max Radin, *Maintenance by Champerty*, 24 CALIF. L. REV. 48, 58-66 (1935).

¹³ *Id.* Radin's frequently cited critique viewed it as an effort by feudal landlords to maintain their status, and as part of a rearguard action against the development of capitalism.

¹⁴ *Key v. Vattier*, 1 Ohio 132 (1823).

¹⁵ *Id.* at 136-37.

¹⁶ 3 THE WORKS OF JEREMY BENTHAM (DEFENSE OF USURY) 19-20 (Bowring ed., 1843). The statutory prohibitions, sometimes described as declaratory of the common law, began with early laws dating from 1275 to the early 1300s. See George Barker, *Third Party Funding in Australia and Europe*, 8 J.L. ECON & POL'Y 451 (2012). Barker notes that the most important statute (33 Ed. 1, 1305) was part of a suite of laws aimed to suppress corruption in government. The statutes may have played an important role in the formative period of the common law system. The relative advantage of English government in suppressing corruption of government offices may explain the divergence between common law and civil law systems. See Edward L. Glaeser & Andrei Shleifer, *Legal Origins*, 117 Q. J. ECON. 1193 (2002).

¹⁷ One period in modern American history in which the prohibitions were enforced with an oppressive purpose is that of the civil rights litigation in the 1950s. Several southern states amended their barratry laws in order to obstruct civil rights plaintiffs. See Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1287 (2011).

The preferable alternative to both extreme positions is a fine-tuned effort to distinguish the types of third-party funding that are likely to be harmful and the types that are likely to be socially beneficial. The common law had adopted this approach in many states,¹⁸ and as a result, the prohibitions have been narrowed over time.¹⁹ Still, the courts have not even attempted to identify the benefits and costs of third-party funding within a general assessment of the welfare consequences of litigation.

It should be clear that champerty is closely related to the subject of assignment of potential legal claims, that is, assignment of choses in action. The common law in many states permits the assignment of rights to sue for debt or for property.²⁰ The key barrier to assignment can be observed in the case of personal injury, where the law has traditionally prohibited assignment of a chose in action.²¹ Because of this prohibition, the debate over third-party funding should be understood in large part to concern personal torts (such as accidental injury, assault, battery, defamation, and false imprisonment).²² Moreover, the general prohibition of the assignment of personal torts has either been narrowed or effectively repealed in states that have limited or abolished the champerty rule.

II. ECONOMICS OF LITIGATION AND WAIVER

This part will provide a simple formal analysis of the economics of third-party litigation finance. The third-party finance system that I will examine initially is one involving the purchase of unmatured claims—that is, claims that have not materialized. Thus, a potential victim would assign all or a subset of his potential tort claims to a third party. The specific ar-

¹⁸ See *Osprey, Inc. v. Cabana Ltd. P'ship*, 532 S.E.2d 269, 274-77 (S.C. 2000).

¹⁹ See *id.* (describing development of law in South Carolina); see also Paul Bond, *Making Champerty Work: An Invitation to State Action*, 150 U. PA. L. REV. 1297, 1302-04 (2002). One question that has received little attention in the common law development is the difference between criminal penalties and unenforceability rules. Both rules have applied to varying degrees to champerty. However, one liberalizing approach, observed in recent English law, is to abolish the criminal penalties but leave champertous contracts unenforceable. See Andrea Pinna, *Financing Civil Litigation: The Case for the Assignment and Securitization of Liability Claims*, in *NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE* 109, 113-14 (Mark Tuil & Louis Visscher eds., 2010).

²⁰ See, e.g., Bond, *supra* note 19, at 1299.

²¹ *Id.*

²² Indeed, the controversy over third-party funding of litigation focuses on a novel source of incremental funding that may be relatively unimportant in terms of the overall market for litigation finance. Lawsuits are already funded by lawyers who accept contingent fees, though one could view this as form of self-financing by plaintiffs. There is already a large industry in lending directly to personal injury plaintiffs and to law firms. See STEVEN GARBER, *ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWN AND UNKNOWN* 9-13 (RAND Corp. 2010), available at http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf (describing markets in lending to plaintiffs and to law firms).

rangement I will consider is one in which claims are sold to a financier, who then assigns or sells the claims to litigators (or enforcers). The sale of an unmatured claim can be considered equivalent to the sale of a legal right.

However, before I discuss third-party finance of litigation, I will begin with an examination of the economics of litigation and of waiver agreements. The basic results on litigation and waiver will be used later in the paper to shed light on the economics of third-party funded litigation.

I start with a simple model of litigation from Shavell, which contemplates two types of agents: potential victims and potential injurers.²³ For simplicity, I will often refer to the potential victim as “the victim,” and the potential injurer as “the injurer.” I will also use “plaintiff” to refer to the victim at times, and “defendant” to refer to the injurer.

An injurer can take care, which is costly, and thereby reduce the likelihood of injuring a victim. If the victim is injured, he will bring a lawsuit, provided that his expected recovery exceeds the cost of bringing suit. The basic variables in this analysis are as follows:

p = probability of injury if the injurer does not take care.

q = probability of injury if the injurer takes care, $0 < q < p$.

v = loss suffered by the victim if an accident occurs.

x = the cost of care for the injurer.

c_p = cost of litigation for the victim (plaintiff).

c_d = cost of litigation for the injurer (defendant).

In addition to these definitions, I assume that society’s costs when injurers fail to take care are greater than society’s costs when injurers do take care.

$$pv > qv + x. \quad (1)$$

Thus, taking care is socially desirable. It follows that injurers will take care whenever suit is permitted because $pv + pc_d > qv + x + qc_d$. To simplify matters, I will assume strict liability and $v > c_p$, so that the victim will always sue when injured. If I assumed that the rule of negligence applied, all of the results of this model would remain with only minor modifications in the arguments.

The assumption that taking care is socially desirable is equivalent to assuming that enforcement of the law is socially desirable. Although I adopt this assumption as a basic premise to simplify the model’s presentation, my analysis of the economics of litigation does not require it.

I will treat all of the parties as risk neutral. This is a simplifying assumption. In many real-world settings, the victim and the injurer will be risk-averse.²⁴ I set the issue of risk-aversion aside because I want to focus on the incentive consequences of litigation.

²³ Shavell, *supra* note 7 at 334-35.

²⁴ On liability and risk aversion, see Jennifer H. Arlen, *Liability for Physical Injury When Injurers as Well as Victims Suffer Losses*, 8 J.L. ECON. & ORG. 411, 412-15, 422-23 (1992).

A. *Private Versus Social Incentive to Litigate*

Within this framework, Shavell establishes the following result:

Incentive Divergence Theorem: Litigation is socially desirable when the deterrence benefit from litigation exceeds the expected cost of litigation. A lawsuit is privately desirable from the plaintiff's perspective when the expected award exceeds the expected cost of litigation to the plaintiff. Thus, the private incentive to litigate diverges from the social incentive.

The proof of this claim follows from comparing society's costs when litigation is prohibited to its costs when litigation is permitted. When litigation is prohibited, injurers do not take care and the total cost borne by society, on a per capita basis, is pv . When suit is permitted, injurers take care, and society's costs are $qv + qc_d + qc_p + x$. Thus, suit is socially desirable if and only if $qv + qc_d + qc_p + x < pv$ or alternatively

$$(p - q)v - x > q(c_p + c_d) \quad (2)$$

The left-hand side of this inequality is the social benefit from deterrence. It is equal to the injuries avoided by taking care less the cost of taking care. The right-hand side of the inequality is the expected cost of litigation. Thus, if the deterrence benefit exceeds the expected litigation cost, suit is desirable from society's perspective. The final step in the argument is to note that the private incentive to litigate is simply $v > c_p$, which implies that a plaintiff may have an incentive to file a suit that is not within society's interests. If the inequality in (2) is reversed so that the deterrence benefit is less than the total cost of litigation, prohibiting litigation could enhance social welfare—even when a plaintiff wishes to sue.

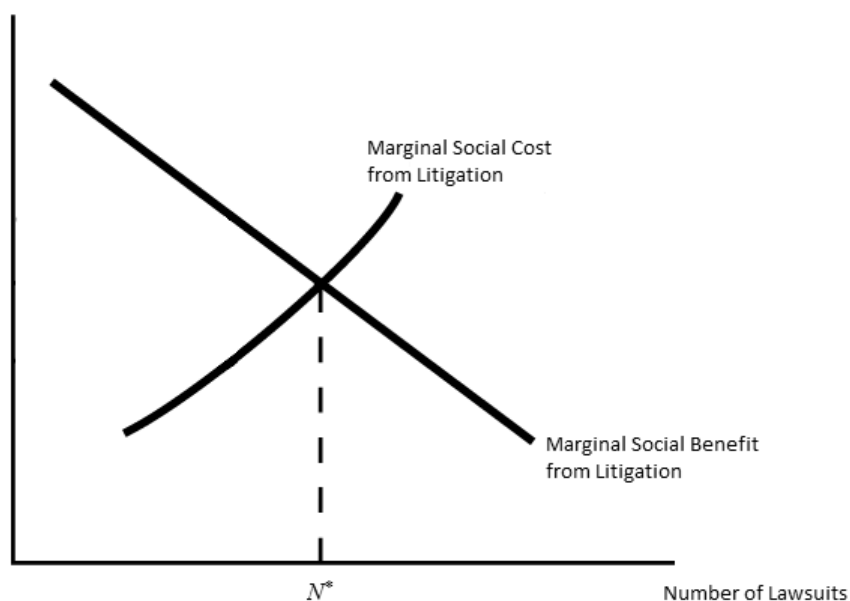
When a plaintiff decides to sue, he thinks only about his own judgment and his own cost of litigating. But the social interest is different because it depends on whether the deterrence benefit from litigation, which is the difference between the losses avoided by taking care and the cost of taking care, is greater than the expected costs of litigation.

In this framework, conditions are uniform among agents. If litigation is socially desirable, then every lawsuit enhances society's wealth, and if litigation is not socially desirable, then every lawsuit reduces society's wealth. The uniformity assumption makes the analysis simple, but it is not a realistic description of litigation.

If we introduce heterogeneity (for example, in the size of the victim's loss or in the cost of taking care) to this framework, we observe diminishing returns to litigation. The first lawsuit may be worthwhile in terms of the deterrence benefits it brings to society, but the one hundredth lawsuit may be undesirable. Because of diminishing deterrence returns, there is likely to be an optimal number of lawsuits. Moreover, if the total cost of litigation rises as more lawsuits are filed—for example, because of court congestion—then there may be an optimal number of lawsuits even if the uniform-

ity assumptions regarding care and accident injuries are maintained. The result is depicted in Figure 1, which shows that there is a frequency of litigation (e.g., number of lawsuits per year) where the marginal social benefit from litigation (based on deterrence benefits) is just equal to its marginal social cost (based on litigation expenses).

FIGURE 1. OPTIMAL FREQUENCY OF LAWSUITS



Any proponent of an expansion in litigation should consider whether the rate of litigation is below or above N^* , the optimal frequency of lawsuits. The prospect that an expansion of third-party funded litigation could bring forth more lawsuits does not indicate whether social welfare would be enhanced by such a change. Indeed, Rubin has argued that the rate of litigation in America is probably beyond the optimal frequency, given the widespread acceptance of contingency fee arrangements and class action lawsuits.²⁵ This is an empirical question that I will not attempt to answer here. My focus is on identifying the reasons third-party finance may or may not enhance social welfare.

²⁵ Rubin, *supra* note 6, at 8-9. One important factor weighing in favor of Rubin's argument is that class actions and third-party enforcement cases will often involve claims that would be unprofitable for the victim to assert. In the American litigation environment, those claims are brought forward today under the class action device. Introducing third-party funding and enforcement would not be necessary to bring such claims into court. Indeed, lawyers might prefer to use the class action device rather than purchase claims in order to enforce vicariously.

B. *Low Transaction Costs*

The Incentive Divergence Theorem discussed in Part A does not take into account the possibility of litigation waivers. A litigation waiver is an agreement between a potential victim and a potential injurer in which the victim agrees not to bring suit if he is injured by the injurer. If transaction costs (i.e., the costs of bargaining over and reaching an agreement) are low, potential victims and potential injurers may be able to enter into waiver agreements.

The failure of the Incentive Divergence Theorem to take such waivers into account may be defensible under certain conditions. There are settings in which potential victims and potential injurers cannot identify each other *ex ante*—i.e., before the accident. In those settings, it would be impossible for litigation waiver agreements to be exchanged *ex ante*; transaction costs are too high. However, there are also settings where potential litigants have opportunities to exchange litigation waivers. Consider, for example, places where buyers and sellers of services constantly interact, such as the workplace. Litigation waivers may be observed in these low transaction cost settings. Alternatively, consider a firm's decision to sell a patent to its potential infringer or someone who is unlikely to enforce the patent—such a sale would be equivalent to waiving the right to sue for patent infringement.

If transaction costs are sufficiently low so that litigation waivers are easy to exchange, the Incentive Divergence Theorem will no longer hold. The reason is that litigation waivers will be traded whenever the social benefit from a lawsuit is less than its social cost. To see this, return to the model described earlier. Suppose the victim can sell his right to sue to the injurer. What price will he set on that right?

If he sells the right to the injurer, the injurer will no longer take care. Thus, the victim can expect to suffer the harm pv after selling the right. However, selling the right permits him to forgo the expense of suing, which is worth qc_p . He also forgoes the compensation he would receive for any injuries that occurred when he possessed the right to sue, but that compensation merely offsets the injuries suffered by accidents. This implies that the minimum price asked by the victim to waive his right to sue is

$$pv - qc_p. \quad (3)$$

What is the maximum offer price that the injurer will pay for the waiver? By purchasing the waiver, the injurer avoids the cost of taking care as well as the cost of litigation and compensation. It follows that the maximum price the injurer will offer for a litigation waiver is

$$x + qv + qc_d. \quad (4)$$

The injurer and victim will therefore sign a litigation waiver agreement only when $pv - qc_p < x + qv + qc_d$, which is equivalent to $(p - q)v - x < qc_d + qc_p$, the same condition under which litigation is socially undesir-

able (2).²⁶ The efficiency gain from waiving litigation is $q(c_d + c_p) + x - (p - q)v > 0$. This proves the following proposition:²⁷

Litigation Waiver Theorem: Litigation waivers will be exchanged when and only when the deterrence benefit from litigation is less than the expected total cost of litigation. Thus, if transaction costs are low, socially undesirable litigation will not be observed.

The Litigation Waiver Theorem has implications for arbitration agreements as well as waiver agreements. In some circumstances an arbitration agreement may serve the same purpose or have the same effect as a waiver agreement. Suppose, for example, that the victim agrees to resolve all disputes with the injurer in an arbitration forum that is obviously biased in favor of the injurer. In this case the arbitration agreement operates in effect as a waiver. Waiver and arbitration agreements can enhance society's wealth by reducing the frequency of wealth-reducing litigation. Moreover, the Litigation Waiver Theorem implies that such agreements are likely to be observed in those settings in which litigation reduces society's welfare.²⁸

There are issues of information and disclosure that could stand in the way of the efficiency implications of the Litigation Waiver Theorem. For example, a potential victim might sign a waiver agreement without realizing its scope. Alternatively, a potential victim might sign an arbitration agreement without realizing that it is effectively a waiver agreement. These features could lead to inefficient waivers. However, these are general issues of contract acceptance. They do not, without more, justify a ban on

²⁶ Recall that I have assumed that a strict liability rule applies in order to simplify the analysis. If the negligence rule applies, the analysis changes a bit, but the conclusion remains the same. Under negligence, if the potential victim agrees to a waiver, he knows that the potential injurer will not take care, so the expected cost to the potential victim is pv . If the victim did not agree to a waiver, then his expected cost is equal to $qv + qc_p$. This reflects the assumption that the victim would sue the injurer and lose because the injurer, having taken care, would not be found negligent. Under these assumptions, the injurer would be willing to pay a maximum of $x + qc_d$ for a waiver. Waivers will therefore be exchanged when the potential legal claim is inefficient. If I assume, instead, that the victim observes the injurer's care level and decides not to sue under negligence, then there would be no litigation costs to consider in this analysis.

²⁷ Hylton, *supra* note 8, at 221.

²⁸ I have not considered the case of dormant legal rights—that is, the case where $v < c_p$. When litigation would be unprofitable, the victim will not sue. Given this, the injurer would not have an incentive to take care. In the zero transaction cost setting, the victim would be willing to pay $(p - q)v$ for the injurer to take care. The injurer loses only x by taking care. Thus, whenever $(p - q)v > x$, a contract will be arranged in which the potential victim purchases care from the potential injurer. Indeed, if transaction costs are zero, the victim and injurer will contract for optimal care and litigation will not be necessary in any event. I am assuming in this framework that transaction costs can be sufficiently low for a waiver agreement to be formed, and at the same time too high for the parties to contract directly over the level of care.

waiver or arbitration agreements. However, they do justify an effort on the part of courts to distinguish genuine agreements from agreements based on fraudulent representations.

C. *Example*

The framework described so far can be summarized with an example that illustrates its applicability as well as some of its limits. Suppose a ski resort has a choice whether to adopt additional precautions to reduce the risk of injury to skiers or offer them an option to waive tort liability in exchange for a reduction in the price of a season ticket. The precautions will cost the resort \$40 per skier in a season.²⁹ If the ski resort takes no steps to enhance safety, the likelihood of an injury during the season to the typical skier is 75%. If the resort adopts precautions, the likelihood of an injury is 25%. The expected harm from an injury is \$100. Suppose, in addition, that the cost of litigation (taking settlement rates into account) is \$60 for the skier (victim) and for the ski resort (injurer). If a skier is injured, he would have an incentive to sue the resort because he would net \$40 from the lawsuit. What is the minimum amount by which the season ticket would have to be discounted to get the skier to accept a tort litigation waiver? How much would the ski resort be willing to discount the season ticket price in exchange for a waiver?

Litigation would be inefficient in this example because the deterrence benefit is less than the expected total cost of litigation. On the other hand, the threat of litigation would, in the absence of any waivers, induce the ski resort to pay for additional precautions.

The skier would be willing to waive his potential tort claims against the resort if the resort discounted the entrance price by $(.75)(\$100) - (.25)(\$60) = \$60$. The resort would be willing to discount the season ticket price by the amount it saves from avoiding tort suits, which includes the savings from not paying for additional precautions. The maximum amount that the resort would be willing to discount the ticket price by is equal to the sum of the per-skier season precaution cost (\$40) and the cost of a tort suit $((.25)(\$100 + \$60))$; thus, the maximum discount is \$80. Because the resort gains \$80 from the waiver and the skier loses \$60 from the waiver, there is room for a welfare-enhancing litigation waiver provision in the season ticket contract. In view of the savings from the inclusion of a waiver provision, competition would cause ski resorts to include such a provision as the default.

²⁹ To avoid issues generated by the public-good nature of care, I will assume in this example that the precautions can be limited to an individual skier. If precaution is a public good, in the sense that providing it for one means that it is effectively provided for all, then it is possible to have socially inefficient waivers.

Because the cost of transacting is low in this example, the waiver agreement enables the parties to avoid inefficient litigation. However, some cases will raise questions as to whether the injury is the type that should be understood to have been covered by the waiver clause. Some injured skiers will argue that they never understood or even noticed the waiver clause. In light of these issues, some courts may refuse to enforce the waiver agreement.³⁰

III. THIRD-PARTY FINANCE OF LITIGATION

The type of third-party finance I will examine initially is the purchase of unmatured legal claims. An example would be a third party who purchases a potential victim's right to sue before any claim arises. Under such an agreement, the third party would have the right to sue on behalf of the real victim and collect all or some share of the damages awarded to the victim. The third party would also have the right to waive the victim's future legal claims.³¹

To offer a concrete example, suppose the third-party enforcer is an insurance company, as Cooter proposes.³² Under a system in which unmatured claims are transferable, the insurance company could purchase the potential claims and then prosecute them when an injury occurs (as insurance companies do already in subrogation actions) or waive them immediately in exchange for a payment from the potential injurer (or the potential injurer's liability insurer). In a setting in which lawsuits are extremely costly and have a negligible deterrence effect, numerous waivers would be observed.

Because the third-party enforcer will acquire the contingent legal claim of a victim, the contract between the victim and the third party will typically specify some combination of up-front payment for the legal claim and perhaps some portion of the damage award that will be shared between the enforcer and victim. The up-front payment need not be positive; the contract could involve the victim paying the enforcer to take control of the victim's future claims. The size of the up-front payment will depend on the litigation expenses the enforcer will bear and the share of damages passed on to the victim.

³⁰ See, e.g., *Dalury v. S-K-I Ltd.*, 670 A.2d 795 (Vt. 1995).

³¹ One could imagine an alternative system in which third parties gain ownership of potential claims but without control. In such a system, third-party funding would be just a system of risk reallocation. A securitization market in which financiers were unable to exercise control over the allocation of rights of action would serve this function. The benefits of risk reallocation as a justification for third-party funding have been thoroughly explored in the literature, though without formalization.

³² Cooter, *supra* note 6, at 385.

There are four parties in this analysis: the potential victim, the potential injurer, the claim purchaser (financier), and the claim litigator (enforcer). I have separated the financier from the enforcer to isolate their potentially different functions in a third-party finance scheme. However, for the most part, I will treat the third-party financier and the enforcer as a single entity; references to one should be taken generally as references to the other. Where their functions differ, it is noted.

