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Third-Party Financing of Litigation: Civil Justice Friend or Foe?

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Economic Implications of Third-Party Litigation Financing on the U.S. Civil Justice System

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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 might not otherwise be pursued due to the plaintiff's 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 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 lack of economic resources. Others view third-party financing much more skeptically, sounding warnings of abusive litigation, disincentives to accept reasonable

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[1] *See* Kirby Griffis, "Follow the Money: Litigation Funders Back Your Foes," The Metro. Corp. Counsel (July 1, 2011), *available at* http://www.metrocorpcounsel.com/current.php?artType=view&EntryNo=12468.
[2] *Id.* The association, the American Legal Finance Association, was founded in 2004 and is located in New York City.
[3] *See* Anthony Lin, "The Smart Money: Australia's Litigation Funding Giant Looks Abroad," *available at* http://www.law.com/jsp/tal/PubArticleFriendlyAL.jsp?id=1202498856903, (quoting Hugh McLernon, IMF (Australia) Ltd.'s cofounder and managing director) (July 1, 2011).
[4] *See, e.g.*,

settlement offers, consumer protection and usury problems, and ethics, conflicts of interest, and privilege and confidentiality concerns, each of which may yield deleterious consequences on economic systems throughout the world.[5]

In this paper, we address two critical research questions: one, whether third-party financing of litigation, *ceteris paribus*, will increase the aggregate amount of litigation, and two, 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 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. 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 good a 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.

Our analysis suggests, however, that the type 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. 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 desire to maintain investment fund returns will likely lead to an increase in speculative litigation and strike suits on the margin.

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[5] *See, e.g.*, John Beisner, et al, *Selling Lawsuits, Buying Trouble: Third-Party Litigation Funding in the United States*, U.S. Chamber Institute for Legal Reform (Oct. 2009); Roger Parloff, "Have you got a piece of this lawsuit?", *available at* http://features.blogs.fortune.cnn.com/2011/06/28/have-you-got-a-piece-of-this-lawsuit-2/ (June 28, 2011); Kirby Griffis, "Follow the Money," *supra* note 1.

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 defendant for its litigation costs, including attorney's fees, if the defendant prevails or the plaintiff drops the case. Plaintiff would not be entitled to similar indemnification in cases where third-party financing is utilized, 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 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

[6] *See* Terry Carter, "Cash Up Front: New Funding Sources Ease Financial Strains on Plaintiffs Lawyers," A.B.A. J. 34 (Oct. 2004).
[7] *See* Andrew Hananel & David Staubitz, *The Ethics of Law Loans in the Post-Rancman Era*, 17 Georgetown J. Legal Ethics 795, 798 (2004).

based on a percentage of plaintiff's recovery[8] 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 and change, 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 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 investments 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 U.S. to Las Vegas entrepreneur, Perry Walton, the "self-proclaimed father of the modern litigation finance industry."[16] Walton founded

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[8] Elizabeth Sniegocki, "The Advanced Litigation Funding Industry: Gambling on Justice?", Fla. Underwriter, 29 (May 2003).

[9] *See* Susan Lorde Martin, *The Litigation Finance Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 Fordham J. Corp. & Fin. 55, 66 (2004).

[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. 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.*

[11] *See* Law Council of Australia, Regulation of third-party litigation funding in Australia, 4 (June 2011), *available at* http://www.lawcouncil.asn.au/shadomx/apps/fms/fmsdownload.cfm?file_uuid=FDE54AA6-C860-A078-ED07-5BB15F2A31E3&siteName=lca.

[12] *Id.*

[13] *Id.*

[14] *Campbells Cash and Carry Pty Ltd v. Fostif Pty Ltd* (2006) 229 CLR 386.

[15] *See* Marco de Morpurgo, Article: A Comparative Legal and Economic Approach to Third-Party Litigation Funding, 19 Cardozo J. Int'l & Comp. L. 343 (Spring, 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, *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).

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.

In the U.S., 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 $200,000,000 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 he 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 92% 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 makes them easy targets for third-party-financed litigation (and potential settlement) as well.[24]

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[17] Terry Carter, *Cash Up Front*, A.B.A. Journal, Oct. 2004, at 36. *See also* Julia H. McLaughlin, *Litigation Funding: Charting a Legal and Ethical Course*, 31 Vermont L. Rev. 615, 619, n. 11 (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.").

