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## Modeling the Likely Effects of Litigation Financing

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# Modeling the Likely Effects of Litigation Financing

*Jeremy Kidd, Ph.D.\**

*The arguments for and against third-party litigation financing are based on incorrect assumptions regarding the impacts on total litigation. A formal model incorporating the choices of the plaintiff, the lawyer, and the financier shows only minimal impact on total litigation, largely positive. Yet, after addressing the potential for long-term, strategic behavior by financiers, it is obvious that some dangers remain. Divorced from the dramatic claims of proponents and opponents, litigation financing is merely a tool that can be used for good or bad, and differentiating by types of claims and the incentives of the parties allows that tool to be appropriately implemented.*

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## I. INTRODUCTION

Does the future hold the promise of poor victims finally achieving the justice they are entitled to,<sup>1</sup> or does an existential threat to our justice system loom?<sup>2</sup> The battle over third-party litigation financing—also known as alternative litigation financing<sup>3</sup>—certainly evokes a dramatic flair in its combatants. What if reality is far more boring, like an accounting balance sheet or actuary tables?

To be certain, each side has some legitimate arguments and even some areas where they agree. Most prominently, both sides agree that third-party litigation financing means some people’s claims see the

1. Maya Steinitz, *Whose Claim Is this Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268 (2011) (illustrating the benefits of third-party litigation financing with examples of: (1) a woman seeking redress from her “powerful and wealthy former employer” who sexually harassed her, and (2) “a group of indigent villagers in Angola, whose village has been subject to a negligent and lethal chemic spill”). See generally Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367 (2009) (providing a more general discussion of third-party financing).

2. JOHN H. BEISNER & GARY A. RUBIN, U.S. CHAMBER INST. FOR LEGAL REFORM, STOPPING THE SALE ON LAWSUITS: A PROPOSAL TO REGULATE THIRD PARTY INVESTMENTS IN LITIGATION (2012) (“Third party investments in litigation represent a clear and present danger to the impartial and efficient administration of civil justice in the United States.”). Other, equally vivid images invoke the lawlessness of the wild west. See generally Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should be Tamed Not Outlawed*, 10 FORDHAM J. CORP. & FIN. L. 55 (2004) (discussing the enforceability of litigation finance).

3. For an explanation of the two terms, see Terrance Cain, *Third Party Funding of Personal Injury Tort Claims: Keep the Baby and Change the Bathwater*, 89 CHI.-KENT L. REV. 11, 13 n.15 (2014).

inside of a courtroom where they otherwise would not. The broad assumption is that there will be an increase in the volume of cases brought; proponents and opponents disagree only on whether those cases will be meritorious or frivolous. Surprisingly, no one has tested the validity of that underlying assumption: will loosening the rules against third-party litigation financing really throw open the courthouse doors?

Part II provides a simple model to test that assumption and finds it to be largely false. The reason for the disparity between ad hoc predictions and this theoretical approach is the addition of a pivotal fact—that financing only occurs when *both* the plaintiff and the financier agree. Surprisingly, most analyses to date have ignored that fact and focused exclusively on the benefits to needy plaintiffs; but that need is irrelevant to the financier's business decision in providing funds.<sup>4</sup> An oversight of this magnitude must be rectified if a sound policy on third-party litigation financing is to be achieved. Once both sides of the financing transaction are included, the model reveals that the introduction of third-party financiers makes very little difference to whether a case is brought. The notable exceptions are: (1) cases that are brought for strategic goals that are advanced by—but otherwise have very little to do with—the present case;<sup>5</sup> and (2) cases where the plaintiff cannot afford the nonlegal costs that accompany a lawsuit.

The limited nature of the change promised by third-party litigation financing might lead a reasonable person to conclude that, perhaps, this is much ado about nothing. There are a number of factors, however, that argue against that conclusion. First, those plaintiffs for whom financing makes a difference are worth our consideration. Second, the number of lawsuits and the merit of those lawsuits are entirely independent considerations, and third-party litigation financing might have an impact on the merit of claims brought. Third, lawsuits brought for strategic purposes might pose additional dangers not previously considered by much of the literature.

As an introduction to the larger debate, Part III presents a brief synopsis of the general benefits and costs of litigation financing. Those benefits and costs can largely be categorized into justice-centered arguments and efficiency arguments. Special attention will be paid to a

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4. In economic terms, plaintiffs demand funds and financiers supply those funds; the confluence of those two forces determine the market price for financing as well as the total quantity of funds exchanged, but supply and demand operate independent of each other.

5. *E.g.*, Jeremy Kidd, *To Fund or Not to Fund: The Need for Second-Best Solutions to the Litigation Finance Dilemma*, 8 J.L. ECON. & POL'Y 613, 629–31 (2012).

potential cost that is almost entirely ignored by the third-party litigation financing literature—the danger of path manipulation,<sup>6</sup> a form of judicial rent-seeking that can have significant distortionary effects on the evolution of legal rules.

Of course, every case is different, and the aggregate costs and benefits of third-party litigation financing are much different from the costs and benefits imposed by individual cases.<sup>7</sup> As Professor Engstrom notes, the literature is largely lacking the type of differentiated analysis that could account for the many factors that are relevant to the discussion of how third-party litigation financing impacts our justice system.<sup>8</sup> Part IV provides that needed differentiation by using the analysis from the previous Part to identify categories of litigation that are more or less prone to judicial rent-seeking in the form of path manipulation.

There is no shortage of opinions and policy prescriptions in this debate. Most proponents argue for abolition or revision of rules against maintenance<sup>9</sup> and champerty,<sup>10</sup> along with usury laws<sup>11</sup> and others in order to facilitate third-party litigation financing.<sup>12</sup> Opponents—and some tepid supporters—argue that regulation is required to prevent

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6. *Id.* at 629–30.

7. Huang, in describing what questions ought to be asked when considering the impact of litigation financing, illustrates the multitude of factors that can make a difference in the analysis. Bert Huang, *Litigation Finance: What do Judges Need to Know?*, 45 COLUM. J.L. & SOC. PROBLEMS 525, 529 (2012).

8. Nora Freeman Engstrom, *Lawyer Lending: Costs and Consequences*, 63 DEPAUL L. REV. 377, 382 (2014).

9. Black's Law Dictionary defines maintenance as “[i]mproper assistance in prosecuting or defending a lawsuit given to a litigant by someone who has no bona fide interest in the case; meddling in someone else's litigation.” *Maintenance*, BLACK'S LAW DICTIONARY (10th ed. 2014).

10. Champerty is a form of maintenance, and is defined by Black's Law Dictionary as [a]n agreement between an officious intermeddler in a lawsuit and a litigant by which the intermeddler helps pursue the litigant's claim as consideration for receiving part of any judgment proceeds; specif., 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.

*Champerty*, BLACK'S LAW DICTIONARY (10th ed. 2014).

11. *E.g.*, Martin, *supra* note 2, at 58–59. It is worth noting, however, that some third-party financiers lend a fixed amount in return for a percentage share of any settlement or award. Given the inherent legal uncertainties regarding lawsuit duration and award amounts, it is impossible to know what the effective interest rate would be until after the case has ended, making imposition of criminal penalties problematic.

12. True liberalization of litigation financing would have to include more than just elimination of maintenance and champerty (and other usuary) restrictions; it would also require eliminating bans on sharing fees with non-lawyers. *See, e.g.*, Jonathan T. Molot, *Litigation Finance: A Market Solution to A Procedural Problem*, 99 GEO. L.J. 65 (2010) (arguing for market transactions to promote settlement accuracy).

severe harm to the judicial system.<sup>13</sup> One of the most vociferous opponents of third-party litigation financing has been the U.S. Chamber Institute for Legal Reform, which has outlined a list of regulations that it believes are necessary to prevent “private parties [from subjecting] businesses involuntarily to the coercive effects of our litigation system, all for the purpose of profit.”<sup>14</sup> Part V tests proposals for reform and regulation—including those from the Chamber—using the modeling tools from Part II and the theoretical tools from Parts III and IV. The results are mixed, with minimal impact on total litigation but some positive impact in other areas.

As a final, practical step, it is worthwhile to delineate the ways in which financing rules can be relaxed in order to maximize the societal rewards while minimizing risks. Part VI concludes by combining the theoretical discussions of risk and reward with the insights of the formal model to provide such a list of potentially useful paths to follow.

## II. TESTING THE CLAIMS

Will increased third-party litigation financing result in increased access to justice, increased frivolous claims, or both? This Part tests the claims with a simple model that incorporates the incentives of both plaintiffs and financiers.

Any analysis of litigation financing must consider the impact of contingent-fee arrangements, which allow lawyers to finance the legal expenses associated with a lawsuit. Importantly, contingent-fee arrangements cannot include a variety of personal expenses that plaintiffs often face.<sup>15</sup> That can potentially leave a plaintiff, who has a valid claim and a lawyer willing to prosecute that claim, still required to decline the claim because their personal expenses cannot be paid during the lawsuit. Third-party litigation financing began to fill the gaps left by contingent-fee arrangements in the mid-1990s,<sup>16</sup> but that group of financiers comprises only one segment of the third-party litigation finance industry. This first category is often described as consumer

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13. *E.g.*, BEISNER & RUBIN, *supra* note 2, at 4–6; Martin, *supra* note 2, at 67–68.

14. BEISNER & RUBIN, *supra* note 2, at 15.

15. Lauren J. Grous, Note, *Causes of Action for Sale: The New Trend of Legal Gambling*, 61 U. MIAMI L. REV. 203, 206 (2006); MODEL RULES OF PROF'L CONDUCT R. 1.8(e) (AM. BAR. ASS'N 1983).