The first step in examining third-party litigation finance is the analysis of waiver agreements to discover their implications for third-party agreements. At first, the two types of agreement seem to be entirely different. A waiver involves discarding legal claims in exchange for compensation from the potential defendant. Third-party financing of immature claims, on the other hand, involves selling legal claims to be enforced at the discretion of a third party.

A closer look, however, reveals the similarity between waiver and third-party funded litigation. A waiver involves the sale of a legal right to the potential injurer. A third-party finance agreement covering an unmatured claim involves the sale of a legal right to a third party. The third-party purchaser could be the alter ego of the potential injurer, in which case a litigation finance agreement operates effectively as a waiver. Alternatively, the third-party purchaser could act with the same interest and zeal as the victim himself. These two cases—sale to the alter ego of the injurer and sale to the alter ego of the victim—represent the two endpoints on the spectrum of outcomes that could be observed in a third-party litigation finance system.

A. *Asking Prices for Legal Rights*

Consider the incentives of a potential victim to sell his unmatured claim to a third party. If the potential victim sells to the alter ego of the potential injurer, the victim will demand the same price that he would ask of the injurer, that is, $p_v - q_{c_p}$. The victim knows that if he sells his claim to the alter ego of the potential injurer, the injurer will no longer take care, so the victim will suffer the same costs as if he had relinquished his potential legal claims to the injurer.

If the potential victim sells his claims to someone who enforces with the same zeal that the victim would—that is, to the victim's own alter ego—the result would be that the potential injurer would take due care and there would be no increase in the risk of harm to the victim. The key gain to the victim would be avoiding future litigation costs, as those costs would be borne by his alter ego enforcer. Given this, there is room for the alter ego to profit from such an exchange if the alter ego's litigation expenses are lower than the victim's expenses.

This description of the victim's price-setting incentive is arguably incomplete because it does not take into account the damage-sharing ar-

rangement that the third-party financier might demand. The third-party financier may offer a contract in which he takes part of the damage award in exchange for a smaller up-front transfer.³³ However, I will assume that the contracts involve only an up-front payment for the victim's legal right, with the financier taking the entire damage payment.

The model could be made more complicated by allowing for a damage-sharing arrangement, as shown in the Appendix, but the additional complications do not change the fundamental results of this model. In this model, incentives to trade legal rights are unaffected by the financing arrangement—whether it is an up-front payment or the combination of up-front payment and damage sharing. For this reason, it is appropriate in this model to treat the third-party finance contract—which typically involves a combination of up-front payment and damage sharing—as a special case of a contract that trades a legal right.

The most obvious real-world example of an alter ego enforcer is the insurance company. If the insurance company is viewed as the victim's alter ego in litigation, then one can understand why potential victims would purchase insurance, even if they are not risk-averse. Consider, for example, a health insurance firm. When the victim is injured, the insurance firm pays off the victim's medical expenses and brings a subrogation action against the injurer. In the subrogation action, the health insurance firm serves as the third-party enforcer for the victim.³⁴ The insurance firm combines the

³³ One important feature of this arrangement is that the risk preferences of the victim and of the financier will determine the optimal levels of the up-front payment and the division of the damage award. If the victim is the more risk-averse party, the contract will generate a relatively larger up-front payment and a relatively small amount of damages. Although the focus of this text is on the incentive effects of third-party funding, it is important to note that the financing arrangement alone can provide efficiency gains to society. Traditional litigation markets involve standardized award-splitting arrangements under contingency fee contracts. The third-party financing system permits the financier to structure a contract that allocates risk optimally between the parties. Shukaiitis, *supra* note 6, at 339-41, notes that risk can be allocated in a superior manner through the sale of tort claims. See also Cooter, *supra* note 6, at 385, 387. As most victims are likely to be risk averse in comparison to the financier, most contracts should specify a relatively large up-front payment and a correspondingly small amount of shared damages. For a proposal for third-party financing limited to the sharing of the risk associated with mature legal claims, see Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champertons or a Market for Champerty?*, 71 CHI.-KENT L. REV. 625 (1995).

³⁴ The analogy is not perfect. The insurer can sue only for the medical expenses it has incurred, not for the total injury to the victim, which may be greater than the medical expenses. Substantial efficiency gains in litigation, as well as enhancements in deterrence, could be secured by permitting medical insurers to contract with their customers to bring subrogation actions for the entire damage award. See Kenneth S. Reinker & David Rosenberg, *Unlimited Subrogation: Improving Medical Malpractice Liability by Allowing Insurers to Take Charge*, 36 J. LEGAL STUD. S261 (2007). Another difference between the "unlimited subrogation" system of Reinker and Rosenberg and a system of complete third-party control is that in the latter system, a third-party who owns a set of claims could choose to waive them. Thus, a medical insurer could act as an intermediary that provides insurance to the customer and, if conditions indicate, waives their potential legal claims. The medical insurer could offer customers a choice to either have their claims litigated in a future subrogation action or waived up

services of insurance and litigation. Another real-world alter ego enforcer is the patent troll. Patent owners transfer their rights to trolls because trolls are more efficient enforcers.

These two extreme cases—injurer alter ego and victim alter ego—suggest there is a way to formally analyze the incentives to sell to a third party. Assume the victim can sell his legal claim to either the injurer's alter ego or his own. Let δ represent the probability that the victim sells to the injurer's alter ego and $1 - \delta$ the probability that the victim sells to his own alter ego.

With these terms in mind, the price a victim would demand in order to sell his legal right or claim to a third party is

$$\text{Asking price} = \delta p_v + (1 - \delta)q_v - qc_p \quad (5)$$

Consider first the case where the legal right is offered to the injurer's alter ego. In the *injurer alter ego* case ($\delta = 1$), the *asking price* is:

$$p_v - qc_p \quad (6)$$

If the asking price is positive, the victim will demand a payment from the injurer–alter ego enforcer in order to sell off his potential claim. In the case of a negative asking price, the victim would be willing to pay the financier to take control of his future legal claim.

Now consider the other extreme, where the third-party financier–enforcer is the victim's alter ego. In the *victim alter ego* case ($\delta = 0$), the *asking price* is

$$q_v - qc_p \quad (7)$$

The victim's alter ego threatens the injurer with a lawsuit if the injurer causes an injury to the victim. Given this, the injurer takes due care and the frequency of injury is consistent with caretaking rather than carelessness.

B. *Offer Prices for Legal Rights: Incentives of Third-Party Financier-Litigators*

How much will a third-party enforcer pay for a legal claim? As the foregoing discussion indicates, the offer price of the enforcer will depend on his incentives, specifically, whether the enforcer will act with the same zeal as the victim and sue for damages or pursue the same goals as the injurer and drop the claim. If the third-party enforcer behaves in the victim's interest, the price he will offer for the victim's claim will depend largely on the degree to which he is a more efficient enforcer than the victim. As the victim gains in this case by unloading enforcement costs onto the third-party enforcer, the enforcer gains only if he is a more efficient enforcer.

front. If waiver is the efficient option, the medical insurer would offer the lowest price for insurance to customers who choose to waive their potential tort claims.

The opposite extreme to consider is where the third-party enforcer pursues the same goals as the injurer. In this case, the third-party enforcer may be willing to pay a premium that reflects the precaution and litigation cost savings that will accrue to the injurer. However, this is a more complicated case to consider than where the third-party enforcer is the victim's alter ego.

I will start with the simpler case, where the enforcer is the victim's alter ego and the victim knows this. Let c_e be the litigation cost of the third-party enforcer. The enforcer's offer price will be less than or equal to the profit the enforcer earns from holding the claim; thus, *the offer price when the enforcer is the alter ego of the victim is*

$$qv - qc_e.$$

Now consider the third-party enforcer who is the injurer's alter ego. The third-party enforcer's acquisition of the legal right means that the claim will be dropped and the injurer will not have an incentive to take care. Because the third-party enforcer is the injurer's alter ego, he benefits as much as the injurer by not having to pay damages. Thus, *the offer price set by the alter ego of the injurer is*

$$x + qv + qc_d.$$

C. A Spot Market in Legal Rights: Low Transaction Cost Case

To examine the properties of a contingent legal claims market where third parties fund litigation by purchasing rights, the simplest type of market to examine is one where victims know precisely the type of enforcer to whom they are selling their claim. There are no transaction costs to exchanging legal rights in this market.

In terms of the model, the low transaction cost assumption implies that each victim knows whether the probability that he is facing an injurer alter ego is equal to zero or is equal to one. In examining the sale of legal claims, this analysis treats victims as homogeneous and assumes that the enforcer can observe the potential injuries they might suffer as well as the relevant probabilities of the injury occurring.

1. Selling Legal Rights to Third Parties

First, consider the sale of a legal right to the victim's alter ego. Because the victim is assumed to know that $\delta = 0$, and the profit earned by the third-party enforcer is $qv - qc_e$, an arrangement in which the third-party enforcer purchases the victim's unmatured claim will occur when

$$qv - qc_p < qv - qc_e,$$

or, equivalently, when $c_e < c_p$. Thus, *when the third party acts as the alter ego of the victim, victims will sell their legal claims to the third parties when and only when the third parties are more efficient litigators than is*

the victim. Such transfers will enhance social welfare by permitting legal rights to be enforced at a lower cost.

Third-party enforcers could be more efficient litigators for several reasons. First, they may have superior skill in detecting legal violations and gathering evidence of violations. Second, because they are repeat players in litigation, they may be superior monitors and managers of attorneys. Third, third-party enforcement may offer superior alignment of interests between litigators and victims (i.e., lower agency costs). As owner of the victim's claim, the third-party enforcer has optimal incentives to invest in litigation. Risk aversion and liquidity constraints, two problems that constrain ordinary plaintiffs from pursuing claims, can be eliminated as factors by transferring ownership of potential claims.

The insurance company, as a third-party enforcer, employs the skills that it develops in the course of identifying and evaluating compensable claims in determining the cause and the severity of injury for litigation purposes.³⁵ The insurance company, as a repeat player in litigation, is also likely to be a better monitor and manager of plaintiffs' attorneys than the typical accident victim.³⁶ The patent troll has an advantage over the typical patent holder in monitoring for instances of possible infringement, responding with credible threats of litigation,³⁷ and managing attorneys. These advantages make it possible for a substantial market to exist in which victim alter egos acquire and enforce legal rights.

Next, consider the sale of legal rights to the injurer's alter ego where the victim knows that this is the case ($\delta = 1$). The third-party enforcer's acquisition of the legal right means that the claim will be dropped and the injurer will not have an incentive to take care. Because the third-party enforcer is the injurer's alter ego, he benefits as much as the injurer by not having to pay damages. The victim will sell to the third-party enforcer when

$$pv - qc_p < x + qv + qc_d,$$

which is the condition under which the Litigation Waiver Theorem holds. *Thus, when the third party acts as the alter ego of the injurer, the victim will sell his potential claim to the third party when and only when litigation would be socially undesirable.*

³⁵ For example, a medical insurer is likely to be far better at detecting and procuring evidence of medical malpractice than is the typical plaintiff's attorney. See Reinker & Rosenberg, *supra* note 34, at S272. The medical insurer will also have an advantage in assessing the severity of loss in connection to malpractice.

³⁶ Reinker & Rosenberg, *supra* note 34, at S273-74.

³⁷ The supply of a credible threat of litigation is probably the most important function of the patent troll. See, e.g., James F. McDonough III, Comment, *The Myth of the Patent Troll: An Alternative View of the Function of Patent Dealers in an Idea Economy*, 56 EMORY L. J. 189, 203-04 (2006). In the absence of a credible threat of litigation, no one has an incentive to respect a patent. Patent holders—especially individual inventors—are unlikely to present credible threats to potential infringers.

Suppose the victim alter ego and the injurer alter ego both are in the market for legal rights at the same time. If the victim alter ego purchases the victim's claim, would he then turn around and sell it to the injurer alter ego? Only if the claim is inefficient, meaning that the deterrence benefit from enforcement is less than total litigation cost. For example, if the victim alter ego were to sell to the injurer alter ego, he would have to set the price at a level that reflects the fact that the injurer would not take care after the claim was transferred to the injurer alter ego. This implies that the victim alter ego would set an asking price of $pv - qc_e$. Now, a mutually beneficial exchange between the victim alter ego and the injurer alter ego occurs only if

$$pv - qc_e < x + qv + qc_d.$$

Thus, the victim alter ego enforcer would sell his potential claim to the injurer alter ego enforcer only if enforcement (litigation) would be inefficient.

Given that both the victim alter ego and the injurer alter ego are in the market for legal claims, who would bid the highest? If the victim knows the type of enforcer who seeks to purchase his claim, the victim will set one price for the victim alter ego and another price for the injurer alter ego. Because the victim sets different prices, he will be tempted to sell to the enforcer who offers the greatest surplus over his minimum asking price. The surplus offered by the victim alter ego enforcer is the potential litigation-cost efficiency gain, $q(c_p - c_e)$. The surplus offered by the injurer alter ego enforcement is equal to the efficiency gain from waiving litigation, $q(c_d + c_p) + x - (p - q)v$. It follows that *the injurer alter ego will outbid the victim alter ego for ownership of the victim's legal right only if the efficiency gain from waiving litigation exceeds the efficiency gain from cheaper litigation*. In terms of the model, this means that

$$q(c_p - c_e) < q(c_d + c_p) + x - (p - q)v.$$

These results have immediate implications for dormant legal rights—that is, rights that are unlikely to be enforced. In the model examined in the previous parts, I assumed victims would assert their legal claims, but this assumption may not be true. Some legal rights are dormant because the cost of litigation for the right exceeds the likely value of the judgment ($v < c_p$).³⁸ In the full information market examined here, those rights may be traded to third-party enforcers who are more efficient litigators. When en-

³⁸ Suit may be unprofitable to the victim for several reasons. First, the monetary expenses of litigation may exceed the award. Second, the award may be so far delayed that the victim is led to discount the value of the award to a small and unprofitable amount. This is equivalent to increasing the cost of prosecuting a claim. Third, the victim may be risk-averse, which effectively increases the cost of litigation. Shukaitis, *supra* note 6, relies on these factors to support his argument in favor of selling rights of action to third parties.

forcement is inefficient, the third-party enforcers will sell their claims to potential injurers.³⁹

The conditions under which dormant legal rights will be traded and enforced are as follows:

$$c_e < v < c_p$$

$$(p - q)v - x > q(c_d + c_e)$$

These conditions imply that the claim is unprofitable to the victim, but profitable to the third-party enforcer. In addition, suit by the third-party enforcer would be efficient.

This discussion implies that in the one-on-one spot market in which legal rights are sold to third-party enforcers, such rights will be sold either to real enforcers (victims' alter egos) or injurers' alter egos. If enforcement of rights is socially desirable, the victim alter ego enforcers (e.g., insurance company or patent troll) will be the highest bidders. If enforcement of rights is inefficient, the injurer alter egos will be the highest bidders, as long as the efficiency gain from waiving the right is greater than that from cheaper litigation. When injurer–alter ego enforcers acquire victim rights, they will extinguish them.

I have assumed that victims are all the same in this discussion. If victims differ, so that litigation would be efficient for some but inefficient for others, the implications of this analysis remain intact. Suppose, for example, half of the potential victims will suffer such small injuries that litigation would be inefficient. The other half of victims suffers large injuries that make litigation efficient. In the efficient spot market examined here, the small-injury victims would sell their claims to injurer–alter ego enforcers and the large-injury victims would sell their claims to victim–alter ego enforcers.

2. Examples

Medical Insurer Example: Return to the ski resort hypothetical from Part II.C. The skier has a medical insurer that charges an actuarially fair price for insurance. If the insurer's administrative cost amounts to \$1 per ski season, the actuarially fair price for a season of insurance is \$26, assuming all of the potential injury losses are medical expenses. Suppose the cost of litigation for the insurer is \$20, only a third of the cost of litigation for the skier (\$60). How much will the medical insurer discount the price of insurance if it subrogates the skier's potential tort claim? How much will the medical insurer discount the price of insurance if it sells the potential claim to the ski resort?

By subrogating the skier's potential tort claim, the medical insurer gets a benefit of $(.25)(\$100 - \$20) = \$20$. Thus, the medical insurer, if it choos-

³⁹ On the divergence of private and social incentives to litigate, see Shavell, *supra* note 7.

es to subrogate, should be willing to discount the price of a season of insurance by as much as \$20. A competitive market for medical insurance should drive the per-season price down to \$6.

However, litigation is still inefficient in this scenario. The deterrence benefit from litigation is $(.75 - .25)(\$100) - \$40 = \$10$. The expected total cost of litigation under the subrogation agreement is $(.25)(\$60 + \$20) = \$20$. As the expected total cost exceeds the deterrence benefit, selling the skier's potential tort claim to the resort can enhance welfare.

The resort is willing to purchase the skier's potential tort claim for \$80. The medical insurer would sell the skier's potential claim for \$20. If the medical insurer sells the tort claim to the resort for more than \$50, it would be able to offer free medical insurance to the skier and still make a profit. Moreover, questions concerning the scope of the waiver are more likely to be addressed at the contracting stage in this scenario than in the case where the skier enters into a waiver agreement directly with the ski resort.

Patent Troll Example: Suppose an inventor has a patent on an invention that potentially guarantees an income of \$100 through use or licensing. A corporation happens to be developing a functionally equivalent invention. The corporation has a choice of whether to invest \$40 in searching prior patents to ensure that it does not infringe the inventor's patent. If the corporation does not search, the probability it will infringe the patent is .75. If the corporation searches, the probability of infringement is .25. Suppose the cost of litigation for both the inventor and the corporation is \$120 each.

Although the inventor has a patent, he will not sue to enforce because the damage award is at most \$100 and the cost of litigation is \$120. This is a plausible and probably common scenario because part of the cost of litigation for the inventor is the opportunity cost of his time, which could be devoted to working in his laboratory rather than pursuing infringers in court. Indeed, the social cost of the inventor's time may far exceed the out-of-pocket expenses of litigation.

If the inventor could credibly threaten to enforce, the corporation would conduct a search. The corporation would do so because the cost to the corporation if it searches is $\$40 + (.25)(\$100 + 120) = \$95$, and the expected liability to the corporation if it does not search is $(.75)(\$100 + \$120) = \$165$. But in the absence of a credible threat to enforce, the corporation will not search among the previous patents. Unlike the ski resort example, the injurer in this case has no incentive to take care (i.e., search), even though care is socially desirable. Because the inventor cannot credibly threaten to sue, the value of the patent to him is equal to the potential income discounted by the probability of infringement, \$25.

Suppose that a patent troll approaches the inventor and the troll's cost of litigation is \$20. Because the troll's threat to litigate would be credible, the troll would be willing to pay as much as $(.25)(\$100 - \$20) = \$20$ for the inventor's potential infringement claim. In a sense, the troll would subro-

gate the owner's infringement claim. The inventor would be willing to sell the right to sue for infringement for any positive price, as it is worthless to him in the absence of a credible threat to litigate.

Once ownership of the infringement suit right is gained, the troll could hold on to it or sell the potential claim to the potentially infringing corporation. The corporation would be willing to pay as much as \$95 for the potential claim. The efficient outcome is the one in which the troll sells the claim to the corporation. This is a transaction that would be unavailable to the inventor because his threat to litigate is not credible.

An alternative contract between the inventor and the troll could involve the inventor selling the patent entirely to the troll, which is probably more common in reality. I examined a more limited contract in which the inventor sells only his potential infringement claim, primarily because that is easily comparable to the ski resort example considered earlier. However, in many real world settings, the litigation rights connected to the patent constitute the most valuable feature of the patent. Given this, my initial assumption that the troll purchases only the litigation rights from the inventor may accurately capture the essential features of transactions among inventors and trolls in many real world instances.

If the inventor sells the entire patent to the troll, he would demand a price of at least \$25. The value of the patent to the troll is equal to the associated income stream, discounted by the probability of infringement—given credibility of enforcement—plus the value of the tort claim in the event of infringement: $(.75)(\$100) + (.25)(\$100 - \$20) = \95 . As the patent is more valuable in the troll's hands than in the inventor's hands, the troll may choose to purchase the patent from the inventor rather than purchase the right to sue for infringement.

D. *Transaction Costs*

The efficient market examined in the previous part may not be observed if transaction costs make it difficult to arrange trades. I will assume here that third-party enforcers cannot sell rights directly to injurers. In other words, victims cannot exchange rights with injurer–alter ego enforcers who would waive them on behalf of injurers.

If claims cannot be sold to injurer–alter ego enforcers, then they will all end up in the hands of victim–alter ego enforcers—insurance companies, for example. As a result, all claims will be enforced, even those whose enforcement is not socially desirable.⁴⁰ In addition, because claims will be

⁴⁰ The following conditions describe this scenario: $(p - q)v - x < q(c_p + c_d)$ (victim's potential claim inefficient), $qv - qc_e > 0$ (claim profitable to enforcer), $(p - q)v - x < q(c_d + c_e)$ (enforcer's suit inefficient).

transferred from victims to more efficient enforcers, some dormant rights will also be transferred and enforced.

This is a plausible and important type of market failure for several reasons. First, once a third-party enforcer acquires a victim's rights, he may have difficulty finding the potential injurer or negotiating a waiver agreement. For example, the medical insurer may not be able to identify the potential injurer—or the potential injurer's insurer—if the potential injury is a traffic accident. Alternatively, even if the third-party enforcer can identify the potential injurer, they may be unable to negotiate an efficient waiver agreement—because of externalities among affected parties or informational asymmetry.