[18] *See* Jonathan D. Glater, Investing in a Portfolio of Lawsuits, N.Y. Times, B1 (June 3, 2009).

[19] Our Policy Statement, Juridica Inv. Ltd., *available at* http://www.juridicainvestments.com/about-juridica/our-public-policy-statement.aspx. Juridica states that its "customers are Fortune 1000 companies, FT Global 500 companies, inventors, major universities, and the leading law firms that represent them." *Ida*

[20] Telis Demos, *Chasing 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*, Financial Times (Jan. 25, 2009), *available at* http://www.ft.com/cms/s/o/20eb1686-11dd-9535-0000779fd2ac.html.

[22] *See* Steven Garber, Rand Corp., *Alternative Litigation Financing in the United States: Issues, Knowns and Unknowns*, 13 (2010).

[23] *See* Joanna Shepherd-Bailey, "Ideal Versus Reality in Third-Party Litigation Financing," JLEP

[24] *Id.*

Despite the commercial nature of these primary investments, only Juridica appears to invest solely in business-to-business litigation. Unlike Burford Capital, for example, Juridica does not invest in personal injury or class action cases.

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 current investment strategy, 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]

Other notable personal injury litigation has been funded by Counsel Financial, which is financed by Citigroup. 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] Furthermore, class action litigation has 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, cofounder and managing director of IMF (Australia) Ltd., the largest third-party litigation finance firm, states, "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.

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[25] *See* Griffis, *supra* note 1.

[26] *See* Roger Parloff, *Fortune*, "Have you got a piece of this lawsuit?" (June 28, 2011), *available at* http://features.blogs.fortune.cnn.com/2011/06/28/have-you-got-a-piece-of-this-lawsuit-2/. *See also*, (noting that, "[t]hanks 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," *The New York Times* (Nov. 14, 2010), *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 plaintiffs had understood or approved them).

[28] *See* Genevieve Cotnam and 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, "The Smart Money," *supra* note 3.

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. Claims with 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 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 to 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. 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]

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[30] See *infra* Parts IV and V. *See also* Joanna Shepherd Bailey, *supra* note 23.

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 attenuate fruition of 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. We ignore for purposes of this analysis 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, including 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, 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 U.S.

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. enterprises.[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 wellbeing.

Just as the litigation incentives mentioned above operate to increase the supply of litigation in the U.S., 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

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[31] *See, e.g.,* Towers Perrin; McKinsey and Co. Global Capital Markets Survey (http://www.worldfinancialreview.com/?p=289).

[32] *See, e.g.*, Henry N. Butler and Jason S. Johnston, "Consumer Harm Acts? An Economic Analysis of Private Actions Under State Consumer Protection Acts," Faculty Working Papers, Northwestern Law (2009).

[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.

problematic than the increase in the supply of litigation generally is an increase in the supply of speculative litigation and strike suits. Such suits exacerbate economic inefficiencies driven by a legal culture that underscores the benefits of litigation, often to the exclusion of potential costs.

III. Third-Party Financing = 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; rather they claim that savvy third-party investors/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 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, then increased litigation stemming from third party financing presents a concern worthy of thorough consideration.

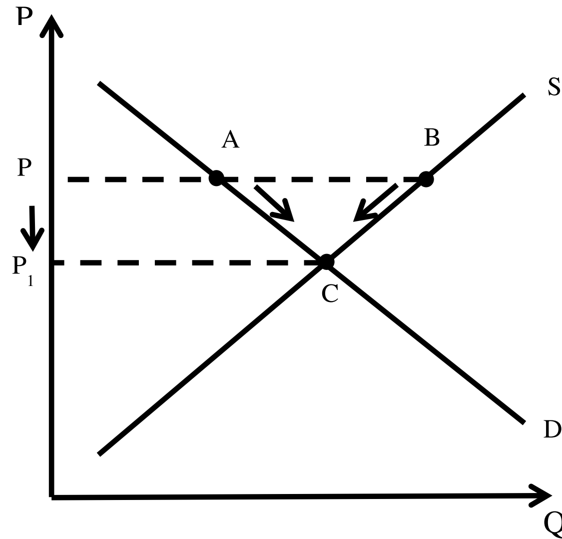
A. Supply and Demand Analysis

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 changes 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 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 from point A to point C). As the

[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.

price drops from P to P_1, quantity demanded increases, and quantity supplied decreases until the new market equilibrium is established (point C).