16. Martin, *supra* note 2, at 55. Interestingly, this form of unorthodox financing was the brainchild of a refugee from another form of unorthodox financing—loansharking—in Las Vegas. *See generally* Jenna Wims Hashaway, *Litigation Loansharks: A History of Litigation Lending and a Proposal to Bring Litigation Advances Within the Protection of Usury Laws*, 17 ROGER WILLIAMS U. L. REV. 750 (2012) (opening the door to a host of creative phrases to describe the industry).

legal funding.<sup>17</sup> The second category, patterned after a hedge fund investment model, typically funds commercial lawsuits,<sup>18</sup> although at least one large-scale international tort-based claim has been funded under this model.<sup>19</sup> The third category is firms that provide loans directly to law firms to finance specific cases.<sup>20</sup> This Article will focus on the first two categories, leaving analysis of the third category to others.<sup>21</sup>

Considering the first two categories of litigation financing, a basic assumption of the increased-access-to-justice claims is that plaintiffs with legitimate claims are too poor to afford the costs of litigation and unable to find external funding for those costs outside of traditional financing methods.<sup>22</sup> Opponents' claims of increased frivolous litigation rest on an assumption of limited resources for litigation that, when relaxed, will allow far more claims to be brought. For both sides of the debate, the assumptions should raise additional questions about the willingness of the financier to provide those funds. That such questions have not been asked in the past is surprising, given the academic firepower that has been brought to bear. Nevertheless, those questions deserve answers and this Part provides at least preliminary answers.

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17. Engstrom, *supra* note 8, at 383. Consumer legal funding is currently available in nearly every state. Anthony Sebok, *Betting on Tort Suits After the Event: From Champerty to Insurance*, 60 DEPAUL L. REV. 453, 453 (2011).

18. Burford Capital and Juridica Investments are commonly cited examples of hedge-fund litigation investment firms, but many others have opened their doors in recent years. See Engstrom, *supra* note 8, at 383. In addition to being based on a hedge-fund model, there is evidence that some previously existing hedge funds have begun investing in lawsuits. Huang, *supra* note 7, at 526 n.7.

19. The case, brought by Ecuadorian plaintiffs against Chevron because of alleged wrongdoing by a predecessor of Chevron and funded by Burford Capital, has been dogged by credible allegations of corruption, including allegations related to the investment firm that financed the case. The case is still pending in the Southern District of New York. *Id.* at 526 n.4; Elizabeth Chamblee Burch, *Financiers as Monitors in Aggregate Litigation*, 87 N.Y.U. L. REV. 1273, 1278 (2012).

20. Engstrom, *supra* note 8, at 383.

21. *Id.*; see also Jennifer Anglim Kreder & Benjamin A. Bauer, *Litigation Finance Ethics: Paying Interest*, 2013 J. PROF'L LAWYER 1 (discussing the ethical implications of charging clients for interest paid on a loan). There are, of course, other ways in which the litigation financing industry can be classified. One such classification is between lending to consumers and lending to commercial interests. See also Anthony Sebok & W. Bradley Wendel, *Duty in the Litigation-Investment Agreement: The Choice Between Tort and Contract Norms When the Deal Breaks Down*, 66 VAND. L. REV. 101, 103 n.2 (2013) (discussing the market for investment in commercial litigation).

22. Methods that include personal loans, home equity loans, and so forth.

### A. NEV Claims

Important to the investment decision of any litigation investor is whether or not the claim is likely to yield a positive return. It should be obvious that the definition of “positive return” could differ based on the preferences of the investor; for some, it will be pure monetary returns, while for others it could be ideological.<sup>23</sup> With that caveat in mind, the investor will be very interested in determining whether the claim is one known as a negative expected value, or an NEV claim. Essentially, an NEV claim is one for which the expected costs of prosecuting the claim outweigh the expected rewards (typically monetary rewards), making it difficult for an NEV plaintiff to find a lawyer (or financier, in our case) willing to participate.

NEV lawsuits have been the subject of much discussion since 1983, when Professor P’ng first proposed that a plaintiff could rationally bring an NEV lawsuit hoping to extract a settlement offer. The offer would come from a defendant when the cost of settlement was lower than the defendant’s trial costs, if the plaintiff could credibly threaten a trial.<sup>24</sup> Rosenberg and Shavell countered with a model where the plaintiff could not make a credible threat to take the claim to trial because both the plaintiff and the defendant knew that the claim was an NEV claim.<sup>25</sup> The Rosenberg and Shavell model still posited that a plaintiff could extract a settlement, but only if the cost of settlement was less than the cost of responding to the NEV claim. Bebchuk then proposed a model in which a plaintiff with NEV claims could extract a settlement in the presence of uncertainty; so long as the defendant was uncertain of the lawsuit’s true expected value, a rational defendant might settle rather than risk the uncertainty.<sup>26</sup>

Underlying these models is the assumption that NEV lawsuits will not typically be brought because they do not make financial sense.<sup>27</sup>

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23. For examples of those who invest in lawsuits in order to obtain non-monetary “returns,” one need only look to the American Civil Liberties Union, the Institute for Justice, and so on.

24. Ivan P.L. P’ng, *Strategic Behavior in Suit, Settlement, and Trial*, 14 BELL J. ECON. 539, 539 (1983). This was a departure from Shavell’s 1982 article, which premised the claim-filing decision on a determination by the plaintiff that the expected value of the lawsuit was positive. Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55, 56 (1982).

25. David Rosenberg & Steven Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT’L REV. L. & ECON. 3, 3 (1985).

26. Lucian Arye Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEGAL STUD. 437, 441–42 (1988).

27. Even in the case of an ideological—rather than financial—investor, the financial costs and reward are still relevant, so long as we make the reasonable assumption that there are multiple claims that a financier could support. In that case, the analysis is more expressly in terms of



Extracting settlements is not the same as achieving a favorable verdict, and persisting in an NEV lawsuit when settlement is not forthcoming is always a losing proposition. Although there are criticisms of the early models,<sup>28</sup> those objections usually do not attack this fundamental assumption.<sup>29</sup> The assumption that NEV plaintiffs will rarely choose to file is likely a sound one, but it is only part of the relevant question, because many plaintiffs will require assistance with legal and personal costs before they can afford a lawsuit. Legal fees can be obtained under the current financing rules through a contingent-fee arrangement, but only if a contingent-fee lawyer agrees to represent the plaintiff. That still leaves personal costs unfinanced, which might be resolved by liberalizing financing rules, but only if a financier is willing to provide funds.

A complete view of the decision to file a lawsuit requires a three-part analysis, considering the rational decisions of the plaintiff, the lawyer, and the financier. The following model does just that. Before proceeding to the model, however, one introductory comment is in order. It is possible to think of NEV lawsuits as having no merit, perhaps because they impose a cost on society,<sup>30</sup> but the soundness of the plaintiffs' legal claims should be considered independent of the net value to society of those claims.<sup>31</sup> The model is not intended to provide a normative judgment as to whether any individual plaintiff is deserving or whether the claims have any social value. The only question is what impact third-party litigation financing will have on plaintiffs who wish to bring a lawsuit but cannot afford to do so. As shown below, the answer is "very little."

### B. The Model

To begin, we define the expected value of the lawsuit in standard fashion, as the expected payout from the lawsuit minus the expected

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opportunity costs, or the potential claims that the financier does *not* fund because resources are expended elsewhere.

28. See, e.g., Warren F. Schwartz & Abraham L. Wickelgren, *Advantage Defendant: Why Sinking Litigation Costs Makes Negative-Expected-Value Defenses But Not Negative-Expected-Value Suits Credible*, 38 J. LEGAL STUD. 235, 236 (2009).

29. But see Joseph A. Grundfest & Peter H. Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267, 1277 (2006) (arguing that an NEV lawsuit can be seen as an out-of-the-money option that is pursued because the cost is low enough that it is outweighed by the total value of the lawsuit).

30. By definition, an NEV lawsuit provides lower benefits than cost, even when only considering the plaintiff's costs. Combine that fact with the costs imposed on the defendant and the administrative costs borne by society, and an NEV lawsuit imposes a net monetary loss.

31. Both questions are important, but the law can authorize lawsuits that have no social value or it can refuse to recognize claims that would be socially valuable.

costs of the lawsuit:  $EV = E(\pi) - E(c)$ , where the expected payout,  $E(\pi)$ , is the sum of all possible payouts multiplied by their probabilities:  $E(\pi) = \rho_1\pi_1 + \rho_2\pi_2 + \dots + \rho_n\pi_n = \sum_1^n \rho_k \pi_k$ .<sup>32</sup> The expected cost of the lawsuit,  $E(c)$ , is a function of the time it takes to resolve the case and the complexity of the case, with costs increasing in both time and complexity,  $\partial c/\partial t > 0$ ,  $\partial c/(\partial \sigma^2) > 0$ .<sup>33</sup> Total costs can be divided into legal costs and personal costs,  $c_T = c_L + c_P$ .<sup>34</sup>

The increased access to justice argument relies on an assumption that certain individuals cannot afford the costs of litigation. This assumption can be tested by adapting the cost function to account for the possibility of borrowing:  $EV = \sum_1^n \rho_k \pi_k - E(c_T)^{1+i}$ , where  $i$  is the interest rate. If an individual is capable of self-financing a lawsuit,  $i$  will be close to zero, while an individual without that capacity will face a higher interest rate. The precise interest rate might be obvious in some circumstances, such as when a plaintiff uses equity in her home to obtain a loan with a stated interest rate. Alternatively, the percentage demanded by a contingent-fee lawyer could be transformed into an annual interest rate.<sup>35</sup> If an individual is incapable of accessing any of these traditional sources of credit, the interest rate they face could rise dramatically, approaching infinity for those with no legitimate means of obtaining

32. This formulation differs from what some scholars refer to as the neoclassical method for valuing claims:

[W]hen considering whether to proceed to trial, a plaintiff and its business partner, the funder, should multiply the expected damage award by the probability that the court will award it, subtract the anticipated litigation costs, add settlement costs, and subtract opportunity gains from receiving payment now as opposed to a judgment later.

