

## Third-Party Litigation Funding: Tipping the Scales of Justice for Profit

### Introduction

Third-party litigation funding, also known as litigation financing or lawsuit lending, refers broadly to the practice of providing money to a party to pursue a potential or filed lawsuit in return for a share of any damages award or settlement. A relatively new phenomenon in the U.S., litigation funding has the potential to radically alter our legal landscape, affecting the civil justice system in ways that are mostly negative.

Several state legislatures have recently enacted or are considering legislation to regulate litigation funding. So far, however, these efforts have focused exclusively on a particular corner of the litigation funding industry – what we refer to as the individual plaintiff funder – and have been limited to marginal “consumer protection” measures, such as setting standards to improve transparency in the terms of the funding arrangement. Such measures have been inspired by anecdotal evidence of deceptive sales tactics and other abuses by funding companies that cater primarily to individual plaintiffs.<sup>1</sup> Yet in many cases, the litigation funding industry itself has drafted and promoted these measures, in part to placate policymakers and consumer advocates concerned about consumer welfare, but more importantly, to establish third-party litigation funding as a legitimate business enterprise in jurisdictions where it may currently be unlawful.

The narrow scope of current legislation ignores the most pressing public policy issues surrounding litigation funding. This paper looks beyond current proposals and examines the broader legal and economic implications of litigation funding. Among the questions it addresses are:

- What are the main types of third-party litigation funding?
- Will litigation funding increase the overall volume of litigation in the U.S.?
- Does increasing the volume of litigation facilitate the pursuit of justice?
- What types of litigation are likely to attract the interest of litigation funders?
- How will litigation funding influence the behavior and affect the interest of plaintiffs, defendants, and attorneys?
- How will litigation funding affect the operation and integrity of the civil justice system?
- What are the economic costs and benefits of third-party litigation funding to society as a whole?
- What effect will litigation funding have on insurers and their policyholders?

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### Two Models of Litigation Funding

There are two distinct types of litigation funding, and it is important to distinguish between them. In the first type, which we will refer to as the individual plaintiff (IP) model, a company advances money to plaintiffs and charges interest on a monthly or daily basis at annualized rates that can exceed 100 percent of the loan value. The loans are non-recourse, meaning that if the plaintiff loses, the funder has no claim for repayment. The loan is repaid only if the suit eventually ends in a monetary award for the plaintiff. Such loans are generally for relatively small amounts – often less than \$10,000 – and the plaintiff is usually an individual involved in a personal injury case.

In the second type of litigation funding, which we will call the corporate litigant (CL) model, money is advanced to plaintiffs in exchange for a predetermined pro rata share of any proceeds that result from the lawsuit. The funding company is a specialized investment firm or hedge fund, and the borrower, under current practice, is typically a corporate litigant (although it could also be a plaintiff attorney engaged in a class action or mass tort, as will be discussed later). Depending on the value of the case, the sums advanced to the borrower may exceed \$15 million.<sup>2</sup> Another significant difference between IP funding and CL funding is that third-party loans in the commercial context are sometimes made directly to the attorney or law firm rather than the individual plaintiff. Such loans may be attached either to a particular case or to a portfolio of cases.

CL loans are also made on a non-recourse basis, which gives third-party funding a superficial resemblance to contingent-fee arrangements between attorneys and their clients. However, both funders differ from contingency-fee attorneys in at least one crucial respect: they are strangers to the litigation. That is, they are neither litigants nor advocates for the litigants; their role is solely that of a profit-seeking investor whose goal is to maximize the return on their investment. The presence of a third-party funder transforms a justice system designed to adjudicate disputes in a fair and impartial manner into a marketplace where disputes are commoditized and manipulated to serve the interests of investors.

### Effects on Plaintiffs and Attorneys

Litigation funders insist that they make no effort to influence the lawsuits in which they invest, but it is difficult to take these claims seriously. Since

all investors inherently desire to protect and nurture their investments, it is reasonable to expect that litigation funders will naturally seek to exert control over strategic decisions that affect their litigation portfolios. This should not be particularly difficult in situations where the attorney has contracted directly with the funding company and thus has contractual duties to it that are independent of the attorney's duties to his nominal client, the plaintiff. Indeed, over time one would expect partnerships to develop between particular funders and attorneys that would operate to the mutual advantage of each party. For example, a funding company that specializes in lending to personal injury plaintiffs might provide borrowers with referrals to particular attorneys who agree to prolong cases, thereby extending the time period during which interest accrues on the funds advanced.