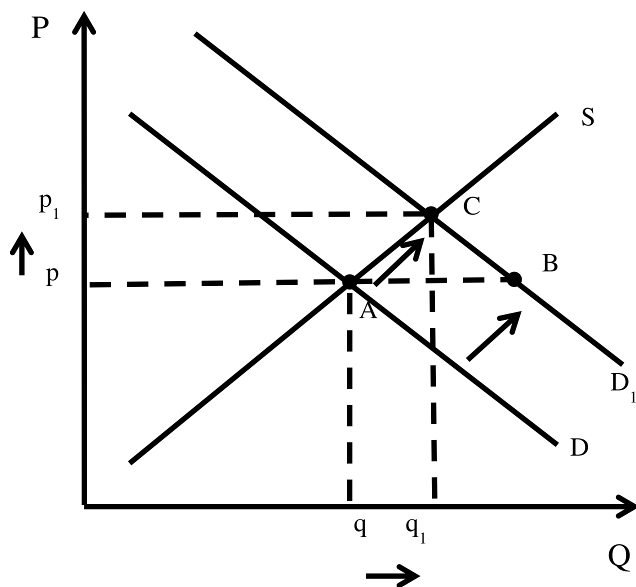
Figure 1



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, or 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 D1.

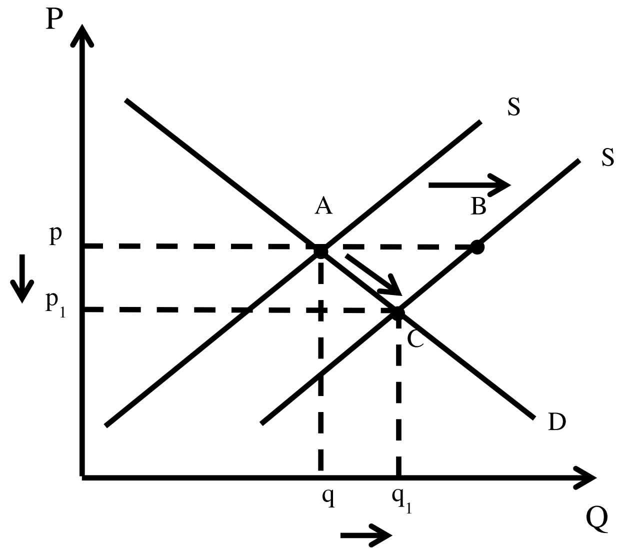
As a result of the extra cash in consumers' pockets, there is an excess of demand over supply at the original market price (p); this excess is the difference between points B and A in Figure 2. Seeing that consumers are demanding more of the product and are willing to pay a higher price for it, producers 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 S1. There is now 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 (movement from B towards C in Figure 3). Falling prices will entice consumers to demand more (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 (a) to distinguish between the two markets operating here—the general market for litigation and the capital market for litigation finance—and (b) to 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. This rightward shift occurs for at least two reasons in our analysis. 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 – in essence, once again, increasing the absolute number of dollars available to finance litigation.[36]

The impact of our innovative, new market entrants on the market for litigation financing is illustrated in Figure 4. As the number of litigation financiers increases, the supply curve shifts to the right, as demonstrated in Figure 4. This shift creates an excess

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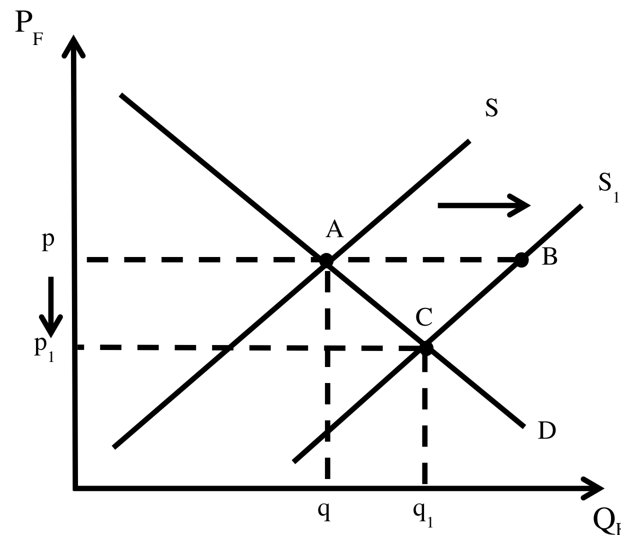
[35] Areas of expertise that third party litigation funders are likely to possess relative to contingent fee lawyers or traditional bank lenders include professional skills in originating transactions (i.e., sourcing litigation investments), conducting due diligence, underwriting litigation, documentation 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. This topic is addressed in greater detail in section IV.