Second, there may be informational gaps between the victim and the enforcer that result in divergent enforcement incentives. If the victim could negotiate directly with the injurer, he may choose to waive his right. But the enforcer may have incentives that differ from the victim's and the enforcer may choose to enforce the right even when enforcement is inefficient.

When transaction costs prevent third-party enforcers from transferring potential claims to injurers, enforcement will be socially excessive. Dormant legal rights will be purchased and enforced by third-party enforcers, perhaps to the point of eliminating instances in which rights that could be efficiently enforced remained dormant. But rights that would be inefficient to enforce could not be extinguished by contract.

Patent Troll Example: Return to the example of Part III.C.2. For the inventor, the value of the right to sue for infringement is equal to zero because the anticipated damage judgment would be less than the inventor's cost of litigation. Hence, the inventor would not sue and any threat on his part to sue would not be credible. For the patent troll, the value of the right to sue for infringement is $(.25)(\$100 - \$20) = \$20$. The potentially infringing corporation would purchase the right from the patent troll for any price less than \$95. Litigation in this setting is inefficient because the potential infringer could easily buy out the troll's potential claim. But if transaction costs prevent such a transfer from taking place, the troll will sue for infringement and litigation will occur.

Social welfare could be enhanced by a rule barring the inventor from selling his potential claim to the troll.⁴¹ However, this conclusion relies in part on this framework's focus on the welfare consequences of litigation. A broader perspective would consider the innovation incentives provided by patents. If the inventor were prevented from contracting with the troll, the value of the inventor's patent would be \$25. If the inventor were permitted to contract with the troll, the value of the inventor's patent would rise to as

⁴¹ This example could explain the empirical findings of the Bessen, Ford, and Meurer study of patent trolls. James E. Bessen et al., *The Private and Social Costs of Patent Trolls* (Bos. Univ. Sch. of Law, Law & Econ. Research Paper No. 11-45), available at <http://ssrn.com/abstract=1930272>.

much as \$95—the sum of \$75 and the value extracted from selling the infringement suit right to the troll. Even though litigation by the troll would be inefficient, the inventor’s payoff from innovation would be greater. Therefore, the innovation benefits from transacting with trolls could outweigh the welfare losses generated by their litigation.

E. *Mistaken Beliefs*

In addition to transaction costs, another source of inefficiency is mistaken beliefs. Victims might mistakenly believe that all claims would be allocated to real enforcers—rather than to the injurers—and therefore sell their claims too cheaply.⁴²

Suppose victims assume that a third-party financier will allocate their claims to a real enforcer or an injurer—in accordance with their shares of the population of enforcers—but in actuality, the claims are allocated only to injurers. Now exchange would occur when

$$\delta pv + (1 - \delta)qv - qc_p < x + qv + qc_d$$

which is equivalent to

$$\delta(p - q)v < x + qc_d + qc_p.$$

Thus, there may be instances in which victims who would not sell to injurers (because their asking prices exceed the injurers’ offer prices) choose to do so because they mistakenly assume that the rights will be allocated to a real enforcer. In this setting, the market in legal rights could reduce social welfare because some rights are inefficiently extinguished.

F. *Sham Enforcement and Agency Costs Generally*

I will continue to consider the case in which rights are transferred to third-party enforcers and transaction costs prevent those enforcers from transferring rights to injurers. As a result, legal rights are transferred only to third-party enforcers. In this part, I will assume that some third-party enforcers choose not to enforce rights promptly—they engage in sham enforcement.

The key feature of sham enforcement is that it is not done with sufficient vigor to induce injurers to take care. Injurers understand that the

⁴² This strikes me as a more plausible assumption about informational asymmetry than the assumption that victims know more about their claims than do third-party financier–litigators. For this reason I have not emphasized the lemons problem discussed by Abramowicz, *supra* note 6. Most victims know very little about the value of their claims. Shukaitis, *supra* note 6, at 348, worries that financiers would take advantage of unsophisticated victims. Indeed, one argument in favor of third-party financing is that it will enable victims to get information on the value of their claims from financiers. Rubin makes the related point that a contingency fee arrangement reveals information about the value of the claim. See Rubin, *supra* note 6, at 4-5.

threat of liability from sham enforcers is not strong enough to give them an incentive to take care.

Why might sham enforcement occur? Once the third-party enforcer owns the victim's legal rights, he may prefer to see more injuries, rather than less, because his revenue increases as the rate of injury increases. It may be profitable for an enforcer to purchase claims and then reduce his level of enforcement to the point that the injurer no longer has an incentive to take care.

To see the sham enforcement problem in terms of the model, let θ represent the frequency with which the sham enforcer brings an action against an injurer. The revenue for the sham enforcer is

$$p\theta(v - c_e).$$

The revenue for the victim–alter ego enforcer is $q(v - c_e)$. If the rate of enforcement is such that $p\theta > q$, then the enforcer might profit by purchasing victims' claims and enforcing them less diligently.

Because the sham enforcer's threat of action will not induce the injurer to take care, the expected cost to the injurer, if he does not take care, must be less than the expected cost if he does take care:

$$p\theta(v + c_d) < x + q\theta(v + c_d)$$

This means that even with the threat of a lawsuit from the sham enforcer, the injurer will still choose not to take care because it is expectedly cheaper to pay off the damage claims than to take care.

As long as care is socially desirable, sham enforcement reduces welfare relative to real enforcement. To see this, note that under sham enforcement, society's costs are

$$pv + p\theta(c_d + c_e).$$

Under real enforcement, society's costs are

$$x + qv + q(c_d + c_e).$$

Real enforcement is preferable to sham enforcement if

$$(p - q)v - x > (q - p\theta)(c_d + c_e),$$

which is true as long as care is socially desirable. Thus, sham enforcement may be profitable to third-party enforcers but harmful to social welfare. This is valid even if real enforcement is inefficient relative to no enforcement. It should be clear that sham enforcement is inefficient relative to no enforcement because sham enforcement involves spending resources on enforcement with nothing to show for it in terms of deterrence.⁴³

Under what conditions would a patent troll have an incentive to engage in sham enforcement under the assumptions of the example in Part III.C.2? If the troll sets his rate of enforcement at 35%, he will profit from

⁴³ An alternative version of sham enforcement is where the enforcer surreptitiously inflates damages through fraud or through manipulation of the courts. In the first period, the injurer has no incentive to take care given the expected level of damages and the observed rate of enforcement. In an enforcement action in a later period, damages far exceed actual losses as a result of the enforcer's distortion of the court's processes.

sham enforcement. The value of the infringement suit right under real enforcement is $(.25)(\$100 - \$20) = \$20$. The value of the infringement suit right under sham enforcement is $(.75)(.35)(\$100 - \$20) = \$21$. Thus, the troll who intends to engage in sham enforcement will outbid the troll who actually intends to enforce the inventor's rights. Moreover, if the troll sets his rate of enforcement at 35%, the corporation's liability if it does not search will be $(.75)(.35)(\$100 + \$125) = \$59.06$; and, if the corporation searches, its cost will be $\$40 + (.35)(.25)(\$100 + \$120) = \59.25 . Hence, the corporation will not search among prior patents. As sham troll enforcers would earn greater profits than real enforcers, assuming rights sellers fail to discover their ploy, sham enforcers would enter the market more frequently and displace real enforcers. The tendency to engage in sham enforcement is probably dampened by the practice of trolls owning the patent rather than merely the patent's enforcement right.

Sham enforcement is just a special case of "agency costs" in enforcement. Third-party litigators may have interests that differ from those of victims, and those interests may lead the third parties to engage in conduct that reduces the welfare of victims or society in general. Third-party enforcers may choose to trade off their deterrence or compensation interest in exchange for enhancing the value of damage claims, gaining favorable precedent, biasing courts by influencing judicial appointments and elections, or bribing judges.

G. *Externalities from Enforcement*

Closely related to the problem of agency costs is that of external effects from enforcement. If enforcement of the victim's legal right by a third party imposes a cost on another party, then third-party enforcement could easily be socially undesirable. Suppose, for example, that the third-party enforcer gets a private benefit from enforcement because it allows the enforcer to impose costs on a rival. In this scenario, relatively high-cost enforcers could outbid lower-cost enforcers and drive inefficient litigation through the courts.

Return to the patent example of Part III.C.2. Suppose that there are two corporations potentially affected by the inventor's work: an "entrant" corporation that is in the process of developing an infringing invention and an "incumbent-monopolist" corporation that could protect its monopoly in a specific market by gaining control over the inventor's invention. The incumbent-monopolist would bid on the inventor's right to obstruct entry by the entrant corporation. By gaining ownership of the inventor's invention, the incumbent-monopolist can threaten infringement litigation and demand excessive royalties in order to block the entrant corporation's entry into its market. Let the incumbent's benefit from obstructing entry be \$200. Then, if the incumbent's litigation cost is \$80, the incumbent would bid as much as $\$200 + (.25)(\$100 - \$80) = \205 for the inventor's infringement

suit right. The incumbent would prevail in a bidding war for the patent and would vigorously enforce it against the entrant corporation. Assuming that the \$200 gain to the rival corporation largely reflects a transfer from consumers, the resulting litigation would reduce societal welfare.

H. *Exchange in a Securitization Market*

In Part III.C, I examined an ideal market in which victims, third-party financiers, and injurers were able to enter into fully informed agreements for the exchange of legal rights. Under these conditions, an efficient market in legal rights would be observed. Such a market enhances society's wealth by enabling the enforcement of legal rights whose enforcement is socially desirable and facilitating the waiver of rights whose enforcement is not socially desirable.

But a real market in legal rights may not be characterized by full information and low transaction costs. Suppose, for example, victims cannot distinguish injurer–alter ego enforcers from victim–alter ego enforcers. A victim comes to the market and offers to sell his legal right. What price would he set? Because the victim knows there is a risk that the purchaser could be the injurer alter ego, he will set a high price, and the only purchaser would be the injurer alter ego. No rational victim would set a low price, because an injurer alter ego would snap up the victim's right immediately. In this scenario, only rights exchanges of waivers would be observed. Moreover, if there is heterogeneity in the potential injuries of victims, adverse selection could cause the market to collapse. Only the most severe types of injurers and their representatives would enter the market to purchase legal rights. Only the victims with the highest asking prices would offer to sell their rights.

Given the difficulties that arise as soon as we step away from the full information market examined previously, I will examine here a simple securitization market in which claims are transferred and pooled into a security. In some respects, this is an ideal setting in which to examine the potential gains from a market in legal claims. If legal barriers to third-party funding of litigation are removed and commerce in legal claims continues to expand, the market could operate in a manner equivalent to other established securitization markets, such as the mortgage-backed securities market.⁴⁴

Consider the case in which legal claims are pooled into a security, auctioned off to a third-party financier, and then allocated by the financier in equal shares among enforcers. This is equivalent to the mandatory exchange market suggested by Abramowicz.⁴⁵ It is an ideal market to con-

⁴⁴ See, e.g., Cooter, *supra* note 6, at 383.

⁴⁵ Abramowicz, *supra* note 6, at 757.

sider because it would not be distorted by adverse selection. The mandatory exchange market is equivalent to one in which matches between victims and enforcer types occur randomly.

Under the mandatory sale and random allocation system, offer prices will be determined by the average valuations between the two types of enforcers. The victim would not know whether the person purchasing his claim is his own alter ego or an injurer. Similarly, third-party enforcers—consisting of victim alter egos and injurers—would acquire claims in proportion to their representation among enforcers.

Under the securitization arrangement, the maximum bid for a claim would be

$$\delta(x + qv + qc_d) + (1 - \delta)q(v - c_e). \quad (8)$$

Claims would be traded in this market as long as the maximum bid exceeds the offer price, which means that

$$\delta pv + (1 - \delta)qv - qc_p < \delta(x + qv + qc_d) + (1 - \delta)q(v - c_e).$$

This, in turn, implies that legal claims will be traded in the securitization market if

$$\delta[(p - q)v - x - q(c_d + c_p)] < (1 - \delta)q(c_p - c_e). \quad (9)$$

Thus, there are two reasons securitized claims will be exchanged: the existence of claims that would be inefficient to enforce, and the existence of more efficient enforcers than the original victims. If litigation is welfare reducing, the left-hand side of (9) will be negative because the deterrence benefit would be less than the cost of litigation (see (2), though reversed). If third-party enforcers are especially efficient litigators, as assumed earlier, the right-hand side of (9) will be positive. Thus, the less efficient litigation is in general, and the more efficient third-party enforcers are relative to original victims, the greater the potential wealth created by the market in legal claims.

One implication of this analysis is that even if litigation is efficient (i.e., where waivers would reduce social welfare), the exchange of legal claims could enhance wealth if the relative efficiency advantage of third-party enforcers is sufficiently great. This would be observed in an auction regime in which the efficiency gain from third-party enforcement is so great that it swamps the welfare loss from inefficient waivers. In more practical terms, some victims would have their potential claims forfeited under conditions that reduce society's welfare, while other victims would have their claims enforced at a much lower cost by a real enforcer.

The other possible extreme case of an efficient claims market is where litigation is inefficient and third-party enforcers are also relatively inefficient. However, the inefficiency of litigation is in fact so great that the welfare gain from extinguishing some potential claims exceeds the loss from permitting more costly enforcement of non-extinguished claims.

Although I have offered this model as a hypothetical device to examine the likely results of third-party funding with securitization, this model also describes actual existing markets. One example is the purchase of pat-

ents, or of patent portfolios, which is the securitization of royalties from patents or other types of intellectual property. The likely infringer can purchase a patent, which is equivalent to waiving the patent holder's right. If a third-party financier were to purchase a security based on a patent, or patents, he would have to consider the probability that the patent would be sold to the likely infringer when evaluating its price.

IV. EXCHANGE OF MATURED CLAIMS

The analysis of the previous parts applies to the sale of matured legal claims, with some modifications.⁴⁶ In this setting, the transfer of rights is assumed to have no effect on the decision to take care, as it occurs after the injury happens. Of course, if the victim and injurer knew beforehand that the claim would be transferred, there might be an impact on the decision to take care. However, I will assume that the parties cannot predict *ex ante* whether the claim will be transferred.

Let P_p be the plaintiff's prediction of the likelihood of a verdict in his or her favor and P_d be the defendant's prediction of the same probability. Suppose the third-party enforcer has a different prediction of the likelihood of plaintiff victory, \tilde{P}_p . The third-party enforcer and the victim will arrange a mutually beneficial exchange of the matured claim if $P_p v - c_p < \tilde{P}_p v - c_e$, or equivalently

$$(P_p - \tilde{P}_p)v < c_p - c_e. \quad (10)$$

Thus, the two factors driving the purchase of matured claims are the third-party enforcer's greater likelihood of success in litigation, and the third party's cost advantage in litigation. Note that the third-party enforcer does not need to have both a cost advantage in litigation and a greater likelihood of success for a claim to be purchased—an advantage on one score can offset a disadvantage on the other.

The plaintiff would settle his claim if $P_p v - c_p < P_d v + c_d$, or equivalently $(P_p - P_d)v < c_p + c_d$, which is the well-known Landes–Posner–Gould settlement condition.⁴⁷ The third-party enforcer who purchases the plaintiff's claim would settle if

$$(\tilde{P}_p - P_d)v < c_e + c_d, \quad (11)$$

assuming that the defendant's prediction of the likelihood of the plaintiff's success remains the same after the claim is transferred to the third-party enforcer. If the third-party enforcer is a more successful litigant ($\tilde{P}_p > P_p$), he will wish to pursue litigation when the victim would prefer to settle.

⁴⁶ For an insightful discussion of markets in matured legal claims, see Peter Charles Choharis, *A Comprehensive Market Strategy for Tort Reform*, 12 YALE J. ON REG. 435 (1995).

⁴⁷ See John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279 (1973); William M. Landes, *An Economic Analysis of the Courts*, 14 J. L. & ECON. 61 (1971); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973).

In addition, when the third-party enforcer is a more efficient enforcer, he will prefer to litigate when the victim would choose to settle the claim. It follows from (11) that either one or both of these conditions will be satisfied whenever the third-party enforcer acquires the victim's claim in a mutually beneficial exchange. These scenarios imply the following proposition (see Appendix for proof): *Whenever a matured legal claim is sold to a third-party enforcer, the third-party enforcer will be more likely to litigate, and therefore less likely to settle, than the victim, provided that the transfer does not affect the defendant's prediction of the likelihood of the plaintiff's victory.*

If the defendant's prediction of the likelihood of success changes as a result of the transfer, the conclusion that third-party litigation necessarily reduces the likelihood of settlement no longer holds. Suppose, after the claim is transferred, that the defendant's estimate of the likelihood of plaintiff success changes to \tilde{P}_d , where $\tilde{P}_d > P_d$. The reason this might occur is that the defendant may realize that the third-party funded litigator has a greater likelihood of success.⁴⁸ Under this assumption, settlement would occur if

$$(\tilde{P}_p - \tilde{P}_d)v < c_e + c_d. \quad (12)$$

In this case, it is unclear whether settlement is less likely to occur under third-party litigation. The gap between expected judgments may shrink after the defendant adjusts his expectation, which would enhance the probability of settlement. *Thus, if the transfer of the matured claim alters the defendant's prediction of the likelihood of plaintiff victory, the probability of settlement may or may not increase under third-party enforcement.*

Some of the case law and commentary on third-party financing has focused on the possible existence of different litigation incentives for third-party enforcers and original victims, and has suggested that this possibility presents a reason for prohibiting the transfer of legal claims. In particular, one critique of third-party enforcement is that it will reduce the rate of settlement.⁴⁹ As this analysis shows, third-party funding of matured legal claims, along with third-party control over litigation, will reduce the rate of settlement if defendants' trial-outcome expectations are not affected by it; otherwise the effect on settlement frequency is ambiguous.

Given that third-party funding is likely to increase the frequency with which matured claims are litigated, the more important question is whether such a change would enhance social welfare. A reduction in the rate at which disputes settle, considered alone, tells us little about the welfare implications of third-party funding. The welfare implications depend on the

⁴⁸ The plaintiff may disclose the third-party funding arrangement in order to persuade the defendant that it has a valid claim. See GARBBER, *supra* note 22, at 15.

⁴⁹ See Rancman v. Interim Settlement Funding Corp., 789 N.E.2d 217, 220 (Ohio 2003); Jason Lyon, Comment, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 U.C.L.A. L. REV. 571, 576, 595-99 (2010).

extent to which the deterrence benefit from litigation exceeds the total cost of litigation. This is an empirical question whose answer will depend on the specifics of the environment in which litigation may arise.

If the sale of a matured claim is foreseeable to victims and injurers, then the price-setting incentives examined previously in this paper would affect the terms of any contracts between potential victims and potential injurers. For example, suppose employees know that any matured tort claims against their employer would be assigned to injurer–alter ego enforcers. The employees would demand compensation in their employment contracts for waiving their tort claims against the employer. The issues examined previously would apply fully to the case of matured claims.

V. DISCUSSION AND IMPLICATIONS

The preceding parts of this paper have identified the benefits and costs of third-party financed litigation. The benefits are easier to see if they are considered in light of the circumstances in which litigation is (or is not) socially desirable.

The potential social benefits of third-party finance and litigation can be traced to several sources. First, to the extent third-party enforcers are more efficient litigators than are original victims, social welfare can be enhanced through a reduction in the resources devoted to litigation. Second, because of their superior efficiency in litigation, third-party enforcers may be willing to enforce socially efficient rights (i.e., potential claims for which the deterrence benefit from enforcement is greater than the total cost of litigation) that would otherwise not be enforced. The third source of welfare gain is, perhaps counter intuitively, from waiving potential claims. If victims cannot waive legal rights easily, sale to third parties may facilitate waiver,⁵⁰ which would be socially desirable in the case of inefficient legal rights.

The settings in which more vigorous enforcement would be observed are those in which the plaintiff's cost of litigation is likely to exceed the expected value of the award. A third-party enforcer who can litigate more cheaply would have an incentive to purchase potential claims of this sort. For example, the vast majority of instances of medical negligence do not result in litigation,⁵¹ probably because most victims of adverse medical events do not have the time, money, or inclination to sue their doctors. The

⁵⁰ Bond, *supra* note 19, at 1322, proposes allowing defendants to purchase a claim without noting that it would be equivalent to permitting waivers. The purchase of matured claims by injurers would be equivalent to settlement.

⁵¹ A. Russell Localio et al., *Relation Between Malpractice Claims and Adverse Events Due to Negligence: Results of the Harvard Medical Practice Study III*, 325 *NEW ENG. J. MED.* 245, 245-51 (1991).

settings in which third-party litigators would purchase potential claims and then waive them are generally those in which the expected injuries are small relative to the cost of avoiding them. Cooter suggested the example of a privately arranged no-fault automobile insurance regime.⁵² A third-party litigator, in this case an insurance company, would purchase potential tort claims for traffic accidents and waive them. Because fault liability does not seem to affect driver care greatly,⁵³ the dominant effect of waiving probably would be a reduction in transaction and litigation costs.

One could argue that the benefit from enhancing enforcement of socially efficient rights that would otherwise not be enforced (because they are unprofitable) is limited today because the class action device already allows many of these claims to be brought to court.⁵⁴ However, the class action device probably does not capture all of the potential claims that are both efficient and unprofitable. In addition, the third-party enforcement system provides the advantage of guaranteed compensation to original victims, which enhances the likelihood that only efficient claims of class harm will be pursued.⁵⁵

A fourth source of welfare gain, not explicitly incorporated into this paper's model, is the reallocation of risk.⁵⁶ The original victim may be risk-averse and the financier could spread risk across a portfolio of investments. When the victim sells his claim to the financier, social welfare is enhanced by the reallocation of risk from a risk-averse party to a risk-neutral party.