Likewise, a funding company that specializes in lending to attorneys and law firms might pressure its borrowers to ratchet up settlement demands in order to maximize the funder's profit, regardless of whether such tactics serve the interest of the plaintiff. For example, if a funder provides \$1 million to an attorney to pursue litigation in return for 50 percent of any award, the funder will naturally seek to ensure that the attorney accepts a settlement offer of no less than \$2 million. The \$2 million amount will be determined, not on the basis of the merits of the claim, but rather on the funder's desire to realize a positive return on its investment (or to at least avoid a negative return).

### *Class Actions*

Class action litigation is particularly vulnerable to the pursuit of profit through third-party funding schemes. There is no practical way to obtain permission from all the potential plaintiffs as to

whether the attorneys representing the class may obtain litigation funding, or from whom they may obtain it. Nor are members of the class in a position to negotiate or approve the terms of the funding arrangement. Thus, the entire process of obtaining funding will occur without the consent, or even the knowledge, of the plaintiffs.<sup>3</sup>

Moreover, once the funding arrangement is in place, decisions regarding the strategy and tactics to be employed in a class action will be entirely at the discretion of the funding company and the attorney, again without the involvement of the plaintiffs. In a case with a single plaintiff, the plaintiff arguably is in a position to monitor the prosecution of the case and raise concerns about the involvement of a third-party funder and his attorney's relationship to the funder. By contrast, there is often no interested plaintiff in a class action, which could easily lead to a situation in which the funding company is effectively controlling the litigation.

### **Effects on Defendants**

By making it more likely that plaintiffs or their attorneys will have sufficient funding to prosecute even questionable claims at trial, third-party funding may create pressure on defendants to settle all but the most frivolous claims, and at amounts much higher than the probable value based on the merits. Indeed, for reasons discussed later in this paper, third-party funding is likely to encourage even the filing of frivolous lawsuits in cases where the potential payout is very large. This effect belies the notion that by enabling potential plaintiffs to bring lawsuits, funding arrangements enhance the pursuit of justice. In practice, it is far more likely to have the opposite effect.

To illustrate, consider the putative relationship between litigation and the pursuit of justice. Litigation is first and foremost a mechanism for resolving disputes in a manner that is formal, non-violent, and binding. Most would agree that as a dispute-resolution mechanism, litigation is vastly superior to archaic alternatives such as vendettas and duels. Justice, however, is an ideal to which the process of litigation can only aspire, and it is undeniable that litigation often fails to produce outcomes that most observers would consider just. An extended critique of the U.S. civil justice system is beyond the scope of this paper, but suffice it to say that there is a vast literature documenting the system's many procedural and substantive flaws.

Moreover, even when litigation does lead to a result that seems meritorious, the process itself may create externalities that are harmful and unfair. Consider, for example, the plight of the defendant who, despite being factually innocent, must bear the costs of a plaintiff's decision to file a lawsuit. A prospective plaintiff (or plaintiff attorney) will consider his own costs when contemplating a lawsuit but will ignore any costs imposed on the defendant, as well as costs to the court system itself, which are paid by taxpayers. It has been estimated that the total cost of the litigation process typically equals roughly two-thirds of the dollar amount at issue, and much of the cost is borne by the accused party regardless of whether it is legally or factually guilty of any wrongdoing.