Maya Steinitz, *How Much Is that Lawsuit in the Window? Pricing Legal Claims*, 66 VAND. L. REV. 1889, 1904–05 (2013). The complexity of litigation requires—and this model incorporates—consideration of a wide variety of possible outcomes, including dismissal or settlement at any point in the proceedings. Moreover, this model is concerned with the initial funding decision or each subsequent funding decision in a case of “staged funding,” and does not require perfect information about all possible outcomes. *See id.* at 1895–03. A lawsuit may follow a “random walk” as it proceeds without impacting the conclusions of the model. *See id.* at 1909.

33. The first assumption should be uncontroversial, as the billable hour practically guarantees that a longer lawsuit will be a more expensive lawsuit. The second assumption should likewise be uncontroversial; it is essentially that costs rise as the variance of the distribution of possible outcomes rises. Increased variance in the distribution means that a lot more precision and attention to detail will be required of the lawyer and the client, and that additional effort will be costly.

34. This distinction is necessary due to the current restrictions in many states regarding lawyers’ providing funds to their clients to cover living expenses, medical expenses, and other personal expenses.

35. The fee received by a contingent-fee lawyer is not, strictly speaking, an interest rate equivalent to a home equity loan, but from the perspective of the plaintiff, the practical function of the two (a reduction in the total benefit from a judgment) is similar. BEISNER & RUBIN, *supra* note 2, at 4–6; Martin, *supra* note 2, at 67–68.

financing.<sup>36</sup> From a practical standpoint, the higher the interest rate, the less likely a plaintiff will be able to afford to bring a claim.

Access to justice might be increased if financing allows the expectations of the plaintiff, the lawyer, and the financier to come into alignment. Specifically, if financing can reduce the interest rate faced by the plaintiff-borrower, then all parties might be able to agree to terms that make the claim feasible. To see why this is so, consider that the plaintiff faces the following expected value:

$$(1) \quad \sum_1^n \rho_k \pi_k - c_T^{1+i}.$$

A contingent-fee lawyer who is consulted on the case, faces the following expected value:

$$(2) \quad (\sum_1^n \rho_k \pi_k) * f_1 - c_L^{1+r}, 0 < f_1 < 1,$$

where  $f_1$  is the contingent fee, the percentage of any settlement or damages award claimed by the lawyer,<sup>37</sup> and  $r$  is the discount rate faced by the lawyer.<sup>38</sup> In simpler terms, the contingent-fee lawyer's return is calculated by subtracting the legal expenditures of the claim from the lawyer's share of the winnings.

If financing is unavailable, it is possible for a plaintiff to face a negative expected value (equation (1) is less than zero) while the contingent-fee lawyer is willing to take the case (equation (2) is greater than zero).<sup>39</sup> The difference arises because the plaintiff-borrower faces such a high interest rate in order to cover personal costs. If financing is available for those personal costs that a contingent-fee lawyer is unable

36. As but one admittedly extreme example, imagine an individual who had no other option but to sell themselves into indentured servitude; doing so would transform a finite cost of a lawsuit into a potentially infinite cost in terms of human liberty.

37. The lawyer has near complete freedom in determining the size of the contingent fee, subject only to professional limits on excessive compensation and market constraints imposed by competition between contingent-fee lawyers.

38. For the purposes of this analysis, we assume that the contingent-fee lawyer does not need to borrow funds to cover legal expenses during the course of the lawsuit. Nonetheless, because use of the lawyer's funds for one lawsuit precludes use of those same funds for any other purpose, it is necessary to include a measure of the opportunity cost of using the funds in this manner. For example, if nothing else, a contingent-fee lawyer could invest in an indexed mutual fund and receive market rates of return.

39. To see how this is true, recall that  $r$  is likely the market interest rate while  $i$  can approach infinity. Thus, to the extent that  $i > r$ ,  $c_T^{1+i} > c_T^{1+r}$  and a borderline case could meet both of the following conditions:  $\sum_1^n \rho_k \pi_k - c_T^{1+i} < 0$  and  $\sum_1^n \rho_k \pi_k - c_T^{1+r} > 0$ .

to bear on behalf of the plaintiff, the financier enters the analysis and faces the following expected value:

$$(3) \quad (\sum_1^n \rho_k \pi_k) * f_2 - c_p^{1+r}, 0 < f_2 < 1,$$

where  $f_2$  is the percentage fee required by the financier in exchange for covering the plaintiff's personal costs.<sup>40</sup> Similar to the contingent-fee lawyer, the financier's return is calculated by subtracting the personal costs—which the financier now bears—from the portion of the winnings to which the financier is contractually entitled. The plaintiff is able to shift all costs to other parties and, as a result, faces:

$$(4) \quad (\sum_1^n \rho_k \pi_k) * (1 - f_1 - f_2).$$

The contingent-fee lawyer and the financier independently choose the fee required to make the endeavor profitable, based on their relative opportunity costs. As a result, the sign of equation (4) is not guaranteed to be positive and the plaintiff may still be unable to bring the claim. However, the possibility of financing at least creates opportunities that did not exist before and interest rates no longer impede the plaintiff's access to justice, at least not directly. Some claims will be brought because the expected return to contingent-fee lawyer and financier are positive and there is some surplus for the plaintiff. Other claims will not. What this shows, however, is that it is possible for litigation financing to make a difference for a small category of plaintiffs who need financing for the personal costs of litigation.

### C. Does Financing Help NEV Plaintiffs?

The operating assumption up to this point has been that the claim is valid and has a positive expected value. More important to the discussion at hand, however, is whether financing can help plaintiffs whose claims are valid but have a negative expected value. Most observers would agree that some lawsuits have a negative expected value because they are frivolous cases and, as a result, have a very low probability of success.<sup>41</sup> However, it is possible that a case may be

40. Like the contingent-fee lawyer, we assume that the financier is largely free to set its contractual share of the lawsuit proceeds, subject only to competitive market pressures and, in some states, the constraints of usury laws. See, e.g., 4 ARK. CODE ANN. 57-109(b)(1) (2015).

41. Alternatively, a frivolous claim might have a positive expected value because the low probability of success is outweighed by the potential payout if a significant shift in the law is achieved. While perhaps unlikely, the evolutionary nature of our laws leaves the door open. The

founded upon legitimate legal claims, with the plaintiff being entitled to compensation by application of existing legal rules. Those cases can still experience a negative expected value if the costs of bringing the case are sufficiently high, and it is these otherwise valid claims that presumably support the increased-access-to-justice arguments in favor of a liberalized financing regime.

It remains to be seen, however, whether the advent of litigation financing will lead to any positive change for plaintiffs in these circumstances. Put simply, the question becomes whether or not the existence of financing can change an NEV claim into a PEV or positive expected value claim.

Other scholars have pointed out that the existence of financing can improve the bargaining position of a plaintiff during settlement negotiations,<sup>42</sup> but that is primarily due to the fact that financing may allow the plaintiff to bargain without the anxiety of tight budget constraints. The existence of financing does not fundamentally alter the facts of a case or the applicable law, rendering the expected payout essentially unchanged. The expectation of the financier will depend on how the payoff to the plaintiff is structured. Equation (3) describes the financier's expectations if the financier pays all personal costs. If the financier completely supplants a contingent-fee lawyer's place in the transaction, covering all costs, the financier's expectations will be:

$$(3a) \left( \sum_1^n \rho_k \pi_k \right) * f_2 - c_T^{1+r}.$$

Alternatively, a financier might be willing to advance a lump sum payment to the plaintiff, rather than commit to covering, on an ongoing basis, a category of costs, in which case the financier's expectations will be:

$$(3b) \left( \sum_1^n \rho_k \pi_k \right) * f_2 - F^{1+r},$$

where  $F$  is the lump sum payment.

The choice of the financier impacts both the decision of the plaintiff and the contingent-fee lawyer. We have already shown, in equations (2), (3), and (4), the expectations of the parties when a contingent-fee arrangement supplies the legal costs of a claim and a financier provides

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possibility of conscious manipulation of that evolutionary process is discussed in Part III.B.3, *infra*.

42. Sebok, *supra* note 17, at 457.

funds for the personal costs. If the financier chooses to finance all of the costs of the lawsuit, then the contingent-fee lawyer is no longer present,<sup>43</sup> and the financier's expectations are represented by equation (3b). The plaintiff's expectations are essentially the same as equation (4):

$$(4a) \quad (\sum_1^n \rho_k \pi_k) * (1 - f_2).$$

If a financier decides to contribute only a fixed amount of financing, the financier's expectations are represented in (3a), the contingent-fee lawyer will face the expectations of equation (2), and the plaintiff will face:

$$(4b) \quad (\sum_1^n \rho_k \pi_k) * (1 - f_1 - f_2) - (c_P^{1+i} - F^{1+r}).$$

In order for financing to increase access to justice for plaintiffs possessing an NEV claim, financing must be able to change expectations sufficiently such that the plaintiff, financier and, where applicable, the contingent-fee lawyer all agree to proceed.<sup>44</sup> If a case has a negative expected value, then equation (1) is negative, so the question is whether that can hold at the same time that any set of expectations (equations (2), (3), and (4); (3b) and (4a); or (2), (3a), and (4b)) are positive.

We begin with the case of a financier who finances the full personal costs. Rewriting equations (2), (3), and (4) as inequalities and rearranging yields:

$$(2') \quad (\sum_1^n \rho_k \pi_k) * f_1 > c_L^{1+r}$$

43. We assume that legal services will be provided under contract with the financier, either with the lawyers employed by the financier on an hourly basis, or else on a contingent-fee basis but subsumed within the financier's fee. Either way, the expectations of the parties are adequately represented without expressly considering the expectations of the lawyers, whose choice is limited to whether or not to work for the financier.