supply of litigation financing (the difference between quantity demanded at point A and the quantity supplied at point B in Figure 4) at the original price p. This excess supply results in declining prices 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 stands to reason 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, both an increase in demand and/or increase in supply 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 and, as a key input to litigating, this should ultimately lower the cost of litigation. An economically rationale plaintiff will pursue a claim only if the expected damages or settlement amount exceeds (or equals) the cost of bringing the suit.

[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.

This logic can be written as a simple rule where plaintiff files a law suit only if EV ≥ 0 as measured by:

$$EV = (\rho_{\pi} \times V_{\pi}) - c$$

Where EV is the expected value of plaintiff's legal claim, ρ_{π} is the probability 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. Decreasing the value of c in this equation increases the number of legal claims that have a positive expected value holding all other variables constant. 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 in 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 might otherwise be financed by a third-party investor. 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 lawyers profits are 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 are 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 plaintiffs lawyers. First, consider the case of the risk-averse plaintiffs lawyer who would like 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. This lawyer is unwilling to accept risks associated with self-financing or the 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 profits on her current book of business or taking on additional risk.[39] In addition to her existing caseload, the risk shifting facilitated by the third party 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-reward stakes. Having access to 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

[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. Due to 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 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.
[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.

can spread the risk of loss through a diversified investment portfolio, and, again, 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 to 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 filing increased in those jurisdictions that allowed the practice and that lawsuit filing 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."

These findings provide some empirical evidence that the incentives described in the previous sections are truly at work. Such a finding is also a 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 = 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 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 others. 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.

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[41] David Abrams & Daniel L. Chen, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes* (2011), *available at* http://www.duke.edu/~dlc28/papers/MktJustice.pdf.
[42] *Id.*
[43] *Id.* at 16.

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. Further suppose that Third-Party Financier A has offered $1,000,000 in funding and that the potential award or settlement value is $4,000,000 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 $1,500,000.

$4,000,000 x 75% = $3,000,000 Expected Award

$3,000,000 x 50% = $1,500,000 Financier A's Share of Expected Award

($1,500,000 ÷ $1,000,000) – 1 = 50% 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 $1,000,000 Case 2, which also has a potential $4,000,000 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 $1,350,000 total return due to the competitive pressure from Financier B.

Now suppose Case 3 also attracts $1,000,000 of funding but has a potential award or settlement value of $6,000,000 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 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 x 50% = $3,000,000 Expected Award

$3,000,000 x 50% = $1,500,000 Financier A's Share of Expected Award

($1,500,000 ÷ $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 and 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 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 = 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 less risk borne by the client (plaintiff and plaintiffs' attorney). 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 pursed to a decision at trial. A negative-expected-value (NEV) suit is one that possesses a negative expected return to the plaintiff due to expected total litigation costs that exceed the expected judgment.[44]

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[44] *See* Lucian Bebchuk, "Suits with Negative Expected Value," 3 The New Palgrave Dictionary of Economics and the Law, 551 (1998). Importantly, an 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.

Utilizing the expected value formula of $EV = (\rho_{\Pi} \times V_{\Pi}) - c$ first introduced in section 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 an 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 an 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 an NEV suit.[45]

Second, the plaintiff may be able to impose large up-front costs on the defendant during the initial stages of litigation. These costs may be sufficiently large to induce a settlement offer from defendant, as settlement may be more cost effective than responding to the suit. Plaintiff has a credible threat insofar as defendant's expected costs of protracted litigation, as well as pretrial work (e.g., discovery), are sufficiently high relative to the proposed settlement offer. Defendant may make such an offer even if she suspects that she would win on a motion to dismiss after discovery or that 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 an NEV suit. If the plaintiff's lawyer spends enough hours on the claim (including during pre-trial preparation and during the trial in absence of settlement) under an hourly fee arrangement, plaintiff's suit may quickly become an NEV one. But if plaintiff hires her lawyer on a contingent fee basis, she may have a credible threat to go to trial if defendant refuses to settle for more than what plaintiff's discovery and litigation costs would be.