In addition to the direct monetary costs of defending against a lawsuit, a company that is the target of litigation will also face opportunity costs. Time,

money, and effort that would otherwise be devoted to developing new products, hiring new workers (or maintaining current workers) and serving customers will instead be diverted to lawsuit defense. These costs include the time and effort devoted to searching paper files, electronic files, and e-mail records in response to document requests, as well as the time and effort involved in preparing testimony in depositions and at trial.<sup>4</sup>

Another potential cost incurred by defendants is reputational damage. It is not uncommon for plaintiff attorneys engaged in high-profile, high-stakes cases to hire "litigation communication" consultants who specialize in orchestrating negative media campaigns aimed at defendants. The effect of such efforts is two-fold: First, the prospect of escalating reputational harm caused by continued negative publicity induces defendants to settle claims quickly and for amounts greater than if the case were adjudicated on the merits. Alternatively, in those instances where the defendant resists settlement and the case goes to trial, the negative publicity onslaught serves to taint the jury pool, making it harder for the defendant to receive a fair trial.

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Litigation-focused media campaigns of this sort can be very expensive, and ordinarily relatively few law firms will be able to afford them.<sup>5</sup> The advent of third-party litigation funding, however, makes it more likely that such tactics will be utilized, particularly in cases with facts that can be used to fabricate sensational or scurrilous allegations against the defendant. Again, the costs associated with

reputational damage are unrecoverable, regardless of whether the defendant actually engaged in any wrongdoing.

Under the “American rule,” so termed because it differs from the practice of most other countries, each party is responsible for its own costs regardless of the outcome of the case. Hence, there is usually no way for an innocent defendant to recover the direct costs incurred in defending against an ultimately unsuccessful lawsuit, and certainly no way to recover opportunity costs and costs stemming from reputational damage. As burdensome as it already is, the cost of litigation to innocent defendants will only become greater as third-party funders enter into the process by increasing the financial resources available to plaintiffs.

## **Effects on the Civil Justice System**

Though a burgeoning third-party litigation funding industry is a relatively recent phenomenon in the U.S., it is based on a concept quite familiar to previous generations of judges and lawyers. That concept, known as “maintenance,” is defined in the *Oxford English Dictionary* as “the action of wrongfully aiding and abetting litigation; spec. sustentation of a suit or suitor at law by a party who has no interest in the proceedings....”<sup>6</sup> A subspecies of maintenance, “champerty,” specifically refers to the type of financial agreement that typically exists between funders and litigants. Champerty, according to *Black’s Law Dictionary*, is “an agreement to divide litigation proceeds between the owner of the litigated claim and a party unrelated to the lawsuit who supports or helps enforce the claim.”<sup>7</sup> The meaning of the two terms has been neatly summarized by the U.S. Supreme Court: “Put simply, maintenance is helping another prosecute a suit; champerty is

maintaining a suit in return for a financial interest in the outcome.”<sup>8</sup>

Throughout most of the history of Anglo-American law, there was a strong consensus among judges, commentators, and legal practitioners against allowing non-litigants to provide money to a person for the purpose of pursuing or maintaining a lawsuit. The eighteenth century jurist Sir William Blackstone, widely regarded as the greatest commentator on the English common law (which would become the foundation of American law), described maintenance as “an officious intermeddling that no way belongs to one, by maintaining or assisting either party with money or otherwise, to prosecute or defend it.” He condemned the practice as “an offense against public justice, as it keeps alive strife and contention, and perverts the remedial process of the law into an engine of oppression.” As for champerty, Blackstone averred that it is “much abhorred by our law” because “no man should purchase any pretense to sue in another’s right.”<sup>9</sup> Throughout the nineteenth and most of the twentieth centuries, it was generally assumed that maintenance and champerty were not permitted under the common law in American courts.

The champerty doctrine, in particular, seems to have been intended to prevent precisely the sort of scheme embodied in third-party litigation finance agreements: a speculative investment in litigation in which a stranger to the suit provides financial backing in the hope of realizing a lucrative result.

Part of the reason that Anglo-American law has historically frowned on third-party funding arrangements is that prominent jurists regarded lawsuits in much the same way as they regarded disputes in non-judicial settings: something that disrupts and subverts the harmonious interpersonal

relationships that are essential to a peaceful and prosperous social order. Although disputes of all kinds, including legal disputes, were inevitable, they were certainly not to be encouraged. Financing of lawsuits by third parties with no involvement in the dispute, it was widely believed, encouraged people who otherwise would not do so to bring lawsuits, and this was thought to be socially undesirable.