44. It is possible for divergent expectations between the plaintiff, the lawyer, and the financier to lead to some financing agreements that would not make sense if expectations were uniform. Essentially, this would require one of them to have an unjustified level of confidence in the successful outcome of the claim, such that higher payoffs to the other two could be accepted. Some adherents to behavioral economics might accept this outcome as probable. See, for example, Steinitz, *supra* note 32, at 1913–15 (2013), for an assertion that a lawyer might overestimate her skills in obtaining a positive result, but that the presence of one impartial participant (the financier) and the fiduciary duties owed by another (the lawyer) to the third (the plaintiff) makes that highly unlikely.

$$(3') \quad (\sum_1^n \rho_k \pi_k) * f_2 > c_P^{1+r}$$

$$(4') \quad (\sum_1^n \rho_k \pi_k) - (\sum_1^n \rho_k \pi_k) * f_2 > (\sum_1^n \rho_k \pi_k) * f_1.$$

Assuming transitive properties, the equations can be combined:

$$(5) \quad (\sum_1^n \rho_k \pi_k) - c_T^{1+r} > 0.^{45}$$

In nonmathematical terms, this means that the only way that the plaintiff, the lawyer, and the financier will all agree to proceed with the case is if the case has a positive expected value. Assuming that the interest rate,  $i$ , and the discount rate,  $r$ , are not significantly different, equation (1) cannot be negative and equation (5) positive at the same time.

Next, we move to the case of a financier who finances the full costs of the case. Rewriting equations (3a) and (4a) as inequalities and rearranging yields:

$$(3a') \quad (\sum_1^n \rho_k \pi_k) * f_2 > c_T^{1+r}$$

$$(4a') \quad (\sum_1^n \rho_k \pi_k) > (\sum_1^n \rho_k \pi_k) * f_2.$$

If transitive properties are assumed, these equations can be combined to derive equation (5)<sup>46</sup> which, as shown above, contradicts the initial assumption that equation (1) is negative. Therefore, the potential for financing, at least where the financier covers either all costs or at least all personal costs, will not increase access to justice for an NEV plaintiff.

Finally, we consider the case of a financier who offers a fixed amount of money. Rewriting equations (2), (3b), and (4b) as inequalities and rearranging yields:

$$(2') \quad (\sum_1^n \rho_k \pi_k) * f_1 > c_L^{1+r}$$

45. Proof: combining (2') and (4') yields:  $(\sum_1^n \rho_k \pi_k) - (\sum_1^n \rho_k \pi_k) * f_2 > (\sum_1^n \rho_k \pi_k) * f_1 > c_L^{1+r}$ , which can be simplified and rearranged to:  $(\sum_1^n \rho_k \pi_k) - c_L^{1+r} > (\sum_1^n \rho_k \pi_k) * f_2$ . This can then be combined with (3') to yield:  $(\sum_1^n \rho_k \pi_k) - c_L^{1+r} > (\sum_1^n \rho_k \pi_k) * f_2 > c_P^{1+r}$ , which can be simplified and rearranged to:  $(\sum_1^n \rho_k \pi_k) - (c_L^{1+r} + c_P^{1+r}) > 0$ . By definition, total costs are equal to the sum of legal costs and personal costs,  $c_T = c_L + c_P$ , allowing us to re-write the equation as  $(\sum_1^n \rho_k \pi_k) - c_T^{1+r} > 0$ .

46. Proof: combining (3a') and (4a') yields:  $(\sum_1^n \rho_k \pi_k) > (\sum_1^n \rho_k \pi_k) * f_2 > c_T^{1+r}$ , which can be simplified and rearranged to:  $(\sum_1^n \rho_k \pi_k) - c_T^{1+r} > 0$ .

$$(3b') (\sum_1^n \rho_k \pi_k) * f_2 > F^{1+r}$$

$$(4b') (\sum_1^n \rho_k \pi_k) - (\sum_1^n \rho_k \pi_k) * f_2 - c_p^{1+i} + F^{1+r} > (\sum_1^n \rho_k \pi_k) * f_1.$$

Once again, assuming transitive properties allow the equations to be combined and simplified, yielding:

$$(5') (\sum_1^n \rho_k \pi_k) - (c_p^{1+i} + c_L^{1+r}) > 0.^{47}$$

Equation (5') differs from equation (5) only in that some personal costs are borne by the plaintiff, to the extent not covered by the financier's fixed-sum payment. As a result, the plaintiff may still suffer from an inability to find traditional financing, which would result in  $i$  being greater than  $r$ . It is important to note, however, that this does not mean that a fixed-sum financing situation will satisfy our search for financing that will transform an NEV lawsuit into a PEV lawsuit.

Two possible outcomes seem likely in this circumstance. In the first, the plaintiff faces a prohibitively high interest rate prior to financing but is able to obtain personal financing at market rates for the smaller amount needed after the financier's lump sum; in the second, the plaintiff faces the same prohibitively high interest rate even though the amount that requires personal financing is smaller. At either extreme, the outcome is the same: financing will not make the difference in allowing the plaintiff to bring a case. In mathematical terms, if  $i > r$ , then  $c_p^{1+i} > c_p^{1+r}$  and total costs with the higher interest rates—even if that interest rate only applies to a portion of personal costs—makes it even more likely that equation (5') will be false. In fact, if equation (5) contradicts equation (1), as already proved, then (5') must do so as well.<sup>48</sup>

If correct, this simple model throws cold water on the overheated claims of both proponents and opponents of third-party litigation financing. The model shows that there is little reason to suspect that

47. Proof: combining (2') and (4b') yields:  $(\sum_1^n \rho_k \pi_k) - (\sum_1^n \rho_k \pi_k) * f_2 - c_p^{1+i} + F^{1+r} > (\sum_1^n \rho_k \pi_k) * f_1 > c_L^{1+r}$ , which can be simplified and rearranged to:  $(\sum_1^n \rho_k \pi_k) - c_p^{1+i} - c_L^{1+r} + F^{1+r} > (\sum_1^n \rho_k \pi_k) * f_2$ . This can then be combined with (3b') to yield:  $(\sum_1^n \rho_k \pi_k) - c_p^{1+i} - c_L^{1+r} + F^{1+r} > (\sum_1^n \rho_k \pi_k) * f_2 > F^{1+r}$ , which can be simplified and rearranged to:  $(\sum_1^n \rho_k \pi_k) - (c_p^{1+i} + c_L^{1+r}) > 0$ .

48. Proof: if (5) is false, then  $(\sum_1^n \rho_k \pi_k) - c_r^{1+r} \leq 0$  which rearranges to  $(\sum_1^n \rho_k \pi_k) \leq c_r^{1+r}$  and can be combined with (5') to yield:  $c_p^{1+i} + c_L^{1+r} < (\sum_1^n \rho_k \pi_k) \leq c_r^{1+r}$ . Breaking  $c_r^{1+r}$  into its component parts, this becomes:  $c_p^{1+i} + c_L^{1+r} < (\sum_1^n \rho_k \pi_k) \leq c_p^{1+r} + c_L^{1+r}$ , which, applying rules of transitivity, simplifies to:  $c_p^{1+i} \leq c_p^{1+r}$ . The basic assumption of our model is that  $c_p^{1+i} > c_p^{1+r}$ , and therefore it cannot be true that (5) is false and (5') is true.



liberalizing litigation-financing rules will have a significant impact on the volume of cases brought. Of course, financing decisions might be motivated by something other than immediate financial returns; a financier might be willing to finance a case at a lower financial rate of return because there are benefits—ideological or monetary—that are only contemplated by the financier.<sup>49</sup> If so, some marginal NEV cases might be transformed into PEV cases.

At any rate, the model does indicate that, for some plaintiffs, the existence of financing can be a game changer; the benefits of third-party litigation financing might be small, but it is reasonable to conclude that, so long as there are benefits, we should proceed with liberalizing our litigation financing regime. This conclusion is reasonable, but potentially shortsighted, because benefits are only one side of the equation, and it would not take much for the costs to outweigh such limited benefits. The next Part provides an overview of the theoretical costs and benefits, putting this model into the context of the larger debate.

### III. BOTH SIDES OF THE BALANCE SHEET

It is natural for opponents to emphasize the costs of third-party litigation financing and for proponents to emphasize the benefits. Good policy decisions, on the other hand, come from consideration of both sides of the ledger. That ledger is a full one, complete with economics, justice, rent-seeking, and lots of dollar signs. For once, however, the ledger can be viewed in the light of the previous Part, understanding that the likely impact on total litigation volume is likely low.

#### *A. Benefits of Financing*

The starting point for almost any discussion of litigation financing will be those centering on improved access to justice, that it allows poor plaintiffs to have their day in court.<sup>50</sup> Other benefits fall under the

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49. See *infra* Part III.B.3 (discussing the potential alternative goals of financing litigation).

50. Some plaintiffs—poor and rich—are able to finance part of their claims using contingent-fee arrangements. Commercial litigants are often able to leverage physical assets, if necessary, to cover litigation costs. Going beyond mere third-party financing, it is also possible to conceive of a broad assignment regime, wherein plaintiffs would be allowed to sell a partial interest in the expected damages award to any willing investor, or perhaps even to simply borrow against the expected value of a lawsuit from a commercial bank. For a theoretical discussion of assignment regimes, see generally Michael Abramowicz, *On the Alienability of Legal Claims*, 114 *YALE L.J.* 697 (2005); Peter Charles Coharis, *A Comprehensive Market Strategy for Tort Reform*, 12 *YALE J. ON REG.* 435 (1995); Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 *J. LEGAL STUD.* 329 (1987).

category of economic efficiency. Put together, the arguments in favor of financing's benefits are persuasive.