Fourth, a plaintiff with an NEV suit might be able to induce a settlement offer if plaintiff is a repeat player with a reputation of going to trial if no favorable settlement is reached. The credibility of plaintiff's threat is stronger from a repeat-player than from a plaintiff engaged in single-instance litigation. While some defendant's 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 plaintiff's NEV suits quickly and efficiently. This latter group may be particularly susceptible to third party

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[45] *Id.*

financed strike suits. The credibility of plaintiff's threat is also enhanced in situations where the defendant is not a repeat player or does not have a reputation of litigating on principle.[46]

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 an 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 wellbeing.

A. Game Theory Model

A simple game theory model can be used to demonstrate how an increase in supply of third-party litigation financing might contribute to an increase speculative litigation and strike suits. The following decision trees illustrate how a defendant may perceive a change in plaintiff's incentives, at the margin, due to an increase in third party financing. This perceived change in plaintiff's likely behavior may increase settlement pressure on the defendant.[47]

In Figure 5 below, defendant's payout is in Italics and plaintiff's payout is in regular font. 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) 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) plaintiff has a 10% probability of prevailing at trial. Note that the plaintiff's $25,000 settlement offer is less than defendant's expected trial costs of $30,000. The key question, based on these facts, is whether defendant should accept plaintiff's $25,000 settlement offer.

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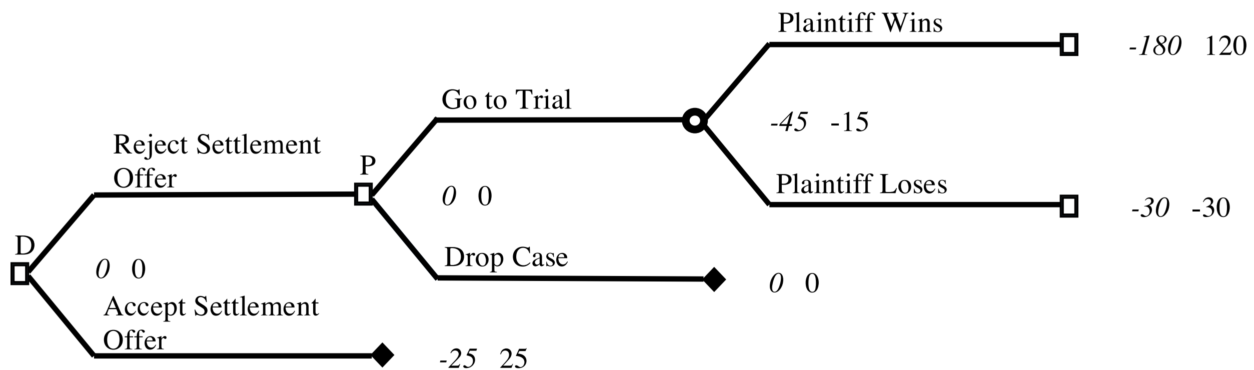
[46] *See* Joe Speelman, "Litigation strategy has to be grounded in principle," Texas Lawyer (July 7, 2008), *available at* http://www.law.com/jsp/tx/PubArticleTX.jsp?id=1202422726268 (arguing that litigation must be based on principles, rather than on economics alone).

[47] This example is based on a similar analysis of strategic litigation behavior discussed in Analytical Methods for Lawyers…need cite.

Figure 5



At the outset, plaintiff has a negative expected value associated with going to trial; thus, definitionally, this is a strike suit. If 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, plaintiff's case yields a negative expected value of $15,000 (10% x $120,000 + 90% x -$30,000 = -$15,000). Based on these facts, the defendant, seeing that plaintiff expects to lose $15,000 by going to trial, would reject 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. Figure 6 illustrates. In Figure 6, 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.[48] Plaintiff calls the defendant and this time *increases* her settlement offer to $35,000. If plaintiff and her financier are successful in extracting a $35,000 settlement, they will receive a 40% return on investment (=($35,000 ÷ $25,000) – 1). The critical question for defendant is whether to accept the increased settlement offer or call 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. In other words, this is still the same strike suit. That said, defendant's perception of what an economically rationale plaintiff would do under these facts may have been fundamentally altered by the introduction of a third-party investor. Defendant may reasonably anticipate that an economically rationale plaintiff would proceed to trail under these facts because to do so will mitigate her losses – plaintiff loses $25,000 by dropping the case but expects total losses of only $15,000 by going to