Today, however, the view has taken hold among many legal elites, if not the population as a whole, that lawsuits are the primary means by which ordinary citizens may obtain “access to justice.” From the

perspective of those who equate “more lawsuits” with “more justice,” financing arrangements that facilitate more lawsuits are unobjectionable and even desirable.<sup>10</sup> It is presumably this view that has prompted many jurisdictions in the U.S. to abandon the doctrines of maintenance and champerty; indeed, courts in as many as two-fifths of the states have overruled defenses based on the doctrines.<sup>11</sup>

One such state is Massachusetts, whose supreme court nullified the doctrines in a case specifically involving a third-party funding arrangement. The court’s opinion contained several observations that are reflective of the pro-litigation mindset. For example, the court justified its abolition of champerty by noting that “we have long abandoned the view that litigation is suspect, and have recognized that agreements to purchase an interest in an action may actually foster resolution for a dispute.” The court further declared that society no longer views litigation as a “social ill, which, like

other disputes and quarrels should be minimized,” adding that “it is now seen as a socially useful way to resolve disputes.”<sup>12</sup>

With the doctrines of maintenance and champerty excised from the common law of some states and their current validity uncertain in others, there would appear to be few, if any, legal barriers to third-party litigation funding. As great as its impact will be on litigants and attorneys, litigation funding’s most profound impact may be seen in its eventual shaping of the litigation process and the law itself.

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#### *Frivolous lawsuits*

We have already discussed some of the ways in which third-party funding, by increasing the volume of litigation, will impose additional economic costs and inefficiencies on defendants regardless of their guilt or innocence. And we have made the point that these concerns merit careful consideration by policymakers, notwithstanding the dubious axiom that more lawsuits

equal more justice. The question more commonly raised in the public policy debate today, however, is whether third-party funding is likely to increase the number of *frivolous* lawsuits.

Proponents of third-party funding argue that the practice does not encourage frivolous lawsuits because a litigation funding company has no incentive to make a non-recourse loan to finance a meritless case. Indeed, in seeking the greatest possible return on its investment, the funding company will select only the most meritorious cases in which to invest. This notion was concisely expressed by a Texas court in a case that examined the validity of third-party funding arrangements:

Presumably, prior to making an investment pursuant to a similarly structured agreement, an investor would consider the merits of the suit and make a calculated risk assessment on the probability of a return on its investment. An investor would be unlikely to invest funds in a frivolous lawsuit when its only chance of recovery is contingent upon the success of the lawsuit.<sup>13</sup>

The court's theory about the behavior of a rational investor may appear to make sense, but as anyone who has ever glanced at an investment sales brochure has learned, different investors have different levels of "risk tolerance" based on their financial condition and appetite for risk. Moreover, focusing solely on the probability that the lawsuit will succeed overlooks the fact that funding companies can negotiate for a larger share of any proceeds that result from a less-meritorious lawsuit, in the same way that investors are able to demand higher yields from the issuers of so-called junk bonds.

When it comes to investing in lawsuits, some investors, especially if they are well-capitalized funding companies, will rationally invest in lawsuits with a low probability of success if the suit seeks a large enough damages figure. Consider, for example, that from an investment standpoint, a suit seeking \$100 million in damages with only a 10 percent chance of success has a net present value of \$10 million. A funding company can pursue a

strategy of taking on the greater risk of investing in a less-meritorious suit by spreading the risk across its portfolio, which may consist of dozens or even hundreds of lawsuits. In sum, claims that third-party litigation funding will not increase the number of frivolous lawsuits do not comport with conventional theories of strategic investment or with the observed behavior of actual investors, and should therefore be viewed with much skepticism.

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### *Strategic Lawsuits*

Because it is a product of the common law of the states, the American tort liability system is continuously altered and shaped by the development of new case law. This occurs despite the tradition of *stare decisis*, which ostensibly obliges judges to follow the precedents established by prior cases. As the fate of the maintenance and champerty doctrines illustrates, judges sometimes alter precedents or abandon them altogether. The malleability of the tort system makes it susceptible to strategic litigation, where the goal is not

simply to prevail in a particular case, but to alter tort law by pursuing cases that have the potential to generate new precedents that are favorable to one's long-term interests. Plaintiff attorneys have been known to engage in strategic litigation of this kind, and well-capitalized third-party funders would seem to have especially strong incentives to do so.