A fifth potential gain is the prospect of greater alignment between the interests of attorneys and those of plaintiffs.⁵⁷ Third-party financiers, because they are more likely to know given litigators' strengths and weaknesses than will ordinary victims, will have incentives to channel lawsuits to the most effective litigators. A litigation funder, such as Juridica Investments, can validate the quality of a claim for investors without raising the suspicions that lawyers might raise under the same conditions, as the litiga-

⁵² Cooter, *supra* note 6, at 385.

⁵³ Studies on the effects of no-fault have been mixed, and suggest a modest effect at most. For a thorough review of the empirical literature, see Alan C. Marco & Casey Salvietti, 2d Annual Conference on Empirical Legal Studies Paper, *What Does Tort Law Deter? Precaution and Activity Levels in No-fault Automobile Insurance*, 7-10 (2007), available at <http://ssrn.com/abstract=998741>.

⁵⁴ Rubin, *supra* note 6, at 8.

⁵⁵ If third-party enforcers did not have to compensate victims in full, there is a significant risk that those enforcers would "sell out" their claims. On such collusive settlements, see Susan P. Koniak & George M. Cohen, *Under Cloak of Settlement*, 82 VA. L. REV. 1051, 1111-15 (1996).

⁵⁶ Shukaitis, *supra* note 6, at 334; Molot, *supra* note 9, at 403-06. Although risk allocation is not incorporated into the model examined in this paper, one could view the litigation efficiency gain from third-party enforcement as arising from the risk allocation advantage.

⁵⁷ See, e.g., Max Schanzenbach & David Dana, *Third Party Financing of Litigation Roundtable, How Would Third Party Financing Change the Face of American Tort Litigation? The Role of Agency Costs in the Attorney-Client Relationship* (2009), available at http://www.law.northwestern.edu/searlecenter/papers/Schanzenbach_Agency%20Costs.pdf.

tion funder is likely to have incentives that are closely aligned with those of investors and plaintiffs.⁵⁸ In class action litigation settings, the requirement that potential or actual claims be purchased would eliminate the worst features of class action and derivative litigation, such as races to the courthouse and collusive settlements. If class action attorneys had to gain the consent of each victim to sue on his behalf, races to the courthouse would not be observed.⁵⁹ The problems of collusive settlements could be greatly reduced if class action lawyers had to purchase the claims of victims (an opt-in system).⁶⁰

But there are also costs that would be associated with a third-party finance and enforcement system. Although I will focus here on implications of the analysis of markets in unmaturing claims, the points are also applicable to the sales of matured legal claims.

A. *Leakage*

In any system in which the control of legal rights is shifted to a third party, there is a risk of leakage: control will fall into the hands of the actors responsible for the injuries underlying the potential claims. Rights that fall into the hands of potential injurers will be effectively waived, as the injurers are not going to sue themselves.

How could leakage occur? If a third party offers to finance the claims of a potential victim, the same third party could be controlled by another party who is likely to be the source of the victim's injury claims. Suppose, for example, firm A purchases potential legal claims of employees of firm B. If firm A is the wholly-owned subsidiary of firm B, then employees will have effectively waived their claims by selling them to firm A. Such a transparent case of leakage may be unlikely, but a market in which potential legal claims are sold could result in complicated transactions and ownership structures. Within such a market, leakage might occur without being obvious.

⁵⁸ See, e.g., GARBER, *supra* note 22, at 15.

⁵⁹ The race to the courthouse famously observed in class action and shareholder derivative litigation is an effort to gain ownership of claims. If a litigator gained ownership directly, he could take the time to develop and research his case rather than running directly to the courthouse with a shoddily researched complaint.

⁶⁰ If class action lawyers had to pay each victim a non-trivial amount of money to gain control over his legal claim, then the lawyers would need to earn a substantial judgment in order to make a profit on the class action lawsuit. At present, civil procedure rules permit class action lawyers to take effective ownership of claims, giving victims an opt-out right. An alternative to the "taking" of control over claims by class action lawyers would be an auction system as proposed in Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

Of course, leakage could be efficient.⁶¹ If the underlying potential claim is inefficient, then a transfer to the injuring party enhances social welfare. However, an opaque or complicated transfer mechanism (e.g., securitization) might lead to contingent claims going to a combination of genuine enforcers and injurers. In such a market, it is possible, depending on how the transfer mechanism is arranged, for contingent claims to be transferred with the result being harmful to social welfare.

B. *Prosecution of Inefficient Claims*

Third-party enforcement may lead to more frequent prosecution of inefficient claims. I considered examples in which this occurs because transaction costs prevent third-party enforcers from transferring claims to injurers. Also, third-party enforcers may have constraints and interests that differ from the original victims', and these differences could lead to the prosecution of inefficient claims. Such differences are likely for several reasons: the inability of the original victim to foresee future costs associated with litigation, informational asymmetry, and a special, perhaps idiosyncratic, gain to the third-party enforcer.

Take the employment setting as an example. A potential victim might sell his unmatured legal claims to a third-party financier–enforcer without having a clear sense of exactly what those claims might be. Later on, the third-party enforcer might discover evidence that he could use to bring a successful discrimination claim against the victim's employer. For example, the enforcer might find evidence that the employer has promoted several individuals whose credentials are less than the victim's. The victim, asked whether to pursue the discrimination claim, might decline because he expects to leave his current employer and would rather not enter the job market under the cloud of a discrimination lawsuit. The enforcer, however, has different payoffs and may find it profitable to pursue the claim. If the victim had foreseen the possibility of this type of claim, he would have sold his legal rights for a higher fee, or perhaps not have sold them at all. But the victim has sold his legal rights, relinquishing the right to control the lawsuit.

There are plenty of examples today of lawsuits that have a negative payoff for the victim and positive payoff for the attorney. Koniak and Cohen criticize class action settlements in which class victims receive coupons or other seemingly trivial awards, while plaintiffs' attorneys receive legal fees in the millions of dollars.⁶² These are negative payoffs—the victims

⁶¹ For the argument that leakage should be prevented under a system in which potential claims are assignable, see Marks, *supra* note 6.

⁶² Koniak & Cohen, *supra* note 55, at 1053-55. Coupons have been criticized because they are often ignored by consumers. However, coupons as a remedy in antitrust cases may be efficient. *See A.*

receive worthless awards and lose the ability to sue for real injuries because they have been compensated (in theory) by the class award. Another setting in which negative payoffs may be observed is where members of the class suffer different amounts of harm and the attorney's fee arrangement imposes a fixed charge on each victim.⁶³ The examples from Koniak and Cohen suggest that class action attorneys already have incentives that diverge from those of at least some of the victims they represent. Class action attorneys are, in effect, third-party litigators—the significant difference is they do not have to purchase their claims from victims.

Yet another scenario in which socially inefficient rights are likely to be pursued by third-party enforcers is where the enforcer gets a special gain from pursuing the injurer in court. Suppose the financier purchases potential claims against its main competitor in the product market—for example, Coke purchases the potential legal claims of Pepsi employees. Welfare gains would be observed when Coke pursues efficient employment-related rights against Pepsi that would otherwise not be pursued by Pepsi employees. However, there is a clear risk that Coke would pursue inefficient potential claims solely to damage its rival.

Competition would spur firms to purchase claims against their market rivals. A firm that refused to purchase such claims would find itself at a competitive disadvantage relative to rivals who had purchased claims against it. As this process continues, the reputation of the courts would suffer.

Patent auctions provide concrete examples of the incentive for third-party financiers to purchase claims against rivals for anticompetitive purposes. Technology firms have incentives to bid aggressively for the patent portfolios of firms in their sectors in order to use those patents to threaten litigation against upstart rivals that hold thin patent portfolios. Even if the efficient allocation of rights would involve a potential infringer acquiring a particular patent, and thereby obtaining a waiver, a competitor might outbid the potential infringer because of the benefit it gains from deterring entry.⁶⁴

Mitchell Polinsky & Daniel L. Rubinfeld, *A Damage-Revelation Rationale for Coupon Remedies*, 23 J.L. ECON. & ORG. 653, 653-61 (2007).

⁶³ Koniak and Cohen describe the settlement in a class action lawsuit brought on behalf of more than 300,000 customers against BancBoston for allegedly requiring its customers to keep more money in their mortgage escrow accounts than it had a right to demand. Koniak & Cohen, *supra* note 55, at 1058-61 (citing *Hoffman v. BancBoston Mortgage Corp.*, No. CV-91-1880 (Ala. Cir. Ct. Jan. 24, 1994)). In at least one case, attorney's fees were allegedly more than 4,000% of the recovery amount. Koniak & Cohen, *supra* note 55, at 1067.

⁶⁴ The best-known recent example of this is the auction of Nortel's patent portfolio, which was awarded to a consortium of wireless communications firms that bid \$4.5 billion. The one firm that was outside of the consortium was Google, which led to speculation that the consortium intended to use the patent portfolio to launch infringement suits against Google's Android software. See John Letzing, *Google: Rivals Are Ganging Up*, WALL ST. J., Aug. 4, 2011, at B4, available at <http://online.wsj.com/article/SB10001424053111903366504576486673239634388.html>.

C. *Informational Disparities*

Informational disparities combine with the factors just mentioned (leakage and inefficient potential claims) to create numerous opportunities for welfare-reducing litigation. Take the employment example just considered. The third-party enforcer may be in a better position to foresee the possible future discrimination claim at the time he purchases the rights from the employee. The employee, unaware of the possibility of such a claim, would negotiate a price that is well below the level that would compensate him for the harms that might arise from his involvement in a discrimination claim.

The information problems present difficulties in any effort to construct an efficient market for the securitization of potential legal claims. In a market for legal rights, victims are likely to be the least informed parties about the value of their rights. Financiers are likely to have an informational advantage because they are likely to know more about the characteristics of enforcers than do the victims.

Although informational disparities can be a source of inefficiency in the market, competition serves as a mitigating force. If financiers compete for ownership of rights, they will bid away all informational rents. The often-mentioned concern that financiers would take advantage of victims by purchasing their claims too cheaply would not be observed in a competitive market for legal rights. However, even though informational rents would be bid away in a competitive market, informational disparities would still result in inefficient waivers as well as inefficient litigation.

D. *Perverse Enforcement Incentives*

One feature I have tried to formalize is that the enforcer, after acquiring the rights of victims, profits when the probability of harm to the victims increases. This provides enforcers with incentives to enforce opportunistically or generate additional injuries—that is, to act as sham enforcers. Patent trolls are often associated with this activity. But the incentive to engage in sham enforcement is a general characteristic of third-party litigation.

One obvious example is where the enforcer purchases the potential claims and then observes opportunities for making them more valuable. Suppose the enforcer purchases the potential tort and discrimination claims of a group of employees. After purchasing the claims, the enforcer would have incentives to generate an environment that promotes claiming and developing new theories of injury in order to enhance the value of his stock

of potential claims.⁶⁵ In addition, the enforcer may have an incentive to ferret out or even fabricate claims that most ordinary people would not consider bringing to court.

Where the claims have been realized (matured claims), the enforcer would have an incentive to fraudulently assert a greater level of injury than has actually occurred. For example, numerous instances of fraud have been discovered in the asbestos and silicosis class actions, where plaintiffs' lawyers have arranged for mass screenings of potential victims.⁶⁶ The incentives for fraud would be at least as strong in the setting where third-party financiers own claims.

Another general opportunity for sham enforcement involves injuries that are trivial impositions and do not lead to any serious loss to the victim. Suppose, for example, that the injuries under consideration are common insults. Care would not be socially desirable because the cost of care exceeds the losses to be avoided. However, the sham enforcer may have an incentive to encourage and pursue these claims in court, especially in a strict liability regime or where the negligence standard may be erroneously applied.⁶⁷ Consider, for example, an item-pricing law that requires grocery stores to stamp a price sticker on every single item stocked on their shelves. Many stores might choose not to comply with the law because of its high supply-side costs and meager consumer benefits. Indeed, it would be nearly impossible to comply perfectly in a market with rapidly changing prices. A third-party litigator would have an incentive to purchase claims from customers allegedly harmed by failures to comply and to encourage additional complaints. If a third party owned some of the potential claims of customers, he may have no incentive to see the store comply with the law, or reach an efficient agreement with customers directly.⁶⁸

The incentive to enhance the value of a portfolio of claims could lead litigation financiers to bribe courts to modify decisions or change the law. Again, this is an incentive that already exists, but lawyers are officers of the courts while financiers are independent of the courts. The combination of poorly compensated judges and richly compensated finance workers would

⁶⁵ Lawyers can enhance the value of potential claims by lobbying to influence legislation affecting those claims, or supporting the campaigns of legislators or of judges who would favor rules that enhance the value of potential claims. The American Association for Justice (formerly Association of Trial Lawyers of America) spends millions each year in lobbying legislatures and supporting candidates for office. See, e.g., *American Assn for Justice*, OPENSECRETS.ORG, <http://www.opensecrets.org/orgs/summary.php?id=D000000065>.

⁶⁶ Lester Brickman, *Disparities Between Asbestosis and Silicosis Claims Generated by Litigation Screenings and Clinical Studies*, 29 CARDOZO L. REV. 513 (2007).

⁶⁷ This may be a reflection of the underlying strict liability model. If the standard were negligence, the court would reject many of these claims.

⁶⁸ This is a case where the optimal arrangement would involve the third party waiving the potential claims. But if he does not own all of the claims, he may have weak incentives to waive. This is another case where transaction costs may stand in the way of an optimal arrangement.

set the stage for corruption in vulnerable courts with lax judicial selection criteria.⁶⁹

The possibility of sham enforcement would require some mechanism for controlling agency costs in enforcement. In the absence of such a mechanism, a market in claims could be damaged by excessive entry of sham enforcers. Adverse selection would appear in the form of sham enforcers outbidding real enforcers, and a type of moral hazard would be observed in the phenomenon of real enforcers switching to sham enforcement after gaining ownership of claims.

CONCLUSION

This is not the first paper to suggest that the ancient prohibitions on third-party funding of litigation should be replaced with a more fine-tuned set of rules that distinguish socially beneficial from socially harmful instances of such funding. Moreover, the common law has already adopted the fine-tuning approach. Many courts have narrowed the scope of the prohibitions to permit third-party funding of litigation if no foreseeable harm is likely to result from the particular arrangement observed by the court.

The key contribution of this paper is to identify the potential sources of welfare gains and losses associated with a system of third-party litigation funding. While previous studies have discussed the risk-sharing benefits of a market in claims, I have suggested that the social gains should be understood in light of the economics of litigation—specifically, the divergence between private and social incentives to litigate and the market mechanisms for correcting this divergence. But this perspective also points to some important sources of social cost, such as socially undesirable waivers, socially undesirable litigation, and the entry of litigators who have a stake in the generation and continuance of injuries. Any empirical assessment of the welfare consequences of expanded third-party funding will have to take these costs into account.

⁶⁹ Perhaps third-party litigation finance would force legislators to raise the compensation of judges, or institute more rigorous selection criteria, in order to reduce the risk of corruption. Of course, simply raising pay may not be enough to reduce corruption. Back-loading compensation for judges would be a more efficient method of reducing corruption. On compensation and corruption of public law enforcement officials, see Gary S. Becker & George J. Stigler, *Law, Enforcement, Malfeasance, and the Compensation of Enforcers*, 3 J. LEGAL STUD. 1 (1974).

APPENDIX

In this part I consider a contract between a victim and financier that consists of two important terms: the upfront payment and the share of damages that will be given to the victim.

Unmatured Claims

Consider the case of a waiver agreement between the potential victim and the potential injurer which includes a damage-sharing provision. Under this agreement, the victim would waive his tort claims, but the defendant would also agree to pay part of the damages suffered by the victim in the event of an accident.

Assume that the injurer has no incentive to take care after signing the waiver. Under such an agreement, the victim's asking price for the waiver would be

$$p(1 - \pi)v - qc_p - q\pi v \quad (\text{A1})$$

This expression reflects the loss that will be imposed on the victim when the injurer stops taking care, but it also subtracts the litigation costs the victim would have had to pay in litigation (if there were no waiver agreement) as well as the damage portion the victim would have if the potential injurer had taken care.

The maximum price from the potential injurer would be

$$x + q(1 - \pi)v + qc_d - p\pi v \quad (\text{A2})$$

which reflects the savings the injurer would get from no longer taking care and the release from a portion of the victim's damages and litigation costs. However, it subtracts the damage payment that the injurer would have to make under the damage sharing agreement.

Using these expressions, a waiver agreement will be entered into if

$$p(1 - \pi)v - qc_p - q\pi v < x + q(1 - \pi)v + qc_d - p\pi v \quad (\text{A3})$$

which is equivalent to $p v - qc_p < x + qv + qc_d$. Thus, in the case of the damage-sharing agreement, the incentive to waive will be the same as in the case without such an agreement. Given this, I have simplified the analysis in the text by focusing on the simpler contract without a damage-sharing agreement.

Matured Claims

The discussion in the text of matured claims is easily modified for the case of a damage-sharing agreement. The third-party enforcer and the victim will arrange a mutually beneficial exchange of the matured claim if $P_p v - c_p < \tilde{P}_p(1 - \pi)v - c_e$, or equivalently

$$(P_p - \tilde{P}_p(1 - \pi))v < c_p - c_e. \quad (\text{A4})$$

Thus, the two factors driving the purchase of matured claims are the third party's greater likelihood of success in litigation, which must be greater still as the proportion of damages shared with the victim increases, and the third party's efficiency advantage in litigation.

The third-party enforcer who purchases the plaintiff's claim would settle if

$$(\tilde{P}_p(1 - \pi) - P_d)v < c_e + c_d. \quad (\text{A5})$$

Proposition: Whenever a matured legal claim is sold to a third-party enforcer, the third-party enforcer will be more likely to litigate (less likely to settle) than the victim.

Proof: Suppose the third-party enforcer would settle the claim, which implies (A5). If the claim was obtained in a mutually beneficial trade, then (A4) holds, which implies $c_e < c_p + \tilde{P}_p(1 - \pi)v - P_p v$. Substituting this into (A5), yields $(P_p - P_d)v < c_p + c_d$. Thus, any legal claim that the third-party enforcer would settle, the victim would settle too. Now suppose the victim would litigate the claim, which implies $(P_p - P_d)v > c_p + c_d$. Substituting (A4) yields $(\tilde{P}_p(1 - \pi) - P_d)v > c_e + c_d$. Thus, if the victim would litigate the claim, the third-party enforcer would litigate.



COMPARING THIRD-PARTY FINANCING OF LITIGATION AND LEGAL EXPENSES INSURANCE

Michael Faure and Jef De Mot***

INTRODUCTION

For decades there have been some remarkable differences between the U.S. and many European countries in the way in which lawsuits are funded. For example, in the U.S., neither the federal government nor any state has enacted a statutory right to counsel in civil cases,¹ however nearly all European nations have enacted statutory rights to counsel in both criminal and civil cases.² In the U.S., contingency fees are allowed to offer a solution in many cases for plaintiffs with limited financial means.³ On the other hand, most European countries do not allow contingency fees.⁴ Some recent trends in litigation financing in the U.S. and in Europe may increase the differences in these two approaches to litigation funding. In the U.S., legal expenses insurance (“LEI”) for bringing claims is virtually absent,⁵ but third-party litigation funding (“TPF”) is a growing phenomenon.⁶ Third-party financing of litigation is the “phenomenon of . . . provision of capital . . . by nontraditional sources to civil plaintiffs, defendants, or their law-

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¹ Earl Johnson, Jr., *Justice, Access to: Legal Representation of the Poor*, in INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL AND BEHAVIORAL SCIENCES 8048, 8049-53 (Neil J. Smelser and Paul B. Baltes eds., 2001) (In the U.S., private charity was the only source of legal counsel for the poor during most of its history. Many states and cities have organized pro bono programs. Others require private lawyers to report on the hours devoted to pro bono services. These pro bono legal services only play a limited role in the delivery of access to justice).

² *Id.* at 8049 (“England’s first such statute was enacted in 1495, France in 1852, Germany in 1877, the rest of Northern Europe in the early twentieth century, [and] Italy in 1923.”).

³ *Id.* at 8051.

⁴ See, e.g., Michael G. Faure et al., *No Cure, No Pay and Contingency Fees*, in NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL, EMPIRICAL, AND ECONOMIC ANALYSIS 33, 33 (Mark Tuil and Louis Visscher eds., 2010).

⁵ See Matthias Kilian, *Alternatives to Public Provision: The Rule of Legal Expenses Insurance in Broadening Access to Justice: The German Experience*, 30 J.L. & SOC’Y 31, 36 (2003).

⁶ Paul H. Rubin, *On the Efficiency of Increasing Litigation*, presented at the Third Party Financing of Litigation Roundtable, Searle Ctr., Nw. Univ. Law Sch. (Sept. 2009), <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

yers to support litigation-related activities.”⁷ Therefore, this term refers to financing by those other than plaintiffs, defendants, insurers, and lawyers.⁸ Although TPF is not widespread, it is playing an increasingly visible role. Its recent growth may be explained by a host of factors including increasing litigation costs; professional responsibility rules that forbid lawyers to pay the living expenses of their clients while litigation is pending; and the lack of capital in the traditional lending market to fund litigation.