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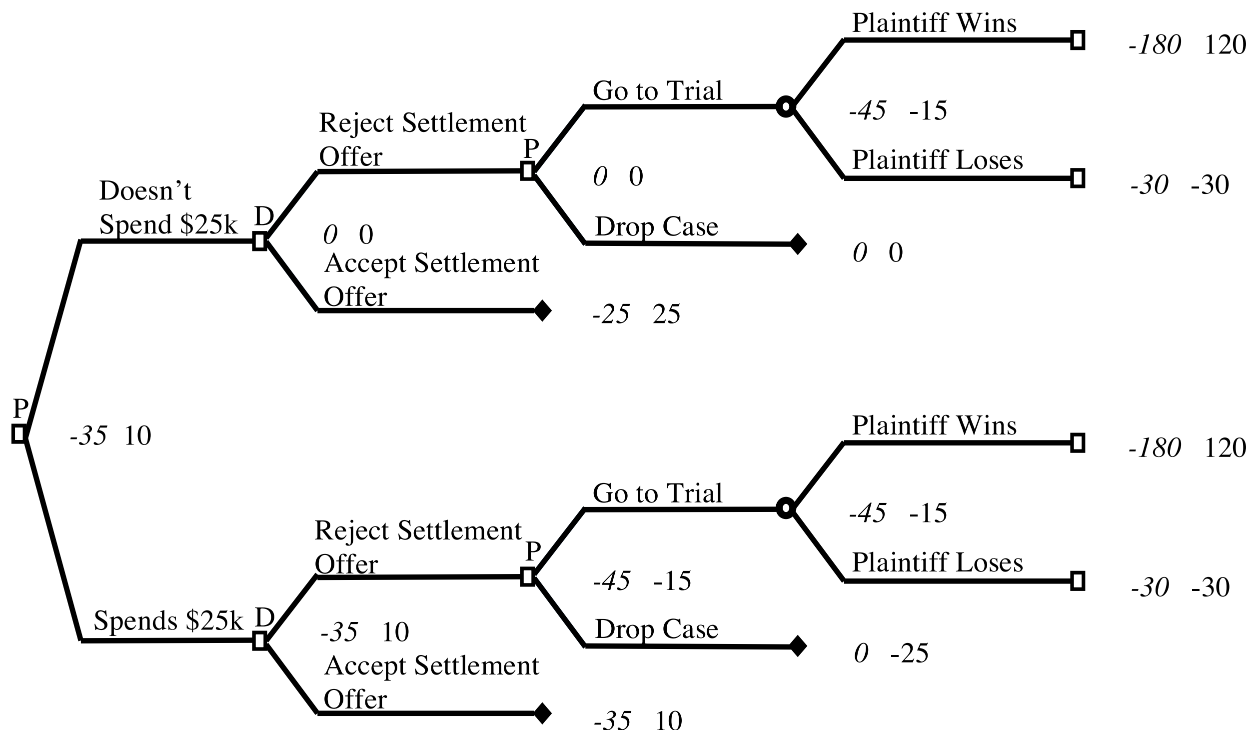
[48] From an economics perspective, the plaintiff is simply transforming marginal costs into fixed costs. This is a well-established strategy for establishing credibility with bargaining partners or otherwise binding oneself to a particular course of action.

trial.[49] Given this assumption about plaintiff's behavior, defendant must now choose between an expected loss of $45,000 by going to trial or $35,000 loss due to settlement.

If plaintiff drops the case, she would lose $25,000, whereas in the previous example plaintiff lost nothing if she dropped the case.[50] If plaintiff proceeds to trial, she would, at worst expect to lose $15,000 – the same negative expected value as before. Recognizing that plaintiff might proceed to trial under these facts if defendant rejects the settlement offer, defendant chooses to accept the settlement offer. The plaintiff and her financier will receive a check for $35,000 for a gain of $10,000. Note that not only was 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



[49] 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 trial is greater than the marginal cost. Specifically, the marginal expected value of going to trial is $10,000 (10% x $145,000 + 90% x -$5,000 = $10,000). In other words, the plaintiff spends an extra $5,000 for anticipated loss mitigation (i.e., benefit) of $10,000.

[50] 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 the perceived ability to influence litigation strategy is on the hook for the $25,000 loss. This perception will be what influences defendant's settlement decision.