Large-scale third-party investors will, by definition, be involved in more cases than any individual law firm and will therefore stand to benefit significantly from any legal change that would positively affect

the outcome of these cases. Hence, they are likely to invest in litigation that they believe will lead to certain types of legal change. Indeed, large, risky, long-duration cases that offer the possibility of a substantial return on the funder's investment may well depend on changes being made to the law. It may be that a sequence of cases, with favorable precedents that build on each other, will be needed to obtain the desired result. It is not difficult to imagine situations in which third-party funding is used specifically to develop the "right" set of precedents. Conversely, third-party funding might be used to preclude the development of precedents that the funder perceives as adverse to its interests; for example, a funding company could invest in cases with unfavorable facts and use its influence to prevent the case from going to trial or being appealed, thereby avoiding the possibility of a harmful precedent being set.

In sum, third-party litigation funding has the potential to alter the law itself, and to do so in a way that is strategically directed by investors for the sole purpose of maximizing their profit.

### **Effects on Insurers and Their Policyholders**

A large share of litigation defense costs is paid by insurers under liability insurance policies. Interestingly, this has led some proponents of third-party litigation funding to suggest that insurance companies act as *de facto* litigation funders on the defense side. By providing plaintiffs with a source of

external financing, litigation funding companies serve to "level the playing field" and thus provide a valuable public service, according to this view.

Equating litigation funding companies with liability insurers may have a superficial plausibility, but as the foregoing discussion has shown, what really matters when assessing the systemic impact of third-party funding are the funder's objectives and incentives. And in this respect, funding companies and insurers could hardly be more different. Whereas the primary objective of funding companies is to promote and profit from litigation, insurers seek to avoid litigation and minimize its costs. That is why insurers have never been accused of maintenance or champerty. In any case, it stands to reason that as third-party funding increases the volume of litigation, the litigation defense costs that insurers incur under personal and commercial liability policies will increase as well. This, in turn, will cause premiums to rise.

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In addition, litigation funding will have a more direct impact on insurers in cases where the insurer itself is the defendant. Some portion of the millions of insurance claims filed in the U.S. each year lead inevitably to coverage disputes between the insurer and its policyholder. In such cases, the policyholder may sue the insurer for non-payment or underpayment of a claim, and the question to be adjudicated is whether the policy as written provides coverage for the policyholder's loss, or whether a covered loss actually occurred. Just as third-party funding will likely increase the number of frivolous lawsuits in general, so

too is it likely to increase the number of meritless or fraudulent insurance claims that eventually become the subject of litigation.

It is not hard to see why this would be so. Suppose an insurer is faced with a meritless claim for \$200,000 in insured losses. If, based on its experience with similar claims, the insurer calculates that it will cost \$20,000 to successfully defend against a potential lawsuit for non-payment of the claim, it makes sense from an economic standpoint for the insurer to deny the claim. Now suppose that the insurer calculates that it will cost \$150,000 to defend against the same lawsuit because of the presence of substantial third-party funding on the plaintiff's side. In this situation, it will be more cost-effective for the insurer to settle the claim for \$100,000, even though it believes the claim is fraudulent or that coverage does not apply under the terms of the insurance contract. Insurers already write "nuisance checks" to settle meritless claims in order to avoid the cost of litigation. As third-party litigation funding becomes more prevalent, they will likely find themselves writing many more such checks – and for much larger amounts. These increased costs will be passed on to consumers in the form of higher insurance premiums.

### Conclusion and Recommendations

Based on the considerations raised in this paper, NAMIC believes that sufficient grounds exist for enacting a blanket prohibition against the practice of third-party litigation funding. For those policymakers who believe that the practice can be tamed through regulation, we hope that this paper has at least convinced them of the need for policy measures that would limit the negative economic and legal impacts of litigation funding.