Although many European countries still provide generous legal aid, others have pushed—or are seriously considering pushing—consumers into entering private insurance arrangements to guarantee access to the courts. For example, before December 1, 1997, most Swedes could rely on public legal aid when they needed legal advice or a lawyer to go to court.⁹ Since that day, however, most Swedes have had to rely on their mandatory LEI policy to have access to legal services.¹⁰ A 2007 report prepared on behalf of the UK’s Ministry of Justice concludes that legal insurance is an under-explored means of promoting access to justice.¹¹ The report also offers different suggestions to promote LEI to a broader public.^{12 13} Briefly summarized, the trend in Europe reflects an *ex ante* approach to funding of litigation, whereas the trend in the U.S. reflects an *ex post* approach.

This article compares TPF and LEI from an economic perspective. Such a comparison deserves attention for at least two reasons. First, as this article will argue, LEI is not as widespread in Europe as it is often alleged. In most European countries in which the government does not push LEI (e.g., by making it compulsory), LEI is not that common.¹⁴ The possibility of entering into contingency fee contracts cannot explain this phenomenon

⁷ STEVEN GARBER, ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWN AND UNKNOWN 1 (RAND Corp. 2010), available at http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf.

⁸ Lawyer funding is more common in the U.S. than in Europe. For an overview of contingency fees in Europe see Faure et al., *supra* note 4, 33-56.

⁹ Francis Regan, *The Swedish Legal Services Policy Remix: The Shift from Public Legal Aid to Private Legal Expenses Insurance*, 30 J.L. & SOC’Y 49, 50 (2003).

¹⁰ *Id.*

¹¹ OONA McDONALD, IAN WINTERS & MIKE HARMER, THE MARKET FOR ‘BTE’ LEGAL EXPENSES INSURANCE, MINISTRY OF JUSTICE 51-56 (July 2007), <http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf>.

¹² *Id.*

¹³ LEI is also on the agenda in Canada. Professor Michael Trebilcock wrote: “I conclude that legal insurance may be one means to significantly improve access to justice in Ontario, particularly in civil matters, including family law. The Law Society of Upper Canada and LAO should accord a high priority to promoting the role of legal insurance in Ontario.” MICHAEL TREBILCOCK, INNOVATIONS IN SERVICE DELIVERY, MINISTRY OF THE ATTORNEY GENERAL, <http://www.attorneygeneral.jus.gov.on.ca/english/about/pubs/trebilcock/section7.asp> (last visited Dec. 30, 2011).

¹⁴ For data, see Table 1 *infra*.

because such contracts are forbidden in most European countries.¹⁵ Also, even though one would expect a large fraction of households in European countries with limited legal aid budgets to be covered by LEI, this is not always the case. For example, in Belgium, contingency fees are prohibited. And while only 20% of the population is covered by public legal aid,¹⁶ the number of Belgians having LEI is quite low.¹⁷ This raises the question whether the market for LEI suffers from market failure, and if a failure in the market for LEI could hinder the development of the market for TPF. We will discuss the following potential reasons for the limited supply of LEI and TPF: the existence of alternatives for access to justice, adverse selection, moral hazard, and the free rider problem.

An economic comparison of TPF and LEI may also shed light on the relative social costs of TPF and LEI. The social efficiency of TPF has been intensely debated in the recent literature¹⁸ and its many advantages and disadvantages have been examined.¹⁹ This article will examine to what extent TPF and LEI differ with respect to these advantages and disadvantages. It will look at the volume of litigation, the quality of litigation, the accuracy and likelihood of settlement, and the transaction costs of disputes. Such a comparison could help policymakers decide whether or not to stimulate TPF (e.g., through relaxing some current legal restrictions) and/or legal expenses insurance (e.g., by a tax deduction).

Part I provides data, facts, and the legal background for both LEI and TPF. It examines differences between LEI in the U.S. and in Europe in greater detail as well as between individual European countries. Use of LEI for bringing a claim is not only quite rare in the U.S.—at least in its pure form—but also in many European countries. Furthermore, in those European countries where a large fraction of households have LEI, this is due to the intervention of policymakers. Part II examines several potential reasons why LEI markets and policies may be underdeveloped. It discusses why most of those reasons cannot fully explain the low prevalence of LEI and analyzes whether these factors could hinder the development of TPF. Finally, Part III examines the advantages and disadvantages of the *ex ante* approach, LEI, and the *ex post* approach, TPF.

¹⁵ Faure et al., *supra* note 4.

¹⁶ See NIEUWSBLAD, *België gierigst met gratis rechtshulp [Belgium Stingiest with Free Legal Aid]* (Oct. 6 2006), http://www.nieuwsblad.be/article/detail.aspx?articleid=DMF06102006_004.

¹⁷ For details on premium income per capita, see CEA INSURERS OF EUROPE, CEA STATISTICS N°37: EUROPEAN INSURANCE IN FIGURES 9 (2009) available at <http://www.cea.eu/uploads/Modules/Publications/eif-2009.pdf>.

¹⁸ For an overview, see GARBER, *supra* note 7.

¹⁹ *Id.*

I. LEI AND TPF IN THE U.S. AND IN EUROPE: LEGAL FRAMEWORK, FACTS, AND DATA

A. *LEI*

1. General Remarks

Generally, LEI is “a voluntary private insurance that covers the costs of lawsuits.”²⁰ It is also known as legal cost insurance, legal protection insurance, or simply legal insurance.²¹ In France, LEI is called *L’assurance de protection juridique*.²² In Germany it goes by *Rechtsschutzversicherung*.²³ European Union Directive 87/344/EEC of June 22, 1987 on the coordination of laws, regulations, and administrative provisions relating to LEI defines the terms follows:

Such consists in undertaking, against the payment of a premium, to bear the costs of legal proceedings and to provide other services directly linked to insurance cover, in particular with a view to (a) securing compensation for the loss, damage or injury suffered by the insured person, by settlement out of court or through civil or criminal proceedings, (b) defending or representing the insured person in civil, criminal, administrative or other proceeding or in respect of any claim made against him.²⁴

This article focuses on LEI for *bringing* claims, as LEI for *defending* against claims is almost always part of liability insurance contracts.²⁵ Furthermore, it focuses on before-the-event (“BTE”) insurance, not after-the-event (“ATE”) insurance. Individuals wishing to protect themselves against potential litigation costs that could be incurred following a future event take out BTE insurance.²⁶ ATE insurance covers future legal expenses in a case where an incident has already occurred, such as an accident that has caused an injury.²⁷ It is also important to distinguish between *add-on* LEI and *stand-alone* LEI. The former is added on to existing LEI policies that already have a high market penetration, such as household

²⁰ Thomas Raiser, *Legal Insurance*, in INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL AND BEHAVIORAL SCIENCES 8638, 8638 (Neil J. Smelser and Paul B. Baltes eds., 2001).

²¹ *Id.*

²² CODE DES ASSURANCES [C. ASS.] art. L127-1.

²³ *Id.*

²⁴ Council Directive 87/344/EEC, art. 2, 1987 O.J. (L 185) 2 (EC).

²⁵ See Willem H. Van Boom, *Financing civil litigation by the European insurance industry*, in NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL, EMPIRICAL, AND ECONOMIC ANALYSIS, 93 (Mark Tuil and Louis Visscher eds., 2010).

²⁶ See Kilian, *supra* note 5, at 33.

²⁷ *Id.* Note that ATE insurance is likely to be available only when the chances of winning the case are high. Otherwise, an insurer could not ensure profit.

insurance and motor vehicle insurance.²⁸ Stand-alone LEI policies, however, are issued separately from any other insurance agreement.²⁹ Most current LEI policies are of the add-on type.³⁰ Finally, a distinction can be made between *pure forms* of LEI and *legal services plans*.³¹ The pure form of LEI—originating in Europe and still predominating there³²—applies principles present in other forms of insurance.³³ It is a means of financing the often-unpredictable costs of civil lawsuits and functions by spreading the risk of these costs among all policyholders. Legal services plans, on the other hand, do not apply insurance principles, but rather create benefits for policyholders by relying on bulk savings.³⁴ These plans are found mainly in the U.S. and Canada.³⁵

2. United States

When discussing LEI in the U.S., it is necessary to distinguish between group legal services plans and prepaid legal services plans, both of which play a sizable role in the American legal system. In 1999, it was estimated that approximately 110 million Americans were covered by some type of legal coverage (personal, business, union, military, or employee) plan.³⁶ In 2002, 122 million Americans were covered either by a group legal service plan (68 million) or prepaid legal services plan (54 million).³⁷

Group legal services plans usually offer free consultations and discounts on legal services to members of groups that sponsor the plans (e.g., unions and membership organizations).³⁸ The members generally only pay

²⁸ Francis Regan, *Whatever Happened to Legal Expenses Insurance?*, 26 ALT. L.J. 293, 294 (2001).

²⁹ *See id.*

³⁰ *The Legal Protection Insurance Market in Europe*, RIAD INT'L ASS'N OF LEGAL EXPENSES INS. 14 (June 2010), available at http://www.riad-online.net/fileadmin/documents/homepage/publications/Annual_Reports/RIAD-Legal-Protection-Market_June2010.pdf.

³¹ Regan, *supra* note 28, at 294.

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ Clarke Canfield, *Lawyers To Go: Some Mainers Are Taking Care of Their Legal Needs Through Prepaid Services*, PORTLAND PRESS HERALD, Apr. 27, 1999, at C1 (citing figures gathered by the National Resource Center for Consumers of Legal Services).

³⁷ *See* Wayne Moore, *The Impact of Group and Prepaid Legal Services: Plans to Meet the Needs of Middle Income People*, 2003, at 1, available at http://www.ilagnet.org/jscripits/tiny_mce/plugins/filemanager/files/Harvard_2003/Conference_Papers/The_Impact_of_Group_and_Prepaid_Legal_Services_part1.pdf. Moore, *supra* note 37, at 1-2. The figure equals 154 million if duplicates are counted. *Id.*

³⁸ *Id.* at 1-2. The figure equals 154 million if duplicates are counted. *Id.*

the membership fee to join the group and then access the legal services for free.³⁹ Discounts are based on the participating lawyers' usual fees.⁴⁰ In 2002, four group legal services plans covered more than 90% of individuals enrolled in such plans.⁴¹

On the other hand, prepaid legal services plans are offered by companies who contract with private practice lawyers. The larger union plans mainly offer legal counseling through their own employees. These employees may be attorneys, but often they are not and have little or no formal legal education.⁴² Most prepaid plans are offered to employees by their employers as part of a benefit package, sold either directly to employees by their employers at special rates, or sold directly to the public.⁴³ In general, the prepaid plans are limited in scope and only provide low-cost assistance for routine legal matters.⁴⁴

3. Europe

The main obligations on insurance companies that offer LEI in European countries can be found in European Union Directive 87/344/EEC of June 22, 1987, which discusses the coordination of laws, regulations, and administrative provisions relating to LEI.⁴⁵ Apart from the regulations implementing this directive, individual countries generally do not impart many specific provisions dealing with LEI.⁴⁶ First, the EU directive requires insurance companies to provide a separate contract or a separate section of a single policy for LEI. Second, to mitigate the risk of conflicts of interest, insurance companies must either (a) have separate management for LEI; (b) entrust the management of claims with respect to LEI to a company with a separate legal identity; or (c) must afford the insured the right to entrust the defense of his interests to a lawyer of his choice, from the moment that he has the right to claim from his insurer under the policy. In all cases where access to a lawyer is available, the insured must have the right to choose his lawyer. Finally, in the event of a conflict of interest or a disagreement over settlement of the dispute, the insurer must inform the insured of his right to choose his lawyer freely and of the possibility of using an arbitration procedure. With respect to mass claim actions, the European Court of Justice

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ Union Plus Legal Services Plan (45%); the AARP plan (20%); elder hotlines (20%); and the National Education Association plan (6%). *Id.*

⁴² Raiser, *supra* note 20, at 8639.

⁴³ Moore, *supra* note 37, at 1.

⁴⁴ DONALD L. CARPER, JOHN A. MCKINSEY & BILL W. WEST, UNDERSTANDING THE LAW 157 (5th ed. 2008).

⁴⁵ 1987 O.J. (L 185) 77-80.

⁴⁶ McDONALD ET AL., *supra* note 11, at 48.

(ECJ) recently ruled on whether clauses that entitle insurers to limit their performance to the bringing of test cases, or, where appropriate, to collective redress or other ways of asserting legal interests by legal representatives selected by them, are a permissible limitation of the insured's rights where the interests of several insured persons are directed against the same opponents.⁴⁷ The ECJ ruled that they are not.

Turning from the legal framework to facts and data, we start with the UK, where BTE insurance has been available for more than thirty-five years.⁴⁸ BTE is sold in a variety of ways. First and foremost, insurance companies sell it as an add-on to motor or household insurance (i.e., as an optional policy). Only some insurers incorporate it into the household insurance policy. In 2005, 75% of all households had home contents insurance,⁴⁹ but many people do not take the BTE option. BTE is also sold directly through banks and building societies, or is attached to travel insurance. For employment matters, people sometimes have access to BTE through membership in a trade union or other affinity group. BTE is often sold through intermediaries such as national brokers, broker chains, and smaller regional brokers.

The UK market is dominated by add-on policies. The penetration rate of comprehensive stand-alone policies remains low—about 2% of households⁵⁰—with the exception of commercial policies. With respect to add-ons, more UK households take BTE as an add-on to motor insurance rather than to household insurance. In 2006, of a total population of about 62 million, about 18.5 million UK consumers held BTE as part of their car insurance, another 14.2 million bought BTE as an add-on to their household insurance, and 4.7 million more purchased BTE with their travel insurance.⁵¹ BTE as an add-on to household insurance offers more extensive coverage than the standard add-on to a motor policy and insurance generally covers personal injury, property protection, tax protection, employment disputes, contract disputes, and certain aspects of legal defense.⁵² Through motor insurance policy add-ons, claims handlers enable individuals to recover from third parties any uninsured losses or compensation for personal injury following a motor accident. The types of claims that typically occur under a personal BTE policy are personal injury (50%), consumer disputes (16%), employment disputes (20%), property disputes (8%), and medical negligence (6%).⁵³

⁴⁷ Case C-199/08, *Eschig v. UNIQA Sachversicherung AG*, 2009 E.C.R. I-08295.

⁴⁸ MCDONALD ET AL., *supra* note 11, at 11.

⁴⁹ *Id.* at 11.

⁵⁰ *Id.* at 39.

⁵¹ *Id.* at 12.

⁵² *Id.*

⁵³ *Id.* at 47.

France was the first European country where LEI products were offered.⁵⁴ In 2008, there were 5.4 million stand-alone LEI contracts (with an average premium of €62) and 15 million LEI policies added to general household insurance (with an average premium of €20 for the add-on).⁵⁵ The low average premiums, together with the fact that LEI only provided for 2.5% of French lawyers' incomes and plaintiffs have some form of LEI in only 2% of French court cases, demonstrate that LEI's economic importance in France is very modest.⁵⁶

The German market for LEI is dominated by stand-alone policies. In 2000, 42% of households were covered by stand-alone LEI policies,⁵⁷ a figure that rose to 44% in 2004.⁵⁸ Most stand-alone policies do not cover all domains of law, allowing policyholders to choose *à la carte* from several areas of coverage according to their needs (e.g., property law, contract law, employment law).⁵⁹ The policies do not cover abstract legal advice, an insured event must first occur.⁶⁰ Given the extensive monopoly rights held by German lawyers, in-house lawyers do not deal with cases. Routine transactions, such as legal advice and assistance with documents, are rarely covered by such stand-alone policies.

In the early 1970s, Sweden introduced one of the most comprehensive and generous legal aid schemes in the world. The scheme, which included advice and assistance related to litigation, was made available to most Swedes and covered most legal problems.⁶¹ However, in 1997, the Swedish government radically reformed its legal services policy and drastically reduced public expenditures on legal aid. Thereafter, relationship between public legal aid and private forms of financing legal assistance has reversed. Since December 1, 1997, most Swedes use their LEI policy to access legal

⁵⁴ Kilian, *supra* note 5, at 32. In France, LEI is regulated by the Loi portant réforme de l'assurance de protection juridique. Loi 2007-210 du 19 février 2007 portant réforme de l'assurance de protection juridique [Law 2007-210 of Feb. 19, 2007 on Reform of Legal Expenses Insurance], JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], Feb. 21, 2007, p. 3051.

⁵⁵ Bernard Cerveau, *Aide Juridictionnelle et Assurance de Protection Juridique*, at 5, http://www.avocats-lille.com/doc/aj/AJ_assurance_protection_juridique.pdf (last visited Dec. 30, 2011). In 2005, 21% of households had legal expenses insurance. Marie-Hélène Beaulieu & Jacinthe Lauzon, *L'assurance juridique: une solution pour une meilleure accessibilité à la justice?* (Mar. 2007), at 21, http://www.option-consommateurs.org/documents/principal/fr/File/rapports/assurances/oc_assurance_juridique_200704.pdf.

⁵⁶ 360,000 cases were opened, 60,000 ended up in court. *See id.*

⁵⁷ The figure is for the year 2000. *See* Kilian, *supra* note 5, at 38.

⁵⁸ *See* Matthias Kilian & Francis Regan, *Legal Expenses Insurance and Legal Aid – Two Sides of the Same Coin? The Experience from Germany and Sweden*, 11 INT'L J. LEGAL PROF. 233, 238 (2004).

⁵⁹ Kilian, *supra* note 5, at 34.

⁶⁰ *See* van Hubert W. van Bühren, *Das rechtsschutzversicherte Mandat*, 52 MONATSSCHRIFT FÜR DEUTSCHES RECHT 745, 748 (1998).

⁶¹ Regan, *supra* note 9, at 52.

services,⁶² and today 97% of Swedes are covered by LEI.⁶³ The pervasiveness of LEI in Sweden is attributable to the fact that coverage for legal expenses is automatically included in household insurance policies.

Data from the Comité Européen des Assurances (CEA) demonstrate that LEI represented only 1% of total European insurance premiums in 2008.⁶⁴ The CEA data also demonstrates the growth of LEI premium expenditures between 2000 and 2008 for several European countries. On the basis of this data, it is apparent that although LEI is becoming more widespread in Europe, its impact in absolute terms remains modest.

TABLE 1

Country	Premium expenditure per capita 2008 (Euro) ⁶⁵	Premium expenditure per capita 2000 (Euro)
Austria	47.98	33.78
Belgium	31.73	21.89
Germany	38.97	32.71
Spain	3.97	1.86
Finland	10.37	5.84
France	11.47	6.06
Italy	4.79	2.11
Netherlands	41.33	15.87
Poland	9.83	2.19
United Kingdom	11.76	2.90

4. Discussion

At first sight, the differences between LEI in the U.S. and in Europe could not be greater. American group and prepaid legal services plans are not truly insurance policies and only cover a limited amount of services, whereas the European LEI policies seem much broader. However, the dif-

⁶² *Id.* at 50.

⁶³ See C.M.C. van Zeeland & J.M. Barendrecht, *Legal Aid Systems Compared*, (2003), <http://www.tilburguniversity.nl/faculties/law/research/tisco/publications/reports/legal-aid-systems.pdf> available at <http://arno.uvt.nl/show.cgi?fid=11571>.

⁶⁴ See CEA INSURERS OF EUROPE, CEA STATISTICS N°37: EUROPEAN INSURANCE IN FIGURES 9 (2009), available at <http://www.cea.eu/uploads/Modules/Publications%5Ceif-2009.pdf>.

⁶⁵ Note that premium income per capita cannot be easily translated into the percentage of households that have LEI in a given country. The premium income per capita may be misleading, as LEI policies can vary from very broad (covering all kinds of legal cases) to very narrow (e.g. covering only motor accident cases).

ferences should not be exaggerated. First, there are many European countries where LEI is virtually absent. Second, some of the European data needs to be put in perspective.

With the Swedish and the German data in mind, one could argue that insurance markets for legal services do not face any inherent obstacles to development. However, Swedish LEI policies are automatically added on to household insurance policies, which already have a large market penetration. Swedes do not have the option to purchase household insurance without LEI; it is integrated in these policies “for free.”⁶⁶ Additionally, claims on LEI require policyholders to pay an upfront fee along with a fraction of the estimated costs of the case.⁶⁷ Finally, many cases are excluded, including divorce.⁶⁸ The Swedish labor movement promoted LEI in the 1960s because legal aid focused on low-income people and failed to reach middle-income earners.⁶⁹ LEI was designed to cover the problems, costs, and groups that were excluded from legal aid. These policies were rather modest, as the legal aid regime at the time was quite comprehensive.

In Germany, other non-compulsory insurances are much more popular than LEI. For example, “65 percent of all households have a [sic] general liability insurance and 75 percent have a [sic] household insurance.”⁷⁰ Research by Matthias Kilian shows that we should expect the demand for LEI to be high in Germany. The regulatory environment in Germany is very favorable for the development of the LEI market⁷¹ because (1) the German government only spends a modest amount on legal aid; (2) almost all forms of output-based remuneration are prohibited including not only contingent fees, but also conditional fees⁷² and success fees; (3) even a party enjoying legal aid who loses her claim has to pay her opponents’ costs and only her own lawyer’s and court fees are covered by legal aid; (4) lawyers enjoy monopoly rights for out of court work (not just for representation in court but also for e.g. legal advice), making it virtually impossible to obtain lower-priced legal advice from non-lawyers (e.g. paralegals); (5) the existence of a very formal and transparent fee regulation, laid down in the Bundesrechtsanwaltsgebührenordnung (BRAGO, German Federal Code of

⁶⁶ The Swedish model is hence what is referred to as compulsory add-on insurance: LEI is automatically added on to voluntary purchased insurance policies with a high market penetration. LEI in Sweden is supposedly added “for free,” but because it is automatically added on to the household insurance, the reality is that the price for LEI is included in the premium for the basic insurance. It is hence obviously not “free,” but rather not directly visible. See Regan, *supra* note 28, at 294.