### 1. Improved Access to Justice

The foundational principles of corrective justice require he who acts wrongfully to correct that wrong by compensating the victim.<sup>51</sup> Our legal system could hardly be said to provide “equal justice under law”<sup>52</sup> if the poor are prevented from pursuing legitimate legal claims due to the high cost of bringing a lawsuit. This is especially the case if the defendants are wealthy and know that they can act with impunity toward the poor because the poor are unable to achieve justice through the court system. And yet, that is precisely what can happen in a world without litigation financing.

Lawsuits can be very expensive, not just in terms of lawyers' fees, court costs, expert witness fees, and the traditional costs of trial, but also the fact that a plaintiff must dedicate significant personal time to trial-related activities, instead of work and recreational activities. There are also personal costs that can impose a significant financial burden on those wishing to pursue legal claims. Indeed, potential plaintiffs in all socioeconomic classes will have to decide between paying the costs of litigation in pursuit of an uncertain result and the very real and pressing needs for food, shelter, clothing, and so forth.<sup>53</sup> Various types of insurance might mitigate these costs, but some portion of litigation costs will always fall on a victim who chooses to seek justice against the one responsible for the injuries suffered. The farther down the socioeconomic ladder someone resides, the less capable of bearing any of these costs she will be. If those costs cannot be borne, then the case does not proceed and the one who inflicted the injuries will escape without having to make it right.

It is impossible to know exactly where the threshold is, below which an individual effectively loses the right to justice because they cannot afford to proceed with trial, but the mere existence of such a threshold is disturbing. Complicating the matter further is the fact that the complexity of the case is also a factor, with more complicated cases typically costing more. To the extent complexity correlates with real harm inflicted on the plaintiff, the lack of litigation financing will

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51. Jules L. Coleman, *The Mixed Conception of Corrective Justice*, 77 IOWA L. REV. 427, 433–35 (1992).

52. Phrase engraved on the front façade of the U.S. Supreme Court building in Washington, D.C.

53. Shukaitis, *supra* note 50, at 334–35.

impose the greatest burden on those least capable of bearing it—poor plaintiffs with serious injuries. But by liberalizing litigation-financing rules, our judicial system might be able to offer hope to those most in need of it.

## 2. Improved Efficiency

Economic arguments do not tug at the heartstrings like those appealing to our sense of justice or fairness, but they are important, nonetheless. Economic principles may not uniformly argue in favor of liberalization of litigation financing, but there are reasons to believe that doing so could improve efficiency. Any wrongdoing imposes uncompensated costs on the wronged party, potentially lowering total social welfare.<sup>54</sup> This inefficient outcome is relatively easy to prevent or at least diminish by making sure that wrongdoers compensate their victims, which requires wrongdoers to internalize the costs of wrongful behavior—if the cost of doing wrong goes up, wrongful behavior is deterred.<sup>55</sup>

A world without litigation financing should have greater levels of wrongful behavior than a world with financing. Interestingly, the increase in wrongful behavior will not be experienced uniformly by all sectors of society. Wrongful behavior increases because there is a lower likelihood that victims will be able to seek compensation; if the cost of litigation is the primary obstacle, it is much more so for poor and middle-class victims. Wealthy individuals are less likely to become victims of wrongful behavior because a potential tortfeasor will take more care to avoid a victim that can afford a lawsuit.<sup>56</sup> The poorer one is, therefore, the more likely it is that he will bear the cost of increased

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54. Theoretically, it is certainly possible for social welfare to be improved by wrongful conduct. That outcome would require that the benefit to the wrongdoer be greater than the harm caused to the victim. While possible, it is unlikely because the wrongdoer has no way of knowing the precise harm caused to another person and—in the absence of effective judicial compensation mechanisms—only limited incentives (personal morals, ethics, or possibly public relations) to even care.

55. See, e.g., Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29, 33 (1972) (examining the social function of liability for negligent acts); Molot, *supra* note 12, at 68–69 (discussing driving forces behind settlement agreements); Ronen Avraham & Abraham L. Wickelgren, *Third-Party Litigation Funding—A Signaling Model*, 63 DEPAUL L. REV. 233, 235 (2014) (providing that consumer legal funding enhances society).

56. For example, construction companies could easily determine that it makes sense to take reasonable care when building luxury office buildings but not when building low-income housing complexes. Kidd, *supra* note 5, at 620. Similarly, it would be reasonable to expect large corporations to breach contracts far more often when the other party to the contract was a small business or a poorer individual.

wrongful conduct. Consequently, those sectors that rely on individuals and businesses with lower incomes—as consumers or as workers—will also be negatively impacted.

Liberalizing litigation-financing rules can reduce these negative externalities and distortionary effects, thereby improving efficiency, but only to the extent that more plaintiffs actually have access to the legal system. As shown by the model, any improvements are likely to be small, limiting the benefits of liberalization. However, there is one economic benefit that would result from liberalized financing rules even if the amount of litigation did not change at all. That benefit is increased competition between suppliers of financing; as third-party financiers begin to potentially compete with contingent-fee lawyers for plaintiffs' patronage, plaintiffs could see the type of improvement that competitive markets typically provide—improved quality and prices.<sup>57</sup>

### 3. Miscellany

There are a number of other benefits that are regularly mentioned by supporters as well as a number of less-well-known potential benefits. Having the additional funding gives plaintiffs more flexibility in seeking a settlement, which should improve the accuracy of settlements.<sup>58</sup> Litigation financiers might be able to monitor bad behavior by lawyers in an aggregate litigation setting, assuring that the plaintiffs' interests are protected.<sup>59</sup> Some have even proposed that litigation financing could introduce more voices into the litigation process, generating more innovation.<sup>60</sup> Many other potential benefits could likely be considered, but all of them tie back eventually to arguments about increasing fairness or efficiency.

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57. Paul H. Rubin, *Third-Party Financing of Litigation*, 38 N. KY. L. REV. 673, 676 (2011). Importantly, however, it is possible that competition could occur in other, less societally beneficial ways. For example, a financier might compete by offering to press for greater damages awards than contingent-fee lawyers, starting a bidding war that could increase damages without justification in law or the facts of the case.

58. Avraham & Wickelgren, *supra* note 56, at 235. By accuracy, I mean more representative of the actual damage inflicted on the plaintiff. See also Cain, *supra* note 3, at 13 n.14 (collecting articles); Andrew F. Daughety & Jennifer F. Reinganum, *The Effect of Third-Party Funding of Plaintiffs on Settlement* (Vanderbilt Univ. Law Sch., Law & Econ., Working Paper No. 13–8, 2013), <http://ssrn.com/abstract=2197526> (discussing settlement bargaining models).

59. Burch, *supra* note 19, at 1276–77.

60. Michele DeStefano, *Nonlawyers Influencing Lawyers: Too Many Cooks in the Kitchen or Stone Soup?*, 80 FORDHAM L. REV. 2791, 2795–96 (2012).

### B. Costs of Financing

One simple truth provided by economic principles is that there are always tradeoffs, always costs, and third-party litigation financing is no exception. The most obvious costs likely formed the foundation of common-law rules against champerty and maintenance; with phrases like “officious intermeddling,”<sup>61</sup> the rules evidence a fear that financing would lead to increased litigation. Other potential costs are a destabilization of our judicial system and an increase in path manipulation.

#### 1. More Frivolous Litigation

Increased money to finance litigation should guarantee some increase in litigation.<sup>62</sup> As the model shows, the amount of increased litigation is likely to be small and litigation is not uniformly bad, but an increase in frivolous litigation would be a cost imposed on society,<sup>63</sup> one that should be balanced against the potential benefits. Procedural rules exist to weed out frivolous claims,<sup>64</sup> and most courts can be counted on to be reasonably vigilant in enforcing those rules, yet some frivolous claims are almost certain to make it past the gatekeepers.<sup>65</sup>

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61. *Officious Intermeddler*, BLACK’S LAW DICTIONARY (10th ed. 2014).

62. *See, e.g.*, Engstrom, *supra* note 8 (asserting that allowing lawyers to pass along to plaintiffs the interest rate on loans made to law firms will make “litigation . . . become more lucrative. If tort litigation becomes more lucrative, we will likely see more of it, for better or worse.”); *see also* Kidd, *supra* note 5, at 613 (noting that litigation financing would reduce barriers to litigation).

63. One study estimates that the direct cost of the U.S. tort system was approximately 2% of Gross Domestic Product in 2007. TOWERS WATSON, U.S. TORT COST TRENDS: 2011 UPDATE 5 (2011). Other studies show the significant indirect costs of litigation. *See, e.g.*, LAWRENCE J. MCQUILLAN ET AL., JACKPOT JUSTICE: THE TRUE COST OF AMERICA’S TORT SYSTEM 26–28 (2007) (lost sales to businesses); A. Mitchell Polinsky & Steven Shavell, *The Uneasy Case for Product Liability*, 123 HARV. L. REV. 1437 (2010) (reductions in consumer purchasing power); Theodore H. Frank, *Riverboat Poker & Paradoxes: The Vioxx Mass Tort Settlement*, LEGAL BACKGROUNDER (Wash. Legal Found., Wash., D.C.), Mar. 21, 2008 (reductions in innovation). For a discussion of how even the costs to the litigants are externalized to society as a whole, see Michael P. Stone & Thomas J. Miceli, *Optimal Attorney Advertising* 12–15 (Univ. of Conn. Dep’t of Econs., Working Paper No. 2010–14, 2010).

64. *See, e.g.*, FED. R. CIV. P. 12 (providing rules regarding pleading); *Ashcroft v. Iqbal*, 556 U.S. 662, 678–79 (2009) (noting certain pleading requirements). For a counter-argument regarding courts’ decisions to label a case “frivolous,” see Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 105 (2011), wherein the author argues that courts often define as frivolous claims those that impose high costs, even though the claims are based on “a plaintiff’s idiosyncratic yet deeply held principles.”