The upshot is that an increase in expended capital or financial obligations up front can increase the credibility of plaintiff's threat, thereby 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 expected probability of success, in order to force defendant into settlement offers. Defendants who have developed reputations as risk-averse, consistent settlers, may be particularly attractive targets for strike suits financed by third-party investors.

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.[51] 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.[52] 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 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 defendant for its litigation costs, including attorney's fees, if the defendant ultimately prevails or plaintiff drops the case.[53] This indemnification rule would not work in reverse. In other words, a third-party financed

[51] *See* Paul H. Rubin, "On the Efficiency of Increasing Litigation," (arguing that any benefits of increased litigation are likely to be outweighed by the costs).

[52] A recent study estimates that the U.S. tort litigation system costs $252 billion per year, amounting to 1.83% of U.S. GDP compared to just 0.5-0.7% in other OECD countries. *See* Tillinghast Towers-Perrin study (2008). Strike suits are not wholly blameworthy for this economic strain; however, they contribute to a tort litigation system whose administrative costs comprise over half of the direct costs incurred in operating the system. *See id.* Insofar as strike suits contribute to the net increase in litigation, third-party financing will likely operate to exacerbate this inefficiency.

[53] 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, 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.

plaintiff would not be entitled to indemnification for its legal expenses, including attorney's fees, if it prevails. This would be true, even if, the underlying statutory or case law generally allowed such indemnification in favor of 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 sides attorney's fees. Our modified version of the English rule requires a third-party financed plaintiff to pay defendant's attorney fees if that plaintiff ultimately loses or drops the case. However, defendant does not pay plaintiff's attorney fees should the third-party financed plaintiff prevail. Thus, 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, the following paragraphs highlight some attributes of the loser pays model that we believe would apply to our one-way fee-shifting proposal.

In the absence of a loser-pays rule, risky, potentially low-probability claims are much more likely to be filed in the U.S. 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, "There is no doubt in my mind that the biggest mistake they made in America was not having [loser pays]."[54] He notes the advantage of increased access to the courts but laments the "terrible price you pay for it." 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."[55]

Nearly every Western democracy except the U.S. follows the English rule. And those jurisdictions generally do not have as many litigation incentives as the U.S. Although the name connects it to England, loser pays 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, devoid of Roman civil justice roots, embrace a loser-pays regime.[56]

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: many plaintiffs with

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[54] *See* Lin, "The Smart Money," *supra* note 3.
[55] *Id.*
[56] *See* Walter Olson, "Loser-Pays makes lawsuits fairer in Europe. It could work here, too," *available at* http://reason.com/archives/1995/06/01/civil-suits/1 (1995).

> 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.[57]

We are not in this article 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 U.S. implement litigation safeguards currently in place in other jurisdictions around the world.[58] 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. They claim to pursue only cases with a high likelihood of success and that they 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 instilling a discipline in IMF's strategy in case funding that will allow his business to thrive in any jurisdiction.[59]

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.[60] However, the use of our modifed English rule for cases financed by third parties likely will not deter such groundbreaking cases because they may still be pursued on a contingent fee or self-financing basis. As argued above, meritorious public interest cases, be they about religious freedom, free speech, or civil rights, will likely be pursued zealously, like any other meritorious claim, and should not be dissuaded by a modified loser-pays rule if financed by third-party capital.[61]

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 U.S. The U.S. civil justice system contains a plethora of mechanisms to incentivize litigation in pursuit of the administration of justice. Contingent

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[57] *Id.*
[58] For example, we are not arguing for a prohibition on the use of contingent fees.
[59] *See* Lin, "The Smart Money," *supra* note 3.
[60] 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." *See* Symposium, The 50th Anniversary of the Federal Rules of Civil Procedure, 1938-1988, *The Federal Rules of Civil Procedure as a Vindicator of Civil Rights,* 137 U. Pa. L. Rev. 2179, 2193 (June 1989).
[61] If civil rights or other notable public interest cases prove to be dissuaded by our modified loser-pays rule, then an exception for such cases might be warranted and could plausibly be created.

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."

The benefits associated with increasing access to justice do not come without substantial costs. The civil justice system seeks to remedy legal imbalances and operates to reduce economic inefficiencies along the way; some cost associated with this process is thus justified. However, there is a point at which the costs outweigh the benefits. Because many of the administrative civil justice system resources are fixed in the shot term, increased litigation likely yields substantial increases in 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, the 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 negative economic effects thereof, 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 long-shot 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.