⁶⁷ *Id.* at 16. There is also a ceiling on the amount that can be claimed per year.

⁶⁸ Kilian & Regan, *supra* note 58, at 15-16.

⁶⁹ *Id.* at 14.

⁷⁰ Kilian, *supra* note 5, at 38.

⁷¹ See *id.* at 43-44.

⁷² Under a conditional fee, the lawyer gets nothing if he loses the case and an uplift on his normal fee if he wins the case. Unlike under contingency fees, the uplift does not depend on the amount at stake.

Lawyers' Fees), that gives insurance companies a good idea of the ultimate risk and simplifies the calculation of premiums; and (6) the German Bar has very little reason to oppose a shift from public legal aid to private insurance.⁷³ Indeed, in countries where the interest of the Bar is sufficiently protected by the regulatory environment, the Bar has generally not opposed government efforts to shift the emphasis from public aid to private insurance.

Whether the German Bar opposes the development of LEI depends primarily on three factors. The first factor is whether lawyers enjoy monopoly rights, not only for representation in court, but also for out of court work. If lawyers enjoy monopoly rights for only in-court representation, they have more to lose when LEI becomes more popular. This means that insurance companies can then handle a large fraction of the cases (the relatively simple ones) themselves, without having to hire a lawyer.⁷⁴ The second factor is whether the insured can freely choose the lawyer that will handle their case. When insurance companies need to hire a lawyer (whether mandated to do so or in complex cases where a settlement cannot be reached), the insurance company has a natural incentive to keep costs under control, unlike a lawyer that is paid on an hourly basis. If the insured can choose his lawyer freely, this eliminates—or at least reduces—the possibility for insurance companies to create competition between different lawyers and law firms.⁷⁵ The third factor is whether the government has established and enforces minimum fees for lawyers. Even when insurance companies can force a lawyer upon the insured, competition between lawyers will never lead to lower than minimum fees when the government enforces minimum fee rules. Minimum fees and monopoly rights for out of court work protect German lawyers from the competitive effects that otherwise would result from the insured being able to choose a lawyer.⁷⁶

B. *TPF in the United States*⁷⁷

The current TPF industry in the U.S. can be divided into three segments: (1) consumer legal funding (non-recourse loans) to individuals (usually personal injury plaintiffs); (2) loans and lines of credit for plaintiffs'

⁷³ Kilian, *supra* note 5, at 43-44.

⁷⁴ See Michael G. Faure, Ton Hartlief & Niels Philipsen, *Funding of Personal Injury Litigation and Claims Culture. Evidence from the Netherlands*, 2 *UTRECHT L. REV.* 1 (2006).

⁷⁵ Council Directive 87/344EEC of 22 June 1987 on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance explicitly provides in article 4 that any contract of legal expenses insurance has to recognize explicitly that the insured person shall be free to choose a lawyer. 1987 O.J. (L 185) 77-80.

⁷⁶ Kilian, *supra* note 5, at 37-38, 44.

⁷⁷ This part briefly describes the TPF industry and its regulatory environment in the U.S. For more elaborate studies and for a description of TPF in other countries, see the other articles in this issue.

law firms; and (3) investments in commercial lawsuits.⁷⁸ All of these segments of the TPF industry provide financial support for plaintiff-side efforts.⁷⁹ Presently, there is very little TPF for American defendants,⁸⁰ although some providers of plaintiff-side TPF are also interested in providing funding to defendants and their lawyers.⁸¹ For now, TPF does not seem like it will play an important role in the U.S. class action market,⁸² as a number of investment firms have claimed that they do not intend to enter that market.⁸³ In the context of consumer legal funding, a consumer's potential recovery from a class action may seldom be large enough to obtain a non-recourse loan.

Dozens of TPF companies provided funding to consumers with pending legal claims in 2010.⁸⁴ As the great majority of these lawsuits involve personal injury claims (mainly auto accidents), and only consumers who have found a lawyer who agrees to represent the client are eligible for funding, almost all of these consumers are being represented on a contingency fee basis.⁸⁵ Typically, the TPF company provides funds to the consumer in exchange for a promise to pay back the funds plus a contracted fee.⁸⁶ Although the fee does not depend on the amount of the recovery, it typically increases with the time elapsed.⁸⁷ The contracts are usually non-recourse loans, meaning that the consumer is never obligated to pay more than the proceeds from the underlying lawsuit. The financing fees can significantly exceed interest rates on consumer bank loans or on credit card balances.⁸⁸

⁷⁸ Because of time and space constraints, we focus on the main forms of TPF in the U.S. and do not discuss (for example) the case of the purchase of retroactive liability coverage. For example, when fire hit the MGM Grand Hotel in Las Vegas in 1980, the hotel's owners had only \$30 million in liability insurance. After the fire, the hotel company increased its liability coverage to almost \$200 million. This new insurance was backdated to twenty days before the catastrophe. This can be explained by a comparative advantage in claims administration. See David Mayers & Clifford W. Smith, *On the Corporate Demand for Insurance*, 55 J. BUS. 281, 285 (1982). Without the extra coverage, the incentives of the insurance company's adjusters' to negotiate efficient settlements could be far from optimal.

⁷⁹ See GARBER, *supra* note 7, at 9.

⁸⁰ Theoretically, this could be due to several reasons: the unlimited downside litigation risk of defendants, adverse selection, moral hazard, the fact that defendants and their lawyers may have better access to capital than individual plaintiffs and their lawyers, and the fact that many corporate defendants have insurance that covers legal expenses (e.g. general liability insurance).

⁸¹ See Ralph Lindeman, *Third Party Investors Offer New Funding Source for Major Commercial Lawsuits*, DAILY REP. FOR EXECUTIVES (BUREAU OF NAT'L AFF.), March 5, 2010, at 3.

⁸² See GARBER, *supra* note 7, at 36.

⁸³ Deborah R. Hensler, *The Future of Mass Litigation: Global Class Actions and Third Party Litigation Funding*, 79 GEO. WASH. L. REV. 306, 323 (2011).

⁸⁴ Some contracts are made after the case is settled because it can take months before the settlement payment is made.

⁸⁵ Most personal injury lawyers work on a contingency fee basis.

⁸⁶ See GARBER, *supra* note 7 at 9.

⁸⁷ See *id.*

⁸⁸ See *id.* at 10.

Typical rates would be 3-5% monthly interest,⁸⁹ although some companies charge less than 2%. The average size of the cash advance tends to be less than 10% of estimated values of the underlying claim.⁹⁰ Consumers may be interested in these loans because their ability to obtain funding from other sources is exhausted or they like that they never have to pay back more than the proceeds of the lawsuit.

Unlike consumer legal funding, loans to plaintiffs' law firms are not non-recourse.⁹¹ A law firm's debts are typically secured by all of the firm's assets, including its real property and future fees from its cases. Little is known about the interest rates charged to firms, but interest rates of about 20% appear to be common.⁹² Law firms' motives for using this type of funding include the desire to remain solvent, alleviate cash-flow problems, compete for business with firms that have more capital, and invest more in pending cases.⁹³

Steven Garber identified six companies that provide capital directly to business-plaintiffs or their outside counsel in order to finance costs of pending commercial claims (business-against-business).⁹⁴ The disputes are usually antitrust, intellectual property, or contracts cases. The TPF companies provide capital in return for a share of the corporate plaintiff's recovery. Several motives have been advanced to explain why companies consider this type of funding. Some companies may want to use less of their own capital to pay outside counsel.⁹⁵ Others may want an assessment of the merits and economic value of their claim in addition to the one provided by their outside counsel.⁹⁶ Next, some companies might use TPF strategically in the hope of strengthening their bargaining position; the provision of TPF could signal that the claim is of high merit to the defendant.⁹⁷ And last, corporate general counsel may be loath to ask for a budget increase.⁹⁸

The legal status of TPF in the United States is unclear.⁹⁹ Laws governing TPF agreements vary widely among states and only a few states have

⁸⁹ See JONATHAN T. MOLOT, A MARKET APPROACH TO LITIGATION ACCURACY, at 24 (Geo. Univ. L. Ctr., 2009), available at http://www.law.northwestern.edu/searlecenter/papers/Molot_Accuracy.pdf.

⁹⁰ See GARBER, *supra* note 7, at 12.

⁹¹ In 2010, there were 9 TPF companies in this segment. See *id.* at 13.

⁹² *Id.*

⁹³ *Id.* at 23.

⁹⁴ *Id.* at 13.

⁹⁵ *Id.* at 15.

⁹⁶ GARBER, *supra* note 7, at 15.

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ See Jason Lyon, *Revolution in Progress: Third- Party Funding of American Litigation*, 58 UCLA L. REV. 571, 575 (2010).

adopted regulations specifically for TPF.¹⁰⁰ However, these statutes generally focus on loans in personal injury cases, not on commercial litigation. To date, no U.S. court has considered the legality of TPF in the context of commercial litigation.¹⁰¹ With respect to loan agreements in personal injury suits, the case law is mixed. Many courts have held these agreements to be valid and enforceable.¹⁰² Other courts, however, have invalidated these agreements.¹⁰³ The most frequently cited criticism is that loan agreements in personal injury suits violate the common law doctrines of maintenance and champerty. Maintenance is the interference in litigation by those without a legitimate interest in the claim. Champerty is maintenance by those who seek to profit from another's lawsuit.¹⁰⁴ Although there have been few prosecutions in the last century, the doctrines are still considered valid in the U.S. By contrast, in Australia, some states have abolished these doctrines (e.g., Victoria, New South Wales, Australian Capital Territory, and South Australia).¹⁰⁵

II. POTENTIAL REASONS FOR A LOW LEI FREQUENCY AND LEI'S INFLUENCE ON TPF

The data in Part I demonstrate that the frequency of purchasing LEI is relatively low in many countries. This part, examines several potential explanations for this phenomenon. It discusses the plausibility of each explanation, and where available, uses empirical research in support. It then analyzes whether these explanations may influence the development of TPF.

¹⁰⁰ Maine, Nebraska and Ohio enacted specific legislation. See Maine Consumer Credit Code Legal Funding Practices, ME. REV. STAT. tit. 9-A, § 12 (2009); Nebraska Nonrecourse Civil Litigation Act, NEB. REV. STAT. ANN. § 25-3303 (LexisNexis 2010); Ohio Non-Recourse Civil Litigation Advances, OHIO REV. CODE ANN. § 1349.55 (West 2008).

¹⁰¹ See Lyon, *supra* note 99, at 575.

¹⁰² See, e.g., Saladini v. Righellis, 687 N.E.2d 1224 (Mass. 1997); Osprey, Inc. v. Cabana Ltd. P'ship, 532 S.E.2d 269 (S.C. 2000).

¹⁰³ See Rancman v. Interim Settlement Funding Corp., 789 N.E.2d 217, 219-21 (Ohio 2003) (declining to enforce a litigation lending agreement because "a lawsuit is not an investment vehicle" and "[a]n intermeddler is not permitted to gorge upon the fruits of litigation"); cf. Odell v. Legal Bucks, LLC, 665 S.E.2d 767 (N.C. Ct. App. 2008).

¹⁰⁴ The U.S. Supreme Court defines maintenance as "helping another prosecute a suit," and champerty as "maintaining a suit in return for a financial interest in the outcome." See *In re Primus*, 436 U.S. 412, 424-25 n.15 (1978).

¹⁰⁵ See Daniel L. Chen & David S. Abrams, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes*, at 9-11 (2011), <http://www.duke.edu/~dlc28/papers/MktJustice.pdf>.

A. *The Existence of Alternatives for Access to Justice*

1. LEI

The first potential explanation relates to alternative methods for settling disputes. In some legal systems, risk-averse individuals may use a results-based compensation system to pay their lawyers. In the U.S., for example, the vast majority of individual plaintiff's attorneys bring cases on a contingency fee basis in tort litigation.¹⁰⁶ In 1995, the United Kingdom instituted a variant of a contingent fee system known as the conditional fee arrangement. Under this arrangement, the attorney pays all of the plaintiff's costs if the case is lost, but receives her hourly wages plus a mark-up if the case is won or if there is a settlement.¹⁰⁷ Demand for LEI may be lower in legal systems where individuals can reduce the risk of a trial via result-based compensation systems.

Additionally, demand for LEI should be lower if victims, ex ante, know that the state will cover at least some part of their trial costs. Demand for LEI may be even lower in systems that provide legal aid. Further, it is possible that when a state reduces the financing of its legal aid scheme, demand for LEI will subsequently increase. Simple economics dictates this result. If potential victims can rely on state aid that would, hypothetically, provide the same quality of services provided via LEI, relying on publicly-provided legal aid is the cheapest option, as there is no premium to be paid. In that sense, state-provided legal aid creates a moral hazard problem because victims can free ride on the state. A similar argument has been made with respect to disaster insurance.¹⁰⁸ Some scholars claim that the low demand for this type of insurance is related to the state's generous ex post relief following an accident.¹⁰⁹ Potential victims would free ride on the state rather than pay a premium.¹¹⁰

Empirical research supports many of these theoretical findings. For example, a recent study from the Netherlands states that the growth of LEI

¹⁰⁶ A U.S. survey by Kakalik and Pace (1986) showed that 96% of individual plaintiff's attorneys in tort litigation brought cases on a contingency fee basis, while 95% of defendants' attorneys worked for an hourly wage. See JAMES S. KAKALIK & NICHOLAS M. PACE, COSTS AND COMPENSATION PAID IN TORT LITIGATION, at 96-97 (1986).

¹⁰⁷ See Daniel L. Rubinfeld & Suzanne Scotchmer, *Contingent fees*, in THE NEW PALGRAVE DICTIONARY OF LAW AND ECONOMICS 415-19 (Peter Newman ed., 1998).

¹⁰⁸ See Louis Kaplow, *Incentives and Government Relief for Risk*, 4 J. RISK & UNCERTAINTY 167 (1991) (arguing that government relief is inefficient due to problems of moral hazard).

¹⁰⁹ In the literature this is referred to as the "Charity Hazard." Paul A. Raschky, P. & Hannelore Weck-Hannemann, *Charity Hazard – A Real Hazard to Natural Disaster Insurance?*, 7 ENVTL. HAZARD 321, 321 (2007).

¹¹⁰ See Richard Epstein, *Catastrophic Responses to Catastrophic Risks*, 12 J. RISK & UNCERTAINTY 287, 293-95 (1996).

between 1970 and 2009 parallels regular cuts in legal aid and increases in private contributions.¹¹¹ However, the availability of public legal aid or results-based compensation systems cannot fully explain the low frequency of LEI in some countries. Even though contingency fees may be useful in many instances, they do not help those who have suffered relatively small losses and plaintiffs in non-monetary disputes. In the United Kingdom, not all cases can be financed under a conditional fee arrangement and therefore citizens may demand LEI.¹¹² There are also countries where the people cannot afford legal costs; only a fraction are eligible for free legal aid, and no-cure, no-pay, and *quota pars litis* arrangements are prohibited, but yet LEI is not widespread. In 2003, 75% of the Belgian population claimed that the costs of a legal proceeding were too high (of the 25% who could afford litigation, 10% had independent financing and 15% qualified for legal aid).¹¹³ Given the prohibition of output-based remuneration systems and low amounts of public legal aid, one would expect a strong demand for LEI in Belgium. However, this is not the case.

2. TPF

There are parallels between the demand for LEI and the demand for TPF. As with LEI, the demand for TPF can largely be explained by the availability of alternatives. In jurisdictions where publicly-provided legal aid is generous, which could cause a moral hazard or “charity hazard” problem, the demand for TPF will likely be relatively small. Litigants will not demand TPF if they can free ride on state provided legal aid. To the contrary, demand for TPF will likely increase where alternative funding systems are unavailable or inadequate. However, even if a country allows contingency fees, TPF may still have a future. Contingency fees are limited in several ways.¹¹⁴ Contingency fees help plaintiffs transfer some litigation risk to their lawyers,¹¹⁵ but there are investment cases that plaintiffs’ lawyers are not eager to take. TPF funding may persuade risk-averse lawyers to take these cases. Also, lawyers cannot pay cash for a fraction of their clients’ claims.¹¹⁶ They can only advance out-of-pocket litigation expenses

¹¹¹ Carolien Klein Haarhuis & Ben van Velthoven, *Legal Aid and Legal Expenses Insurance, Complements or Substitutes? The Case of the Netherlands*, LEIDEN LAW SCHOOL, DEP’T OF ECON., 3, (Feb. 2010), <http://media.leidenuniv.nl/legacy/bvv-2010-02.pdf>.

¹¹² See Michael G. Faure, Fokke J. Fernhout & Niels J. Philipsen, *Resultaatgerelateerde Beloningssystemen voor Advocaten*, METRO, UNIVERSITEIT MAASTRICHT, 59 (June 12, 2006), <http://wodc.nl/onderzoeksdatabase/internationale-vergelijking-beloningssystemen-advocatuur.aspx>.

¹¹³ Report of the working group “Rechten van Slachtoffers” (Rights of Victims), Parliamentary Proceedings of the Belgian Senate 2002-2003, at 2, March 13, 2003, 2-1275/1.

¹¹⁴ See Chen & Abrams, *supra* note 105, at 7-8.

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 8.

under contingency fees. Additionally, contingency fee “lawyers can only pay with their services.”¹¹⁷ This limits the fraction of a claim that a lawyer can purchase.¹¹⁸ When lawyers are the sole source of capital, its amount and timing is quite limited. This reduces competition for capital-constrained clients, which leads to higher costs for these clients. As Daniel Chen and David Abrams put it, “[b]y opening up provision of capital to the market, third-party litigation funding solves a number of shortcomings this [sic] whereas contingency fees do not.”¹¹⁹

Another question is to what extent the existence of LEI could hinder the development of TPF. As previously seen, in some countries a large fraction of the population is covered by LEI, generally after government intervention. LEI is becoming more popular in other countries and several countries, such as the UK, are working to promote LEI to more people. Widespread LEI will substantially diminish the demand in the segment of consumer legal funding. In other segments (loans to plaintiffs’ law firms and investments in commercial claims), however, LEI cannot compete with TPF. Because of moral hazard and adverse selection problems, LEI often provides relatively low upper limits on the maximum amount of coverage. Moreover, TPF does not promote access to justice as much as it serves as a financing and funding instrument. Therefore, even under a contingency fee arrangement, which stimulates access to justice, TPF may still be an attractive instrument to obtain upfront funding for some plaintiffs.

B. *Adverse Selection*

1. LEI

The problem of adverse selection may play a role in the case of LEI. Some individuals may be more likely to file a lawsuit than others. If an insurer cannot distinguish between these two groups, he is forced to average premiums between all of them. Consequently, legal expenses insurance may be particularly attractive for high-risk individuals.¹²⁰ As a result, those taking out LEI are more likely to be litigious, thereby increasing LEI premiums. This may result in only the most litigious individuals being interested in taking out LEI. Ultimately, this could lead to particular risks being uninsurable.¹²¹ Adverse selection problems are likely more substantial for

¹¹⁷ *Id.*

¹¹⁸ Usually between 1/3 and 1/2 of the plaintiff’s recoveries.

¹¹⁹ Chen & Abrams, *supra* note 105, at 9.

¹²⁰ See George Akerlof, *The Market for “Lemons”: Quality, Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 492-94 (1970); see also George Priest, *The Current Insurance Crises and Modern Tort Law*, 96 YALE L. J. 1521, 1541 (1987).

¹²¹ See Akerlof, *supra* note 120; Priest *supra* note 120.

stand-alone LEI products than for add-on legal expenses insurance since, for the latter, LEI policies are added to other types of insurance, which usually have well-balanced risk pools.¹²² However, the market for these add-on policies is thin in many countries.

Nevertheless, theoretical insurance literature indicates that problems of adverse selection can be mitigated in several ways: the exclusion of certain risks from insurance;¹²³ risk-based diversification of premiums;¹²⁴ ceilings on the amount of coverage per period; and offering a variety of insurance policies with different combinations of coverage and premiums.¹²⁵ Also, recent empirical research shows that adverse selection may depend heavily upon the type of insurance market and may not be as serious a problem in many insurance markets, contrary to suggestions in the literature.¹²⁶

Recent empirical research from the Netherlands indicates that there is apparently not an adverse selection problem in the market for legal expenses insurance.¹²⁷ This research uses data gathered in a 2009 “Paths to Justice” survey. The survey investigated the potential for sixty-seven different civil, administrative, and other similar lawsuits in the Netherlands from 2004 to 2008. The survey sample was representative of the Dutch population in terms of age, education and sex. Respondents were asked if they were covered by any kind of LEI policy and, if so, which modules were covered. Nearly 61% of the respondents faced one or more non-trivial¹²⁸ justiciable problem. The average number of potential lawsuits for all respondents was 1.88. The problem frequency of individuals with LEI, at 1.97, was 11% higher than for individuals without LEI, who faced 1.78 problems. The researchers recognized that this difference could be explained by a selection effect and a behavioral effect.¹²⁹ When controlling

¹²² See Kilian & Regan, *supra* note 58, at 240-41. Barzel shows that insurance packages that tie substitutes and exclude complements have desirable effects on moral hazard and adverse selection. With that kind of packaging, the extent of excess use will decline. Also, that type of insurance will be chosen by fewer people who impose larger costs than their valuation and by more people whose valuations exceed their costs. See Yoram Barzel, *Competitive Tying Arrangements: The Case of Medical Insurance*, 19 *ECON. INQUIRY* 598 (1981).