65. A lawyer will have to agree to take the case; even assuming that all lawyers have a desire to follow the rules of professionalism and ethics in their jurisdiction, that is but one of many considerations a lawyer will weigh when deciding to take a case. Those factors include the

Some scholars disagree with this assertion, claiming either that it is nonsensical for a financier to invest in a lawsuit that is likely to be dismissed<sup>66</sup> or that a liberalized market for litigation financing would allow financiers to diversify risk, reducing the need to file frivolous claims.<sup>67</sup> The first counterargument is based on the concept that a rational financier would never invest in a lawsuit that is likely to be dismissed. However, a financier's knowledge that the courts (1) have imperfect screening mechanisms, and (2) are sometimes sympathetic to new legal claims, would lead a rational lawyer to conclude that there was a non-zero probability of success. If the potential damages award is high enough, the expected value of the case will be high enough to warrant filing, even if the probability of winning is low. Indeed, the fact that lawyers currently file meritless lawsuits is evidence that a case need not be considered a "winner" for a lawyer to agree to prosecute.<sup>68</sup>

The second counterargument regarding diversification of risk suffers from two flaws. First, it appears to conflate frivolous claims with strike claims, or low-value claims. As discussed above, however, the question of value and the question of merit are independent. A financier might,

expected monetary award or settlement, existing time constraints from other clients (or lack thereof), complexity of the case, impact on professional reputation, possibility of sanctions, and the moral correctness of the legal theories advanced.

66. Sebok, *supra* note 64, at 106 ("Frivolous litigation is not a necessary byproduct of maintenance . . . ." (emphasis omitted)); Sebok, *supra* note 17, at 455–56 ("The fear that a market in champerty will result in lawsuits that are more likely to be frivolous . . . seems far-fetched."); Molot, *supra* note 12, at 106 ("Although opponents of third-party financing predict that such financing might encourage meritless filings rather than meritorious ones, the claim makes little sense."); STEVEN GARBER, RAND CORP., ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWN, AND UNKNOWN 27 (2010), [http://www.rand.org/content/dam/rand/pubs/occasional\\_papers/2010/RAND\\_OP306.pdf](http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf) ("Many [alternative litigation financing] companies suggest that they are interested in financing only claims with high probabilities of generating a return."); see also Courtney R. Barksdale, Note, *All That Glitters Isn't Gold: Analyzing the Costs and Benefits of Litigation Financing*, 26 REV. LITIG. 707, 726–27 (2007) (discussing interest rates and returns received by litigation by finance companies).

67. Bruce H. Kobayashi & Larry E. Ribstein, *Law's Information Revolution*, 53 ARIZ. L. REV. 1169, 1213–14 (2011).

68. A little simple math confirms this point. Assuming that some meritless cases will always be filed, and that the proportion of meritless to legitimate cases remains relatively constant, lowering barriers to litigation—financial or otherwise—will always result in more meritless cases being filed. If courts' screening mechanisms have a less-than-perfect success rate, it is certain that more meritless lawsuits will be litigated. Let  $\alpha$  represent the share of total lawsuits that are meritless,  $0 < \alpha < 1$ , and  $\beta$  represent the share of meritless lawsuits that are successfully rejected by the courts,  $0 < \beta < 1$ . Let  $X$  represent the number of lawsuits filed in a given time period and  $Y_t$  equal the number of frivolous cases litigated in the courts every year,  $Y_t = \alpha * \beta * X_t$ . If the number of claims increases from the first time period to the second,  $X_2 > X_1$ , then  $Y_2 > Y_1$ . The proof of this is quite simple: If  $Y_1 = Y_2$ , then  $\alpha * \beta * X_1 = \alpha * \beta * X_2$ , which reduces to  $X_1 = X_2$ . If  $Y_1 < Y_2$ , then by the same function  $X_1 < X_2$ .

indeed, file fewer low-value claims and more high-value claims, but that would not be an improvement if the low-value claims were meritorious and the high-value claims were frivolous. Second, the fact that existing financiers no longer need to file strike claims says nothing about whether it is potentially valuable to do so. If a certain class of financiers abandon the field, that merely opens up opportunities for legal entrepreneurs who might be able to find ways to streamline the process and make it profitable as a stand-alone business venture.

## 2. Destabilize the System

If the total amount of litigation increases dramatically under a liberalized financing regime, as supporters and opponents predict, the benefits of financing could be diluted by increased chaos in our judicial system. A frivolous claim imposes costs not only on the defendant but also on society, in that scarce resources must be expended to sort the meritorious from the frivolous. Resources diverted to that sifting process are no longer available for the adjudication of claims that have survived the sifting process. An increase in claims filed—if unsupported by an equivalent increase in judicial funding—will lead to one of two outcomes. Either claims will languish longer without resolution after the sifting process is complete, or else the sifting process will become less accurate.

Both alternatives impose costs on the parties and society. The first delays justice for the parties and postpones resolution of legal claims. The lack of resolution is a source of uncertainty for individuals and businesses. Faced with greater uncertainty, those individuals and businesses will have to waste resources protecting themselves from potential adverse effects. The second alternative is even more risky; if the sifting process becomes less accurate, a higher percentage of frivolous claims will survive and a higher percentage of meritorious claims will be erroneously dismissed. That means that, for some deserving plaintiffs, justice is not merely delayed but actually denied, an unfortunate side effect of liberalized financing, which is portrayed as a way of improving justice. Taking the place of those deserving plaintiffs will be plaintiffs without valid claims, imposing unjustified burdens on defendants and society.

In the end, however, both the “more frivolous litigation” arguments and the “increased chaos” arguments are weakened by the conclusions of the formal model presented here, that the amount of increased litigation is likely to be far less than either proponents or opponents predict. Without additional evidence that a liberalized financing regime

will produce increased claims, particularly frivolous claims, these costs of liberalization are likely to be just as small as the benefits.

### 3. Path Manipulation

Up to now the ledger seems somewhat balanced between uncertain benefits and uncertain costs. One additional cost of liberalized litigation financing has the potential to shift the balance, path manipulation—the conscious and strategic effort to move the law in a direction favorable to the long-term interests of the plaintiff, the lawyer, or the financier.<sup>69</sup> As one scholar has said: “lawsuits can be viewed as similar to research and development.”<sup>70</sup>

The calculus of path manipulation is a simple extension of the decision that any lawyer makes when deciding whether to bring a case. When approached by a potential client, a lawyer must determine the expected value of a lawsuit and the costs associated with prosecuting the case. The possibility of path manipulation gives the lawyer or financier an additional amount of value that must be factored into the decision to accept the case, even if the case is otherwise an NEV claim.<sup>71</sup> Importantly, however, the value of path manipulation is different from normal monetary rewards, in that the value can be achieved even if the case is lost. A case may present a valuable opportunity to nudge an evidentiary rule in a favorable direction, for example, and that goal can be achieved prior to a final resolution to the case. As a result, winning may not be the ultimate goal. These efforts at path manipulation will usually be in pursuit of legal liability without current supporting precedent. In other words, they will typically appear in meritless lawsuits.

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69. Leandra Lederman, *Precedent Lost: Why Encourage Settlement, and Why Permit Non-Party Involvement in Settlements?*, 75 NOTRE DAME L. REV. 221, 235 (1999).

70. Steinitz, *supra* note 32, at 1908.

71. The history of contingent-fee litigation—the first form of litigation financing allowed in the twentieth century—shows that the potential to manipulate the evolutionary path of the law provides incentives to accept cases that would have a negative expected value if considered on their own merits. Paul H. Rubin & Martin J. Bailey, *The Role of Lawyers in Changing the Law*, 23 J. LEGAL STUD. 807, 814–21 (1994); *see also* Martin J. Bailey & Paul H. Rubin, *A Positive Theory of Legal Change*, 14 INT’L REV. L. & ECON. 467, 467–77 (1994). For example, certain firms continued to bring tobacco lawsuits for over a decade, even though their claims had been repeatedly rejected. WALTER K. OLSON, *THE RULE OF LAWYERS: HOW THE NEW LITIGATION ELITE THREATENS AMERICA’S RULE OF LAW* 13–21 (2003). The payout, once achieved, more than compensated those firms involved, even though the multistate settlement precluded additional lawsuits. And, the lesson was well learned by those firms currently bringing claims based on exposure to silica. *In re Silica Prods. Liab. Litig.*, 398 F. Supp. 2d 563, 636 (S.D. Tex. 2005).



The notion of nudging the law a short distance seems easy to understand, but if one wishes to move the law a significant distance, how is it done? The answer is effectively the same as the answer to the old joke of how one eats an elephant—one bite at a time. With careful planning, strategic selection of cases, and a healthy dose of forum shopping, someone wishing to push the law in a particular direction can achieve a series of small victories, each one covering a portion of the desired distance. Every small victory opens up opportunities for immediate gains<sup>72</sup> and shifts the law in the direction of the final goal and larger, long-term gains.<sup>73</sup>

Path manipulation can be costly if the particular legal changes are inefficient or unjust.<sup>74</sup> There is no way to know, *ex ante*, what goals lawyers and financiers will pursue, but it is not hard to imagine changes to the law that would grant personal benefits and profits but distort the law in unhelpful ways. Even if the changes are, ultimately, socially desirable, the process of getting there imposes its own costs. Numerous frivolous cases will have to be filed, each one a small step toward the goal, and each one diverting important judicial resources from meritorious lawsuits and imposing unjust burdens on defendants. Path manipulation can also *decrease* deterrence by increasing uncertainty about what types of action will lead to a lawsuit.

Third-party litigation financing is not the sole cause of path manipulation, in that some path manipulation is likely to occur whether or not a more liberal regime is adopted. Yet, as financiers join lawyers

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72. See Rubin & Bailey, *supra* note 71, at 814–21 (discussing the development of legal change); Bailey & Rubin, *supra* note 71 (noting economic models that explain legal change).