Crafting legislation that is truly effective in this regard cannot be done in a piecemeal fashion. Moreover, it will require a careful and thorough analysis to ensure that all the necessary elements are ultimately included in the legislation. At a minimum, legislative proposals should include the following provisions:

- Third-party funding should not be allowed in class action settings or to finance mass tort litigation.
- Interest rates on funds advanced under third-party financing arrangements must be limited to a "reasonable" amount.
- Third-party funding must be restricted to actions by individual plaintiffs for torts involving personal injury.
- The amount that can be taken as loan repayment from the net recovery should be limited to a percentage of the net recovery.
- Litigation funding companies should not be allowed to make referrals to attorneys on behalf of a potential plaintiff, nor accept advertising from attorneys on their websites or in their marketing materials.
- Attorneys should not be allowed to have a financial interest in a litigation funding company.
- Litigation funding companies should not be allowed to exert influence over the plaintiff's decision to settle or to otherwise direct the course of the litigation.

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- The existence of any third-party funding arrangement should be disclosed to all parties to the lawsuit and to the court.

Legislative proposals seemingly aimed at protecting consumers from predatory third-party funding practices will do nothing to shield defendants, insurers, and taxpayers from the harmful systemic

effects of third-party litigation funding. Indeed, toothless legislation that does little more than create the illusion that litigation funding is a regulated industry may be worse than no regulation at all, in that it will mainly serve to codify the legitimacy of a practice that poses a direct threat to the integrity of the civil justice system.

## Endnotes

<sup>1</sup> See, e.g., Binyamin Appelbaum, “Investors Put Money on Lawsuits to Get Payouts,” *New York Times* (November 14, 2010).

<sup>2</sup> Jason Lyon, “Revolution in Progress: Third-Party Funding of American Litigation,” 58 *UCLA Law Review* 571, at 578 (2010).

<sup>3</sup> John Beisner et. al, *Selling Lawsuits, Buying Trouble: Third-Party Litigation Funding in the United States*, U.S. Chamber of Commerce Institute for Legal Reform (October 2009). Available at [www.instituteforlegalreform.com/images/stories/documents/pdf/research/thirdpartylitigationfinancing.pdf](http://www.instituteforlegalreform.com/images/stories/documents/pdf/research/thirdpartylitigationfinancing.pdf).

<sup>4</sup> Paul H. Rubin, “On the Efficiency of Increasing Litigation,” available at <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

<sup>5</sup> An example of how plaintiff attorneys use public relations firms is provided by the now-defunct Scruggs Katrina Group (SKG), which hired a Washington D.C.-based public relations firm as part of its litigation strategy against State Farm Insurance Company in 2006. The district court judge presiding over the case subsequently issued a ruling that stated in part: “It is abundantly clear that Richard Scruggs and the SKG used formidable public relations resources, including use of The Rendon Group, in an effort to control the public perception of [the defendant and its behavior]. See [www.insurancenetworking.com/news/insurance\\_state\\_farm\\_scruggs\\_claims\\_flood\\_property\\_casulaty-26997-1.html](http://www.insurancenetworking.com/news/insurance_state_farm_scruggs_claims_flood_property_casulaty-26997-1.html).

<sup>6</sup> *Oxford English Dictionary*, p. 226 (2<sup>nd</sup> ed. 1989).

<sup>7</sup> *Black’s Law Dictionary*, p. 262 (9<sup>th</sup> ed. 2009).

<sup>8</sup> *In re Primus*, 436 U.S. 412, 424-25, n. 15 (1978).

<sup>9</sup> William Blackstone, *Commentaries on the Laws of England*, Vol. IV, pp. 135-136 (1769).

<sup>10</sup> In the words of one litigation-funding entrepreneur, “If there’s less money [available to finance lawsuits], you’d have less litigation. But then you’d also have less justice.” Quoted in Appelbaum, *op. cit.*

<sup>11</sup> Paul Bond, “Making Champerty Work: An Invitation to State Action,” 150 U.Pa.L.Rev. 1297, 1331-1341 (2002).

<sup>12</sup> *Saladini v. Righellis*, 687 N.E. 2d at 1226 (Mass 1997).

<sup>13</sup> *Anglo-Dutch Petroleum Intern., Inc. v. Haskell*, 193 S.W. 3<sup>rd</sup> 87, 104-105 (Tex. App. 1<sup>st</sup> Dist. 2006).

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