¹²³ Kilian, *supra* note 5, at 39.

¹²⁴ Whenever possible, insurers should differentiate between high and low risk individuals. If high risk individuals (e.g., those who are very litigious) can be charged higher premiums, the unraveling of risk pools (typical for adverse selection) can be prevented.

¹²⁵ This may induce policyholders to reveal their type. See Winand Emons, *The Theory of Warranty Contracts*, 3 *J. ECON. SURVEYS* 43, 50-52 (1989).

¹²⁶ See Willem van Boom, *Insurance Law and Economics: an Empirical Perspective*, in *ESSAYS IN THE LAW AND ECONOMICS OF REGULATION, IN HONOUR OF ANTHONY OGUS*, at 256-59 (Michael G. Faure and Frank Stephen eds., 2008).

¹²⁷ See Haarhuis & van Velthoven, *supra* note 111, at 5-6.

¹²⁸ The researchers considered a problem as trivial if the respondent had not taken any action either because the problem was not important enough, or the respondent did not dispute the outcome, or the respondent believed that the other side was right.

¹²⁹ See *infra* II.C.

for several personal characteristics such as age, marital status, education and social group, the researchers found that LEI coverage increased the frequency of justiciable problems by 8%. In other words, there was a selection effect of 3% and a behavioral effect of 8%. In sum, it is unlikely that adverse selection can explain the relatively small size of LEI markets.

2. TPF

Adverse selection may also plague TPF markets. The exact nature and extent of this problem may depend on the TPF segment involved. In the segment of consumer legal funding, those consumers who think that they are more likely to obtain little or no recovery outside of their non-recourse loan envisage lower costs to promising to pay out of their proceeds. Because individual transactions are fairly small in this segment, TPF suppliers will not be willing to spend a lot on due diligence costs, or evaluating the prospects for repayment. This relates to the general notion that adverse selection stems from information asymmetry between the individual covered by TPF and the funding agent. The individual may have better information on his case's quality but may not be willing to reveal this to the financing agent in order to get a better deal on the TPF. For small risks, because an individual risk assessment is too costly, TPF agents will, just like insurers, classify risks and try to remedy adverse selection through risk classification. Nevertheless, there is a positive side. Given the relatively small amount of funding per transaction in consumer loans, well-capitalized suppliers can have many concurrently outstanding loans and therefore keep portfolio risks small, at least if the cases are sufficiently unrelated.

The fact that contingency fees are prohibited in many European countries could make it more difficult for this segment to develop in Europe, at least when considering adverse selection problems. When a lawyer has accepted a case on a contingency fee basis, funders may view this as a positive signal about the merits of the case. This could be especially helpful if TPF suppliers have information about how well lawyers screen cases. Eric Helland and Alexander Tabarrok's research finds that legal systems which support contingency fees increase legal quality and decrease the time to settlement.¹³⁰ This is consistent with James Dana and Kathryn Spier's theoretical model, which demonstrates that contingency fees decrease frivolous lawsuits.¹³¹ Paul Fenn and Neil Rickman summarize empirical studies of contingency fee arrangements and find that lawyers who use no-win, no-fee

¹³⁰ Eric Helland & Alexander Tabarrok, *Contingency Fees, Settlement Delay and Low-Quality Litigation: Empirical Evidence from Two Datasets*, 19 J.L. ECON. & ORG. 517 (2003). The authors use a cross-section of states and a time series of medical malpractice claims in Florida.

¹³¹ James D. Dana & Kathryn E. Spier, *Expertise and Contingency Fees: The Role of Asymmetric Information in Attorney Compensation*, 9 J.L. ECON & ORG. 349 (1993).

arrangements screen their cases more and settle sooner.¹³² Of course, this screening is far from perfect. Contingency fee lawyers may still bring weak cases as long as the expected benefit outweighs the cost. This will be especially true for large stakes claims. With respect to plaintiffs' law firms loans, firms nearer to financial collapse are more likely to ask for a loan simply because they have little to lose. TPF suppliers may be willing to spend more on evaluating the prospects for repayment than they would in consumer legal funding since loans are larger on average. Finally, in commercial litigation investments, owners of commercial claims are more likely to share the financial upside of their claims when they are less optimistic about the probability of winning the claim and subsequent damages. However, in commercial litigation, TPF suppliers may be willing to invest more to evaluate the quality of the claim, given the larger amounts at stake.

C. *Moral Hazard*

1. LEI

In the presence of asymmetric information, LEI markets may also suffer from moral hazard problems.¹³³ Moral hazard is a fully insured individual's tendency to exercise less care in protecting themselves against loss. It is a form of ex post opportunism, which occurs when the insurer cannot observe the actions of the insured. In such a case, the insurer is unable to link premiums to an insured's actions. The insured will reduce his level of care, thereby increasing insurance premiums. The increase may be so large that individuals facing the risk choose to increase their private level of care rather than buy insurance. The moral hazard problem, therefore, could cause a breakdown of the insurance market.

In the context of LEI, we can distinguish between several variants of moral hazard. Initially, people who know that they can rely on legal assistance in a legal dispute may be less hesitant to enter into situations that have the potential to generate legal problems. For example, such a person may have a weaker incentive to screen for the reputation for default of a future contract party. Individuals with LEI may also be more likely to bring existing problems to a head.¹³⁴ Next, an insured person may be less hesitant to initiate legal proceedings than an uninsured person, even with a weak

¹³² Paul Fenn & Neil Rickman, *The Empirical Analysis of Litigation Funding*, in *NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE* 131, 145 (Mark Tuil & Louis Visscher eds., 2010).

¹³³ On moral hazard and insurance, see Steven Shavell, *On Moral Hazard and Insurance*, 93 Q. J. ECON. 541 (1979).

¹³⁴ See Haarhuis & van Velthoven, *supra* note 111, at 7.

claim.¹³⁵ Also, a policyholder may want to pursue a claim more intensely than a person without LEI.¹³⁶ He may want his insurer or lawyer to spend more time on the case than it is worth. Finally, the insurer may face a moral hazard problem, not only in his relationship with the insured, but also with the insured's lawyer. Given an insurance company's deep pockets, a lawyer may feel less restricted and behave opportunistically.

As indicated above, there are several standard responses for moral hazard problems that can also be helpful in the context of LEI.¹³⁷ Mechanisms can be introduced in an insured's policy that gives the insurer some control on whether to file a lawsuit or limit the free choice of an attorney, if legally permissible.¹³⁸ In the latter case, the insurer has the advantage of limiting the choice of attorneys to the insured, thereby allowing the insurer to make ex ante fee agreements. Also, the insurer can design contractual limitations that have the effect of risk sharing between insurer and insured, including deductibles, minimum claim levels, co-insurance, etc.¹³⁹ The insured then has an incentive to limit legal costs, at least to a certain extent. Moral hazard on the side of the attorney is obviously more prevalent in legal systems where hourly fees can be charged and fees are unregulated.¹⁴⁰ Hence, it can be predicted that if legal systems regulate attorneys' fees, this could increase the ex ante possibilities of adequate risk calculation for the insurer. Thus, one could predict LEI to be more prevalent in legal systems where attorneys' fees are regulated or other mechanisms exist whereby the insurer can control for moral hazard of the insured and attorneys (see Part I.A.3. for the case of Germany). This may well explain the success of LEI in Denmark; because attorneys' fees are in principle limited to the amount the insured would receive under legal aid, moral hazard can be effectively controlled.

Empirical research from the Netherlands shows that the moral hazard problem is relatively small in the context of LEI.¹⁴¹ LEI coverage increases problem frequency by 8%.¹⁴² German research shows that LEI does not automatically lead to an explosion in litigation. Insured plaintiffs litigate

¹³⁵ BEN VAN VELTHOVEN & MARIJKE TER VOERT, *GESCHILBESLECHTINGSDELTA* 2003, 151 (2003).

¹³⁶ Roger Bowles & Neil Rickman, *Asymmetric Information, Moral Hazard and the Insurance of Legal Expenses*, 23 *GENEVA PAPERS ON RISK AND INS.* 196, 197 (1998).

¹³⁷ For a summary of the literature on moral hazard, see van Boom, *supra* note 126, at 253-76.

¹³⁸ As we already mentioned EC directive 87/344 of 22 June 1987 seriously limits the possibility to restrict the insured's right to choose his own lawyer. This can only be stipulated if specific conditions are fulfilled.

¹³⁹ See Kilian, *supra* note 5, at 39.

¹⁴⁰ For a summary of the literature, see Frank H. Stephen & James H. Love, *Regulation of the Legal Profession*, in *ENCYCLOPEDIA OF LAW AND ECONOMICS*, 987-1017 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

¹⁴¹ See Klein Haarhuis & van Velthoven, *supra* note 111, at 7-8.

¹⁴² See *infra* II.A.1.

only 5%–10% more often than uninsured plaintiffs.¹⁴³ As a result, it seems unlikely that moral hazard can explain the low frequency of LEI in certain places.

2. TPF

Moral hazard problems can also be present in the market for TPF. In the context of consumer legal funding, as soon as a consumer's prospect of having money left after paying the TPF supplier gets sufficiently small, the consumer has no incentive to pursue his claim. Of course, this will drive up the price of the non-recourse loans. But again, moral hazard may be problematic, although not insurmountable, under TPF. The TPF contract can, for example, contain clauses guaranteeing the consumer's cooperation even after the initial sum has been received. That may indeed be the main problem in each TPF segment: creating incentives for the decision maker (the TPF receiver or supplier) to account for both entities' costs and benefits, rather than only its own. As long as the decision maker bears an equal share of the costs and benefits of each additional investment in the case, he can be expected to behave in an optimal way from the point of view of both the TPF receiver and supplier. Under such a scheme, the decision maker's marginal costs equal his marginal benefits at the same point where total marginal costs equal total marginal benefits.¹⁴⁴ However, such incentive schemes are not observed in the three different segments of TPF, so some moral hazard problems should be expected.

One may fear that TPF of mass consumer claims may increase the incentive to file frivolous and weak class action suits. Even without TPF, some observers feel that the settlement leverage created by class certification pressures defendants to settle these suits.¹⁴⁵ The main reason is that class actions magnify the stakes and complexity of an action. This compounds the defendant's litigation, reputation, and risk-bearing costs. Several reform proposals have been advanced: strengthening sanctions for frivolous filings, shifting some portion of the winner's attorney's fee to the losing side,¹⁴⁶ having the trial judge conduct a preliminary merits review at

¹⁴³ See ERHARD BLANKENBURG & JANN FIEDLER, *DIE RECHTSSCHUTVERSICHERUNGEN UND SEIGENDE GESCHAFTSANFALL DER GERICHTE* (1981).

¹⁴⁴ For such a scheme in the context of contingency fees, see A. Mitchell Polinsky & Daniel L. Rubinfeld, *Aligning the Interests of Lawyers and Clients*, 5 *AM. L. & ECON. REV.* 165 (2003).

¹⁴⁵ See Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 *DUKE L.J.* 1251 (2002); see also George L. Priest, *Procedural Versus Substantive Controls of Mass Tort Class Actions*, 26 *J. LEGAL STUD.* 521 (1997).

¹⁴⁶ See Deborah R. Hensler & Thomas D. Rowe, Jr., *Beyond "It Just Ain't Worth It": Alternative Strategies for Damage Class Action Reform*, 64 *LAW & CONTEMP. PROBS.* 137 (2001).

the certification stage,¹⁴⁷ and having the judge hold multiple class trials and base his or her judgment on a weighted combination of the several verdicts.¹⁴⁸

D. *Positive Externalities: The Free Rider Problem*

1. LEI

Recently, another reason for a market failure in LEI has been advanced.¹⁴⁹ The difficulties of LEI could be attributed to free rider problems that result from positive externalities. Insurance generally does not create positive externalities. For example, if an insured piece of jewelry is stolen, only the owner will benefit from the theft insurance. Legal expenses insurance, however, may create positive externalities. A potential victim with LEI may be able to bring a case to court that he would not otherwise have brought because of risk-aversion or lack of funds. When more individuals take LEI, the probability that an injurer will avoid consequences decreases. A potential injurer takes this into account when deciding on his care level and takes additional care. The additional deterrence created by LEI-driven litigation lowers the probability that *other* people will get injured. So individuals only internalize a small part of the deterrent effect of taking LEI and thereby benefit from others' decisions to take LEI. In theory, this can lead to a free rider problem. Obviously, this effect is only relevant in situations where the injurer cannot differentiate between parties with and without an insurance policy (as is generally the case for torts).¹⁵⁰ Furthermore, the free rider problem can be expected to be most prevalent in cases in which first-party damage insurance is available. If first-party damage insurance is unavailable or only partially available, then potential victims will be more inclined to take LEI if they are sufficiently risk-averse.

Even if potential victims would not have an incentive to free ride, there could be a free rider problem on the supply side when the deterrence benefits of LEI-driven litigation are substantial. For example, if an insurance company has a market share of 10% in the LEI market, then 90% of

¹⁴⁷ See generally Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 DUKE L.J. 1251 (2002).

¹⁴⁸ Bruce L. Hay & David Rosenberg, "Sweetheart" and "Blackmail" Settlements in Class Actions: Reality and Remedy, 75 NOTRE DAME L. REV. 1377 (2000).

¹⁴⁹ See Jef De Mot & Michael G. Faure, *Legal Expenses Insurance and the Free Rider Problem* (Working Paper, 2011), available at: <https://biblio.ugent.be/input/download?func=downloadFile&fileOId=1071903&recordOId=1070897>.

¹⁵⁰ If the injurer can differentiate between parties before deciding on his level of care, insurance for legal expenses would not create positive externalities, at least if the injurer is able to adjust his level of care for each party individually.

the deterrence benefits of each LEI policy will go to other insurance companies. This could lead to a free rider problem that prevents the insurance industry from taking meaningful action.¹⁵¹ This could explain why there are so few companies that offer very comprehensive policies.¹⁵² A similar argument has been made with respect to Lojack.¹⁵³ The question why most auto insurance companies give no discount for Lojack has been answered from two different perspectives.¹⁵⁴ According to one view, Lojack is not a winner for insurers with a relatively low market share, as most of the benefit will go to their rivals.¹⁵⁵ According to another view, Lojack is probably not very effective. If it were, the free rider problem could be easily solved. If car manufacturers would install Lojack on their cars, thieves would stay away from these cars, and the manufacturers would reap the benefits.¹⁵⁶ Even if this argument were correct, it would be hard to find an analogous market solution in the context of LEI for torts.

2. TPF

The previous part has shown that there can be a problem of positive externalities stemming from potential victims' decisions on whether or not to take LEI. In the context of TPF, individuals deciding whether to use TPF will also not take the positive externalities of their decisions into account. This is a straightforward application of Steven Shavell's theory.¹⁵⁷ When a victim has suffered harm, he does not take the general deterrent effect of his lawsuit into account, as filing a lawsuit cannot change the injurer's behavior. The victim only looks at the damages he could be awarded. The previous part has also demonstrated that the presence of positive externalities may lead legal expense insurers not to offer comprehensive LEI. In the context of TPF, however, there may be a different problem. If a TPF supplier provides substantial funding for a specific type of claim, this may in-

¹⁵¹ Especially for negative expected value claims. These are claims for which the expected benefits are smaller than the expected costs. Note that also strong claims can have negative expected value.

¹⁵² See MCDONALD ET AL., *supra* note 11, at 52.

¹⁵³ With Lojack, a small radio transmitter is hidden in one of many possible locations within a car. When a car is reported stolen, the police activate the transmitter and specially equipped police cars and helicopters track the precise location and movement of the vehicle.

¹⁵⁴ In some states, discounts are mandated (e.g. Florida, New York, New Jersey, Pennsylvania). See JOHN R. LOTT, *FREEDOMNOMICS: WHY THE FREE MARKET WORKS AND OTHER HALF-BAKED THEORIES DON'T* 204, n.52 (2007).

¹⁵⁵ Ian Ayres & Barry Nalebuff, *Stop, Thief!*, FORBES (Jan. 10, 2005), http://www.forbes.com/forbes/2005/0110/088_print.html.

¹⁵⁶ When the rate of theft of a car model decreases, the car model becomes more attractive to consumers by lowering insurance premiums. See JOHN R. LOTT, *supra* note 154, at 43-44.

¹⁵⁷ Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333 (1982).

crease deterrence for these claims. Consequently, there will be fewer of these cases in the future, which reduce the future profits of the TPF industry in this particular segment. The company that provides funds for these claims only suffers part of the harm and the rest is externalized; other companies' future profits decrease as well. From the TPF industry's perspective, there may be too much TPF. Each company may only suffer a small future loss if TPF is currently provided on a generous basis and for claims that can rather easily be deterred. But the loss of profit for the entire industry could be substantial.

What if the TPF industry is not competitive or the various suppliers can make agreements about the funds they channel to various types of claims? In such a scenario, funds may not go to the claims that, from a social perspective, are the most deserving of funding—the cases that can be easily deterred. It is unlikely that the TPF industry has an interest in substantially decreasing the accident rate, as the need for TPF decreases when more accidents are deterred. A monopolistic TPF industry will provide funding until its marginal benefit equals its marginal cost. That industry will prefer to divert funds to cases that are difficult to deter because those will not affect the industry's future income stream.

A parallel can be drawn here to the insurance industry's incentives to reduce the accident rate. In the insurance literature, there is a striking diversity in viewpoints with respect to the industry's interest in accident reduction.¹⁵⁸ According to one view, the insurance industry has a positive interest in accident reduction.¹⁵⁹ Another view states that the industry is simply not interested in accident reduction.¹⁶⁰ A third view holds that the industry's interest is served if the accident rate is at a high level.¹⁶¹ Note that insurers may have an interest in a high accident rate under some types of premium regulation. This question has received relatively little attention

¹⁵⁸ See generally GERALD J.S. WILDE, TARGET RISK (1994).

¹⁵⁹ As one commentator puts it: "[I]t is obviously of great interest for the insurance companies . . . to reduce the number of traffic accidents and consequently their cost." Tore Vaaje, *Rewarding in Insurance: Return of Part of Premium After a Claim-Free Period*, 1990 PROCEEDINGS, OECD/ECMT SYMPOSIUM ON ENFORCEMENT AND REWARDING: STRATEGIES AND EFFECTS.

¹⁶⁰ "[I]nsurance . . . is essentially neutral and indifferent with regard to the occurrence of the events that society defines as accidents. . . . Hence, one can rightfully ask if the very mention of 'preventive action by insurance' is not stupid, though well-intentioned." Yvon Chich, *L'Assurance automobile peut-elle et veut-elle investir dans l'action préventive?*, translated in GERALD J.S. WILDE, TARGET RISK (1994), available at <http://psyc.queensu.ca/target/chapter11.html>.

¹⁶¹ See M. Gray, *Insurance Logic that is Blind to Safety Inventions*, LLOYD'S LIST (Nov. 2, 1989) ("All it needs is the insurance industry to require such equipment to be mandatory, suggest these hopeful people—once again falling into the age-old trap of assuming that the purpose of insurance is in some way to increase safety, or alter human nature, or dramatically to affect statistics. It is an argument which apparently has right and justice on its side, until the truth dawns that insurers are not philanthropists or safety agencies, but merely takers of commercial risks—nothing more, nothing less. Consider the conflict of sentiment which would flash through an underwriter's mind if a wild-eyed inventor burst into his office, waving plans for some equipment that would make ships virtually unsinkable.").

in the law and economics literature. In the context of product liability litigation, W. Kip Viscusi notes “in the long run the insurance industry will profit from a high level of liability since that will increase the degree of coverage it can write.”¹⁶² This problem may also arise in the context of LEI. Offering comprehensive LEI policies could also reduce the accident rate for some types of claims. Whether this problem is substantial for LEI will depend on (1) the relationship between profit per insurance contract and the types and frequency of accidents and (2) whether LEI insurers and liability insurers or damage insurers are integrated. It is worth recognizing that the additional premium income from LEI would partially offset the losses in premium income for other insurance policies.¹⁶³

III. ADVANTAGES AND DISADVANTAGES OF TPF AND LEI

A. *The Volume of Litigation*

1. TPF

According to some, an increase in litigation due to the availability of TPF is a matter of simple economics.¹⁶⁴ For example, third-party financing may increase the amount and cost of litigation for business disputes. Without TPF, a business-plaintiff will compare the internal cost of capital with the expected return from filing a lawsuit. The case will be filed only if the expected return is large enough. If TPF is available at a lower expected cost than the internal cost of capital, then there may be more litigation by business-plaintiffs.¹⁶⁵ This cost-reducing effect of TPF may also increase the amount of litigation by reducing the settlement surplus. Indeed, when trial costs decrease, the settlement surplus decreases.¹⁶⁶ This generally leads to more trials, as one of the reasons that parties settle is to avoid the costs of

¹⁶² W. Kip Viscusi, *The Dimensions of the Product Liability Crisis*, 20 J. LEGAL STUD. 147, 148 (1991). However, Viscusi (2004) explains that in markets in which there is substantial price inflexibility due to regulation, the insurance industry could have an incentive to support tort reform, which reduces the potential market for insurance. W. Kip Viscusi, *Tort Reform and Insurance Markets*, 7 RISK MGMT. & INS. REV. 9, 17 (2004).