73. Prior to the advent of *stare decisis* and binding precedent in the nineteenth century, altering the evolutionary path of the law would have been very difficult because any future judge could simply ignore an innovative judicial decision. Todd J. Zywicki, *The Rise and Fall of Efficiency in the Common Law: A Supply-Side Analysis*, 97 NW U. L. REV. 1551, 1578–79 (2003); Maxwell L. Stearns, *Standing Back From the Forest: Justiciability and Social Choice*, 83 CALIF. L. REV. 1309, 1351–53 (1995). Under those circumstances, it could take generations to make significant changes in the law; strategic long-term goals become far less attractive when generations are needed. Introduce binding precedent, and the time horizon of legal change shortens significantly, increasing the chances that someone will consider it worth the effort.

74. Path manipulation has been successfully used in the past to advance socially beneficial goals, such as equal rights for women and minorities. Lederman, *supra* note 69, at 239–41 (discussing how the NAACP used path manipulation to defeat segregation and the Women’s Rights Project used path manipulation in seeking heightened protection for women under the Equal Protection Clause of the Fourteenth Amendment). Even on a general level, evolution in the law is not *per se* improper or harmful. Indeed, the law has “evolved for millennia,” thus there is no reason to revere the status quo. D.G. Hartle, *The Theory of ‘Rent Seeking’: Some Reflections*, 16 CAN. J. ECON. 539, 541 (1983). Yet, the incentives presented within the context of path manipulation urge caution.

in making investments in legal claims, more diverse goals are likely to be pursued, many of which will be motivated purely by profit opportunity.

#### 4. Back to the Formal Model

Without the possibility of path manipulation, the model indicated that the increase in litigation arising from liberalized litigation-financing rules would be minimal. Path manipulation, however, changes the cost-benefit analysis of a financier, as it allows a financier to achieve additional benefits and, as a result, the amount of litigation should increase some additional amount. Notice, however, that this increase in litigation is far more likely to fall within the category of frivolous litigation, so that the costs of litigation financing increase more than the benefits and the arguments of opponents are strengthened.

The potential for path manipulation can be represented in the model by adding an additional term to represent the long-term, strategic opportunity that the financier hopes to exploit. The plaintiff will not see this benefit, nor will a lawyer who does not work directly for the financier;<sup>75</sup> thus, this specific benefit will appear in equations (3), (3a), and (3b). For example, (3) would become:

$$(3'') \left( \sum_1^n \rho_k \pi_k \right) * f_2 + E(\Delta_R) - c_P^{1+r},$$

where  $\Delta_R$  represents the advantageous change in the controlling legal rules obtained by proceeding with the case. To be clear, not every case will be viewed as a vehicle for changing existing legal rules, so  $\Delta_R$  will not play a role in every financing decision.<sup>76</sup> Similarly, the desire to change existing legal rules can be present in litigation decisions for both PEV and NEV lawsuits. It is therefore not possible to know with certainty whether financing has been motivated by a desire for path manipulation.

What can we know about the potential for path manipulation? First, we know that it has no impact on whether the lawsuit is, for general

75. Of course, it is possible for contingent-fee lawyers to engage in path manipulation, as well; thus  $E(\Delta_R)$  would be included in any general analysis of path manipulation's effects on litigation. Because this analysis is aimed specifically at what change we might expect from an expansion of litigation financing beyond contingent-fee arrangements, we limit our consideration to the impacts such an expansion might have, primarily through the financier.

76. This term can be included in the model without loss of generality because in those cases where a financier anticipates no long-term, strategic benefit,  $E(\Delta_R)$  can be set equal to zero and the analysis reverts to that expressed in the previous Section.

purposes, a PEV or an NEV lawsuit, as the term will not be present in equation (1). Second, the availability of long-term, strategic benefits will directly impact the financing decision, as described above. Third, path manipulation will have an indirect impact on the plaintiff's decision to proceed. Although perhaps not as obvious as the first two items, the third is deducible as a combination of the first two.

If the lawsuit is an NEV lawsuit, the absence of broad litigation financing means that the plaintiff, the lawyer, and the financier will not all agree to proceed with the case at the same time. The lawyer or the financier or both may be willing to proceed, for example, but only if promised a larger percentage of the case proceeds than the plaintiff can afford to lose before the lawsuit becomes a net loser for the plaintiff. In other words, there is simply not enough surplus available from the lawsuit to meet the needs of all three parties. Inclusion of a long-term, strategic benefit to the financier increases the total surplus available. Although a portion of that surplus is only available to the financier, the financier is then able to reduce the value of  $f_2$  and still achieve a net gain. Doing so can allow the plaintiff to achieve a net gain, as well, as the total monetary deductions from any cash award are reduced.

To see this mathematically, we substitute equation (3'') for (3), express equations (2), (3''), and (4) as inequalities, and solve using transitivity rules to yield:

$$(5'') (\sum_1^n \rho_k \pi_k) + E(\Delta_R) - c_T^{1+r} > 0.77$$

This is the condition necessary for the lawsuit to proceed; it is different from equation (1'), which identifies whether the lawsuit is an NEV or a PEV lawsuit:

$$(1') (\sum_1^n \rho_k \pi_k) - c_T^{1+r} > 0.78$$

It was shown, above, that equations (1) and (5) could not be simultaneously true. However, the addition of the path manipulation benefit now makes it possible for the plaintiff, the lawyer, and the financier to all agree to proceed with a true NEV lawsuit.

77. Proof: equations (2') and (4') can be combined using transitivity as:  $(\sum_1^n \rho_k \pi_k) - (\sum_1^n \rho_k \pi_k) * f_2 > (\sum_1^n \rho_k \pi_k) * f_1 > c_L^{1+r}$ , and thereafter reduced and rewritten as:  $(\sum_1^n \rho_k \pi_k) - c_L^{1+r} > (\sum_1^n \rho_k \pi_k) * f_2$ . This can then be combined with (3'') using transitivity as:  $(\sum_1^n \rho_k \pi_k) - c_L^{1+r} > (\sum_1^n \rho_k \pi_k) * f_2 > c_P^{1+r} - E(\Delta_R)$ , which when reduced and rewritten becomes:  $(\sum_1^n \rho_k \pi_k) + E(\Delta_R) - (c_L^{1+r} + c_P^{1+r}) > 0$ .

78. Equation (1') is, of course, simply equation (1) expressed in the form of an inequality.

At first glance, it is possible to imagine that this is a positive outcome. After all, there are some NEV lawsuits that are based on perfectly legitimate claims; the fact that those claims are not currently brought forms part of the rationale for the increased-access-to-justice arguments in favor of liberalization. If those legitimate claims are brought due to path manipulation, perhaps that is a cost that society should bear in order to allow plaintiffs with legitimate claims to have their day in court. Yet, there are three potential problems with these arguments: first, it is not clear that only legitimate claims will be brought; second, the net social benefit-cost of changes in the legal rules is unknown,<sup>79</sup> *ex ante*; and third, the incentives of the financier may be poorly aligned with those of the plaintiff.

The decision to finance will be based on the expected value, not directly on whether the claim is meritorious or frivolous. It is possible for both types of claims to be part of a strategic plan to change the law, but the word “change” is the operative one here. If the law needs to be changed, the best vehicles for bringing about that change will be those claims that are not covered by existing legal rules; hence, frivolous lawsuits, with all their accompanying costs, will be more likely. Any long-term strategic plan for changing the law will be more valuable if kept secret,<sup>80</sup> so the end game will be unknown and it is possible that a financier will choose a path that yields tremendous personal gain at the expense of society.

Finally, a claim that is motivated by a desire for path manipulation can cause the incentives of the plaintiff, lawyer, and financier to be misaligned. Put simply, plaintiffs want to win and lawyers care about getting paid and about winning—in order to improve their professional reputation and increase their employment in the long run. For the most part, plaintiffs’ and lawyers’ interests align, especially when a contingent-fee arrangement is in place, because the lawyer only gets paid when the plaintiff does. A financier’s incentives, on the other hand, are to achieve a suitable return on investment. Because that usually means winning, the financier’s interests need not be misaligned with the plaintiff’s; however, when path manipulation enters the equation, the financier need not win the case in order to “win,” at least not in the long run. To be sure, a financier’s primary desire will be to win cases in the short run, but if the long run benefits are sufficiently

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79. And likely unknowable.

80. Failure to keep goals secret would give competitors the opportunity to free ride on all litigation investments. See *infra* Part IV.C.4 (discussing litigation poaching).

high, a financier might be willing to sacrifice an outright victory in one case or a series of cases so long as the long-run goals are advanced.<sup>81</sup>

After considering both sides of the ledger, especially in light of the formal model, many of the costs and benefits of a liberal litigation-financing regime seem exaggerated. It is likely that litigation will increase at the margin, but the amount of that increase is likely to be low. At least, that is the case if path manipulation does not become a regular part of financiers' investment strategy. If that does occur, then the costs increase faster than the benefits and a healthy dose of caution would likely be in order. Nonetheless, even that reality need not be considered justification for abandoning the quest for more liberal financing rules because, as discussed in the next Part, the risks of path manipulation are not uniform, and careful application of financing rules could allow increased liberalization in many areas while retaining restrictions in those areas that pose the greatest risk.

#### IV. FINDING SAFETY

In order to understand why and how path manipulation is costly to society—and how those costs can be minimized—it is essential to understand the concept of rent-seeking and specifically judicial rent-seeking. Because the industry is still quite young<sup>82</sup> and restrictions on third-party litigation financing have only recently begun to weaken, there is little hard data on what impact liberalized financing rules might have. Even less clear is precisely what risk path manipulation poses because it is, by its nature, a long-term process. As a result, the best that can be done is predictions based on accepted economic principles.