¹⁶³ How much of the losses would be offset may depend on many factors like insurance regulation (e.g., premium regulation), barriers to entry, and, more generally, the degree of competition between insurers.

¹⁶⁴ See JOHN BEISNER, JESSICA MILLER, & GARY RUBIN, U.S. CHAMBER INST. FOR LEGAL REFORM, *SELLING LAWSUITS, BUYING TROUBLE: THIRD PARTY LITIGATION FUNDING IN THE UNITED STATES* 2-3 (2009).

¹⁶⁵ See Rubin, *supra* note 6, at 3-4.

¹⁶⁶ Note that for both parties the decision to settle or litigate depends on a comparison of the expected returns from litigating with the cost of capital.

trial. TPF can also increase the volume of litigation involving individuals as plaintiffs. In the U.S., these plaintiffs can often rely on contingency fees to finance litigation. This does not mean that TPF will not increase litigation in this segment, however. There are positive expected value cases that individual attorneys or law firms are unwilling to accept on a contingency fee basis because of the large risk attached to them (e.g., large class actions).¹⁶⁷ At the same time, limits on economies of scale make litigation in many very large cases infeasible. Here, third-party financing could fill a gap¹⁶⁸ because there are greater economies of scale in finance than in litigation.¹⁶⁹ A recent empirical study by Daniel Chen and David Abrams found that the number of suits increased in Australia after it allowed the free sale of lawsuits.¹⁷⁰

Others are more hesitant to draw such a general conclusion for various reasons.¹⁷¹ First, the fact that TPF allows more individuals or organizations to bring claims that they otherwise would not bring, or to fight a claim more vigorously, increases the deterrence of behavior that could lead to lawsuits. Consequently, the availability of funds to pursue litigation does not unambiguously increase litigation.¹⁷² Second, because Abrams and Chen's statistical analyses rely on small sample sizes (five to seven observations), more empirical research is necessary. Third, the question of whether TPF will substantially increase the volume of litigation may vary by country, depending on the instruments currently available in that country to increase access to the courts. For example, the resulting increase in litigation in the U.S. could be modest if lawsuits are not currently filed not because of a lack of capital, but because of a lack of additional potential claims that contingency fee lawyers are willing to take.¹⁷³ In Europe, however, TPF's potential to increase litigation may be greater, as contingency fees are prohibited in many European countries, public support for legal aid is being reduced in some European countries, and LEI is not generally widespread.

As Garber points out, the conditions needed for TPF to increase litigation may strongly depend on the TPF segment involved.¹⁷⁴ Regarding loans

¹⁶⁷ The risk can be so large that losing such a case would lead to bankruptcy of the law firm.

¹⁶⁸ See Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697, 739 (2005).

¹⁶⁹ See Rubin, *supra* note 6, at 6.

¹⁷⁰ See Chen & Abrams, *supra* note 105.

¹⁷¹ See GARBER, *supra* note 7, at 29.

¹⁷² See David Dana & Max Schanzenbach, Northwestern Univ. Law Sch., *How Would Third Party Financing Change the Face of American Tort Litigation? The Role of Agency Costs in the Attorney-Client Relationship*, 9 (2009) (paper presented at Searle Public Policy Roundtable on Third Party Financing of Litigation, Chicago, Ill. September 24-25, 2009), available at http://www.law.northwestern.edu/searlecenter/papers/Schanzenbach_Agency%20Costs.pdf.

¹⁷³ See, e.g., Herbert M. Kritzer, *Contingency Fee Lawyers as Gatekeepers in the Civil Justice System*, 81 JUDICATURE 22 (1997) (showing that contingency fee lawyers only accept a small minority of cases).

¹⁷⁴ See GARBER, *supra* note 7, at 29-30.

to plaintiffs' law firms, an increase in the volume of litigation is to be expected if firms use the funds to take on more clients instead of smoothing their cash flow or working more on the cases that they have already taken.¹⁷⁵ For investments in commercial claims, the number of claims may increase substantially where the economics of a claim look attractive to a TPF supplier, but companies are not able or willing to use internal capital to pay hourly legal expenses and cannot find a law firm to represent them on a contingency fee basis. The strength of the effect in this segment is difficult to predict, as there are many unknowns regarding these conditions. For example, it is unclear whether TPF suppliers have the capacity or willingness to make TPF available to companies that are truly capital-constrained. Also, it is unknown whether the level of demand for contingency fee-based legal services in commercial litigation exceeds supply or not. If it does, there could be a considerable demand for TPF in this segment.

2. LEI

On a theoretical level, LEI may increase the volume of litigation for several reasons. First of all, a person with LEI may face more justiciable incidents as a result of moral hazard.¹⁷⁶ However, empirical research from Germany and the Netherlands has shown that the effect of moral hazard is relatively small. Second, given a justiciable problem, LEI lowers the threshold for undertaking legal action. Claims with negative expected value may now be pursued because the insurer pays a portion of the cost.¹⁷⁷ Note, however, that costs such as psychological costs and the opportunity cost of time are not externalized to the insurer. Third, LEI promotes the filing of suit by risk-averse plaintiffs, as they do not bear the full risk of litigation cost. Fourth, with LEI, liquidity-constrained plaintiffs may now bring suit where they otherwise would not have been able to do so. Recent empirical research from the Netherlands sheds some light on the question of whether LEI holders react differently from non-insured individuals when faced with a justiciable problem.¹⁷⁸ Of all the individuals who faced a justiciable problem but did not have LEI, 7.5% did nothing, 47.4% sought to resolve the problem without help, and 45.1% sought advice from one or more experts or organizations. LEI holders seek more advice and are less inclined to resolve the problem without help: 4.8% did nothing, 37.7% sought to resolve the problem without help, and 57.5% sought advice from

¹⁷⁵ Of course this will increase the costs of individual cases.

¹⁷⁶ See Part II.C.

¹⁷⁷ See, e.g., Roland Kirstein, *Risk Neutrality and Strategic Insurance*, 25 THE GENEVA PAPERS ON RISK & INS. 251, 260 (2000).

¹⁷⁸ See Klein Haarhuis & van Velthoven, *supra* note 111, at 9.

one or more experts or organizations. The difference between the insured and the non-insured specifically holds for the higher income classes.

Finally, during settlement negotiations, an insured plaintiff may take a tougher stance against the defendant, as he does not bear all of the costs of a trial. Because the settlement surplus decreases, the frequency of trial can be expected to increase. However, this does not account for the active role that legal expenses insurers may play in the settlement stage. In countries like Belgium, where lawyers enjoy monopoly rights for representation in court but not for out-of-court work, an insurer can reserve the right to take all necessary steps to settle the case.¹⁷⁹ Because the insurer bears most or all of the costs, he may have a large incentive to settle the case. The fact that the settlement frequency of claims covered by LEI (80%) is perceived to be significantly larger than the settlement frequency of other claims seems to confirm this.¹⁸⁰ However, this result could also be the consequence of selection effects. According to the standard relative optimism model of litigation, the settlement frequency is larger for smaller claims,¹⁸¹ and LEI can be expected to stimulate some of these smaller claims, as empirical research has shown that LEI promotes the settlement of some smaller cases.¹⁸²

In countries like Germany, however, where lawyers enjoy monopoly rights not just for representation in court but also for out of court work, the insurer's role in the settlement process may be more limited. Empirical research from Germany shows that the trial frequency of claims covered by LEI is somewhat larger than for claims not covered by LEI.¹⁸³ Research from the Netherlands shows that court proceedings were started in 4% of problems for individuals without LEI and in 6.5% of problems for individuals with LEI.¹⁸⁴ The difference is more substantial for higher income classes. Similar to the case of TPF, the presence of LEI may increase deterrence, which may have a mitigating effect on the volume of litigation. Hence, one should always be careful in interpreting these numbers: if the volume of cases increases under LEI, then from a social welfare perspective this is not always an undesirable effect. It might be undesirable if LEI claims are brought with a so-called nuisance value, but precisely because access to justice is costly without LEI, there may in fact be too few claims and hence under-deterrence.

¹⁷⁹ See PHILLIPE COLLE, HANDBOEK BIJZONDER GEREGLIMENTEERDE VERZEKERINGSCONTRACTEN 304 (2005).

¹⁸⁰ *Id.*

¹⁸¹ See, e.g., Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55, 59 (1982).

¹⁸² See Vivian Prais, *Legal Expenses Insurance*, in REFORM OF CIVIL PROCEDURE: ESSAYS ON "ACCESS TO JUSTICE" 439 (Adrian A.S. Zuckerman & Ross Cranston eds., 1995).

¹⁸³ *See id.*

¹⁸⁴ See Klein Haarhuis & van Velthoven, *supra* note 111, at 12.

B. *The Quality of Litigation and the Accuracy of Settlements*

1. TPF

Some commentators expect that TPF will increase the number of lawsuits that have no, or dubious, legal merit.¹⁸⁵ The reason that this may be the case is because plaintiffs (and their lawyers) are more eager to bring such lawsuits if they are not fully financing the cases themselves. However, it is quite unlikely that consumer legal funding will substantially increase the volume of meritless cases. These loans are typically less than 10% of the estimated recoveries in the underlying lawsuits.¹⁸⁶ Concerning loans to plaintiffs' law firms, TPF suppliers do not want to lend to firms who hold many low-probability claims, as the suppliers do not share in the upside potential of these claims. The precise effect on the proportion of lawsuits with low probabilities will depend on the due diligence processes. The situation may be different for investments in commercial claims. For commercial claims, TPF suppliers share in the upside potential of the claim. Given that low-probability suits can have high-expected profits, TPF suppliers may choose to invest in these cases.

Some scholars, however, doubt that the effect on the volume of low-probability cases will be substantial.¹⁸⁷ First, TPF suppliers seem to find more than enough investment opportunities among claims with relatively high probabilities of recovery. Second, concentrating investments in claims that have high probabilities of recovery may be the best risk-management strategy. It seems that the TPF companies are not sufficiently capitalized to have enough cases in their portfolio so that their portfolio risk is negligible. Juridica, for example, rejects claims "that raise novel legal questions or that will probably end up before a jury."¹⁸⁸ Of course, things could change, but for now, large capital providers such as banks and insurance companies have stayed away because of the legal uncertainty that surrounds litigation funding.¹⁸⁹ If this uncertainty vanishes, investing in nuisance suits may be a viable business model for these corporations. Also, the high rates of return that current TPF suppliers receive may attract new capital into this market. Some TPF suppliers that lack the skills to evaluate complex cases effectively could enter, which may lead to an increase in lawsuits that lack merit. In the long run, however, investing

¹⁸⁵ See e.g., BEISNER ET AL., *supra* note 164.

¹⁸⁶ See GARBER, *supra* note 7, at 30.

¹⁸⁷ See *id.* at 32.

¹⁸⁸ See Jonathan D. Glater, *Investing in Lawsuits, for a Share of the Awards*, N.Y. TIMES, June 3, 2009, at B1.

¹⁸⁹ See MOLOT, *supra* note 89, at 32.

in meritless cases will lead to losses, and these suppliers will disappear from the market.

Imbalances in risk preferences may skew settlement amounts. A repeat-player defendant who faces many suits from one-time plaintiffs can expect to settle many cases below the mean damages award, as the one-time plaintiff will be more fearful of the worst case scenario than the repeat-player defendant, who can pool the litigation risks. The problem may be especially large in personal injury lawsuits. For these suits, the spread of possible damages is large and the disparity between the parties' ability to cope with litigation risk is enormous.¹⁹⁰ Thus, settlements that reflect bargaining power more than legal merit can be expected. Third-party financing may promote more accurate settlements by leveling the playing field between plaintiffs and defendants.¹⁹¹ However, whether the availability of TPF currently has a significant effect on the accuracy of settlement amounts is uncertain. In the context of consumer loans, very high interest rates and the rapid accumulation of interest strips this mechanism of much of its value. Also, investment funds only invest in large commercial claims, not in smaller claims or personal injury claims held by individuals.

2. LEI

It is often alleged that LEI causes a flood of unmeritorious litigation.¹⁹² In theory, a plaintiff may be interested in pursuing a claim that has virtually no chance of winning because someone else bears the expenditures—the insurer. In reality, it is highly unlikely that an insurer will provide coverage for weak claims. Legal expenses insurers have a relatively strong incentive to carefully screen cases before granting coverage, as insurers bear all or most of the costs of a trial but reap no direct financial benefits.¹⁹³ In practice, legal expense insurers weed out weak cases through various mechanisms. For example, most LEI policies include a deductible.¹⁹⁴ Of course, a deductible will not only filter out some weak cases, but will also hold back some strong cases with small stakes. Additionally, LEI policies often include a merits test. In the absence of such a clause in the contract, doctrines of contract law may allow an insurer to decline coverage for unreasonable and futile claims, or for claims that lack evidence.¹⁹⁵ A German research

¹⁹⁰ See Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 85 (2010).

¹⁹¹ *Id.*

¹⁹² See, e.g., Kilian, *supra* note 5, at 45.

¹⁹³ We can thus expect that legal expense insurers have a stronger incentive to screen cases than hourly fee lawyers and contingency fee lawyers.

¹⁹⁴ Kilian, *supra* note 5, at 46.

¹⁹⁵ For example, the contractually implied obligation of good faith. See COLLE, *supra* note 179, at 305.

report shows that litigants with LEI won their cases slightly more often (3 %) than self-financing litigants who paid their lawyers a fixed fee at every stage of the litigation process.¹⁹⁶ This could be a reflection of more careful case screening. However, the result could also be explained by a selection effect, as LEI will induce the filing of some strong claims with stakes that are relatively small but still greater than the deductible.

C. *The Timing of Settlements*

1. TPF

TPF may increase a defendant's willingness to settle at an earlier stage for several reasons.¹⁹⁷ First, a defendant who knows that the plaintiff has TPF may realize that certain threats made during the negotiations are no longer credible, thereby decreasing the defendant's bargaining power. Also, a TPF supplier's willingness to fund a case may be seen by the defendant as a signal that the case is of relatively high quality. Empirical research by Fenn and Rickman has shown that high-quality cases settle earlier. The authors have found that the more the defendant thinks he is liable, the shorter the delay of settlement.¹⁹⁸ Likewise, they have found that cases in which the insurer believes its policyholder is fully responsible are associated with shorter delays of settlement.¹⁹⁹ Finally, their research has discovered that cases in which a hospital initially believes it is not liable survive much longer before settling compared to cases where the hospital initially believes it is liable.²⁰⁰ Furthermore, the arrival of new information weakening a hospital's case speeds up the settlement process and leads to longer durations before a case is dropped. That signal may be especially relevant for investments in commercial claims because of the rigorousness of due diligence processes.²⁰¹

If, however, investing in nuisance suits may be or becomes a viable business model for TPF suppliers, then TPF may no longer signal case quality. In the context of consumer legal funding, TPF may decrease the proportion of plaintiffs that are eager to settle early, because the loans enable plaintiffs to pay their bills in the interim. Also, TPF may sometimes

¹⁹⁶ See Prais, *supra* note 182, at 439.

¹⁹⁷ See GARBER, *supra* note 7, at 32-34.

¹⁹⁸ Paul Fenn & Neil Rickman, *Delay and Settlement in Litigation*, 109 *ECON. J.* 476, 487 (1999).

¹⁹⁹ Paul Fenn & Neil Rickman, *Asymmetric Information and the Settlement of Insurance Claims*, 68 *J. RISK & INS.* 615, 627 (2001).

²⁰⁰ Paul Fenn & Neil Rickman, *Legal Liability and the Timing of Settlement in Medical Malpractice* 21 (American Law & Economic Association Annual Meetings, Paper No. 44, 2005), available at <http://law.bepress.com/cgi/viewcontent.cgi?article=1543&context=alea>.

²⁰¹ See GARBER, *supra* note 7, at 26.

reduce the willingness of a plaintiff to settle late in the life of the underlying claim, because the amount owed to the TPF supplier can eventually exceed what the defendant is willing to offer during settlement. The plaintiff may then prefer to go to trial, hoping for a recovery that is larger than the amount owed to the TPF supplier. During the period in between the initial and the later phases of the settlement process, consumer legal funding may promote earlier settlements due to the rapid rate at which a plaintiff's debt to a TPF supplier increases. Likewise, a law firm paying interest on a loan may have a relatively strong incentive to settle quite early so it can repay its debt from the proceeds.

2. LEI

An empirical study by Paul Fenn et al. finds that claims funded by LEI in England and Wales settle faster than claims funded by other means.²⁰² This can be explained quite easily. Because the insurer internalizes the costs—either in whole or in large part—of the settlement, he has every incentive to settle early. This effect will be largest if the insurer is in charge of the settlement negotiations.^{203 204} But if an outside lawyer is in charge of the settlement negotiations, the case may still settle earlier than cases that are not funded by LEI. This is because the insurer is probably in a better position to control for lawyer opportunism than an individual without LEI. The lawyer monitored by an insurer will shirk less and will settle a case sooner on average.

D. *The Costs of (Individual) Disputes*

1. TPF

Generally speaking, whether and how TPF will influence the costs of individual disputes depends on whether TPF suppliers are able to influence

²⁰² PAUL FENN ET AL., REPORT TO THE DEPARTMENT FOR CONSTITUTIONAL AFFAIRS, THE FUNDING OF PERSONAL INJURY LITIGATION: COMPARISONS OVER TIME AND ACROSS JURISDICTIONS 51 (2006), available at http://webarchive.nationalarchives.gov.uk/+http://www.dca.gov.uk/research/2006/02_2006.pdf.

²⁰³ In Belgium, for example, lawyers' monopoly rights only extend to representation in court. In the context of LEI, legal services are often provided by in-house salaried personnel.

²⁰⁴ Of course, an important limitation is that policyholders always have the right to free choice of counsel from the moment they are involved in judicial or administrative proceedings. See Art. 4(1)(a) Directive 87/344/EEC on the Coordination of Laws, Regulations and Administrative Provisions relating to Legal Expenses Insurance, official reporter 1987 O.J. (L 185) 77, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31987L0344:en:NOT>

how cases are pursued.²⁰⁵ Unfortunately, this is unknown.²⁰⁶ Expenditures will generally increase when TPF is sought primarily to loosen cash constraints (this can be the case for loans to consumers, loans to plaintiff law firms, and investment in commercial litigation). Cash-constrained plaintiffs tend to invest less in out-of-pocket expenses (e.g., expert consultants and witnesses). Regarding investments in commercial litigation, the effect on expenditures depends, to a large extent, on the share of the recovery and the costs for the TPF supplier.

2. LEI

Obviously, LEI can be expected to increase the costs of individual disputes. A plaintiff without LEI has to pay for each additional hour his lawyer spends on the case, whereas a plaintiff with LEI can use LEI staff, or, if necessary, a lawyer at no or reduced cost. Recent Dutch empirical research confirms this, at least for the high-income class.²⁰⁷ The intensity of the contacts with legal advisors is significantly higher for the highest income earners once they are insured (2.09 contacts versus 1.73 contacts).²⁰⁸ For lower income classes, the impact of LEI is mainly by substitution.²⁰⁹ The direct assistance of LEI staff comes, to a large extent, in place of the subsidized lawyer.²¹⁰ The researchers are aware that other factors may have played a role in the use of legal advisers.²¹¹ After controlling for other relevant factors like type of problem, gravity and complexity of the problem, expected revenue, and personal characteristics, multivariate analysis corroborates their findings.²¹² As a person actively responds to a justiciable problem, LEI increases the chance that a person will seek more legal advice.²¹³ Income is an important factor when people are not insured: the number of contacts with legal advisers decreases with income.²¹⁴ When individuals are insured, the effect of income is insignificant.²¹⁵

²⁰⁵ It may also depend on whether TPF suppliers provide information that helps lawyers make a more productive use of time and money.

²⁰⁶ See GARBER, *supra* note 7, at 35.

²⁰⁷ See Klein Haarhuis & van Velthoven, *supra* note 111, at 10.

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *Id.* at 11.

²¹² *Id.*

²¹³ See Klein Haarhuis & van Velthoven, *supra* note 111, at 10.

²¹⁴ *Id.*

²¹⁵ *Id.*

CONCLUSION

It is unlikely that LEI is a substantial barrier to the development of TPF. The reason is simple: LEI is underused in the U.S. and many European countries. Only countries where LEI is mandatory (as an add-on to household insurance, like in Sweden) have wide coverage. Regarding the social welfare effects of both instruments, TPF does not necessarily do worse than LEI as far as the volume of litigation, the quality of litigation, and the timing of settlements is concerned. So far, legal systems in Europe are rather hostile towards TPF, because they consider it contrary to public policy. However, given the low coverage of LEI and reduced legal aid in many European legal systems, TPF can effectively promote access to justice even though such a goal may not be its primary function. For example, by providing the possibility of upfront payment to plaintiffs, litigation can be made more attractive, even when it is used in combination with other techniques like contingency fees. Thus, TPF certainly merits further analysis and could serve important social goals by promoting access to justice and providing further deterrence, reducing accidents and personal injury.