##### A. *A Brief Rent-Seeking Primer*

Rent-seeking is the process by which individuals seek to obtain personal benefits by manipulating public decision makers, whether regulators, legislators, or, in this case, judges.<sup>83</sup> If a government official

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81. In a worst-case scenario, a financier might even be willing to offer a greater return to the plaintiff—by reducing the amount the financier requires as a payout if the case is won—to make sure the case proceeds, but then sacrifice the plaintiff's ability to win in order to achieve whatever outcome plays a role in the strategic plan.

82. The industry is relatively young in the United States but has a longer history in other countries. For a more detailed explanation of the way litigation financing works in various countries, see Jasminka Kalajdzic et al., *Justice for Profit: A Comparative Analysis of Australian, Canadian, and U.S. Third Party Litigation Funding*, 61 AM. J. COMP. L. 93 (2013).

83. The theory of rent-seeking was pioneered by Gordon Tullock in the context of regulatory agencies. Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967). The phrase "rent-seeking" was later coined by Anne Kreuger. Anne O. Kreuger, *The*

has the ability to bestow private benefits—rents—then individuals will expend resources seeking to obtain favorable decisions and, therefore, the rents. The methods used by a judicial rent-seeker may differ from a more traditional legislative or regulatory rent-seeker, but that is because the decision-making structures are different; the goals are largely the same.

The primary costs of rent-seeking lie in the fact that it is an attempt to benefit by gaining the favorable decision of a government official, rather than by producing something of value.<sup>84</sup> Lobbying for the creation of legislative monopolies, adoption of regulations that benefit the regulated party, and various other efforts to impede competition to the advantage of the rent-seeker are all examples of rent-seeking behavior. Waste arises because individuals and businesses could have spent the resources improving societal welfare instead of asking the government to take from someone else and give to the rent-seeker.<sup>85</sup> Of particular relevance to judicial rent-seeking is that a transfer might do more than just distort economic efficiencies; it can distort justice, as well, by establishing an unjust rule that will persist because of stare decisis.

If rent-seeking benefits an individual or small group at the expense of society, how can it possibly continue? After all, wouldn't individuals in a democracy reject special benefits and privileges for small groups or individuals? Sadly, the answer is often that the costs of rent-seeking are spread across society as a whole and the benefits are concentrated. This scenario of concentrated benefits and dispersed costs means that most members of society do not realize they are paying the costs of rent-seeking and even those who are aware have minimal reason to object.

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*Political Economy of the Rent-Seeking Society*, 64 AM. ECON. REV. 291 (1974).

84. DENNIS C. MUELLER, PUBLIC CHOICE II 229 (1989). The earliest discussions of rent-seeking were in the context of monopolies and trade licenses, where businesses sought to have the government impose barriers to entry, thus ensuring monopoly power, or to obtain one of a limited number of import licenses, which guaranteed the ability to charge a premium for imported goods. Tullock, *supra* note 83, at 228–31. Kreuger argues that rent-seeking diminishes social welfare beyond the reductions occurring anytime free trade is impeded. Kreuger, *supra* note 83, at 300–01.

85. Tullock, *supra* note 83, at 230.

Transfers themselves cost society nothing, but for the people engaging in them they are just like any other activity, and this means that large resources may be invested in attempting to make or prevent transfers. These largely offsetting commitments of resources are totally wasted from the standpoint of society as a whole.

*Id.*; see also Kreuger, *supra* note 83, at 295 (arguing that “competitive rent-seeking . . . entails a welfare cost in addition to the welfare cost that would be incurred” if the same result were obtained using non-rent-seeking methods). Tullock also noted that successful rent-seeking invites copying, so that the costs of rent-seeking will tend to multiply. Tullock, *supra* note 83, at 231.

### B. Judicial Rent-Seeking

What form will judicial rent-seeking take? One possible form is judicial elections, where a judge seen as favorable to certain goals might be the recipient of increased campaign contributions.<sup>86</sup> Similarly, rent-seekers might attempt to influence sitting judges to change their perspective and jurisprudence in a way that benefits the rent-seeker.<sup>87</sup> This type of judicial rent-seeking might be referred to as supply-side rent-seeking; that is, seeking beneficial judgments by manipulating the process that produces judgments.<sup>88</sup> And, judicial elections are only the most transparent version.<sup>89</sup>

Rent-seeking can also occur on the demand side, typically through case selection. Each individual who is involved in a lawsuit will, of course, prefer a particular outcome. To the extent that people use the judicial branch to pursue personal goals, then, a very soft form of rent-seeking occurs in nearly every case and may actually be an integral part

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86. For a discussion of how judicial campaign contributions appear to the public, see *Caperton v. A.T. Massey Coal Co.*, 556 U.S. 868 (2009). Although opponents of judicial elections rarely phrase their objections in terms of rent-seeking, the foundation of their arguments are, in essence, that judicial elections lend themselves to attempts to buy judicial outcomes, which is identical in substance to public choice arguments against rent-seeking. Sandra Day O'Connor, *The Essentials and Expendables of the Missouri Plan*, 74 MO. L. REV. 479, 480 (2009) ("Litigants are attempting to buy judges along with their verdicts"). Anecdotally, the author once participated on a panel discussion regarding judicial elections during the 2013 National Convention of the American Constitution Society. The other members of the panel had never before heard the term "rent-seeking" and were initially uncomfortable with its use. Once the concept was properly explained by the author, the other participants and audience questioners had no trouble interpreting the problems with judicial elections as a rent-seeking problem.

87. The most blatant form of this type of judicial rent-seeking would be to bribe a judge. Of course, that has drawbacks even beyond the ethical implications, because a judge that has accepted bribes could be removed from the bench, destroying all of the rent-seeker's investments.

88. See, e.g., Zywicki, *supra* note 73, at 1557–58 (describing judges as the producers—or suppliers—of judicial decisions, subject to attempts by litigants to "buy" a result through money, appeal to ideology, and so on).

89. Todd Zywicki & Jeremy Kidd, *Meaningful Tort Reform: A Public Choice Analysis* 25-29 (Feb. 11, 2010) (unpublished manuscript), <http://ssrn.com/abstract=2273943>. The nomination process for federal judges has become an increasingly important issue in presidential and senatorial campaigns. It would not be a stretch to assume that some of the contributions to presidential and senatorial candidates are motivated by a desire to shift the balance of the federal courts in a way that is favorable to the donor. In those states where the Governor appoints judges, the same result should be expected. Even merit selection panels, a favorite of former Justice Sandra Day O'Connor, are not immune from supply-side rent-seeking, as time and resources are spent influencing the choices made in forwarding names from the merit selection panel or in the composition of the panel, itself. Edward W. Najam, Jr., *Merit Selection in Indiana: The Foundation for a Fair and Impartial Appellate Judiciary*, 46 IND. L. REV. 15, 29 (2013) ("Since her retirement after twenty-four years on the United States Supreme Court, Justice Sandra Day O'Connor has become the most visible and formidable critic of judicial elections and an advocate for merit selection in the states.").

of our adversarial system. As an inherently evolutionary system, the common law seems designed to adapt according to judicial rent-seeking pressures, both benign and nefarious. The adaptability of the common law is the foundation for the “efficiency of the common law” hypothesis.<sup>90</sup>

According to Professor Rubin’s formulation of the hypothesis, the common law evolved over centuries as individual litigants fought against each other solely to resolve independent disputes.<sup>91</sup> No litigant obtained any long-term gain from a positive judicial decision because they were unlikely to be a repeat player on the same side of similar disputes. As a result, no player had any incentive to act strategically, and any rent-seeking efforts were limited to contemporaneous gains. Similarly, a litigant was equally as likely to be a plaintiff as a defendant, so there was little reason to push the law in a particular direction, as opposed to simply seeking the best possible outcome from the facts of the particular case. If the hypothesis is correct, more litigation would simply aid in the refining of our legal rules, hastening the progression toward efficiency.

But, what if the hypothesis no longer accurately describes our legal system? Some have always rejected the “efficiency of the common law” hypothesis because they prefer other explanations.<sup>92</sup> However, it is possible that the hypothesis was once descriptive but ceased to be so because rent-seeking increased in frequency, changing the dynamic by which judge-made law is created.<sup>93</sup> On the demand side, for example,

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90. Paul H. Rubin, *Why Is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977); George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977). *But see also* Richard A. Epstein, *The Static Conception of the Common Law*, J. LEGAL STUD. 9 (1980) (arguing that legal rules need not evolve in response to every social change). For alternative formulations of the “efficiency of the common law” hypothesis, see RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (1977); John C. Goodman, *An Economic Theory of the Evolution of the Common Law*, 7 J. LEGAL STUD. 393 (1978).

91. Rubin, *supra* note 90, at 211–14. Rubin’s formulation is significantly different from the account earlier theorized by Posner, in which judges intentionally pursued economic efficiency through their decisions. RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 99 (1972).

92. *See, e.g.*, Gillian K. Hadfield, *Bias in the Evolution of Legal Rules*, 80 GEO. L.J. 583 (1992) (arguing that the hypothesis of the common law becoming more efficient over time is for the most part false). Because the Law and Economics movement is a relative newcomer, alternative explanations pre-existed the hypothesis. *See, e.g.*, JEROME FRANK, *LAW AND THE MODERN MIND* (1931) (arguing that legal rules are based on judges’ unconscious biases); EDWARD H. LEVI, *AN INTRODUCTION TO LEGAL REASONING* (1948) (arguing that judges survey all available legal rules—including new rules suggested by the parties—and choose the one that is most analogous).

93. Garoupa and Morriss describe the importance of restricting rent-seeking in achieving efficiency in the law. Nuno Garoupa & Andrew P. Morriss, *The Fable of the Codes: The*



the de minimis rent-seeking that exists in Rubin's model has been replaced by systemic rent-seeking due to changes in the legal culture and the evolution of new rules.<sup>94</sup> No longer are the parties to litigation one-shot players with little incentive to act strategically. The advent of binding precedent transformed legal judgments from generating only contemporaneous benefits to generating long-term benefits that spill over into other disputes.<sup>95</sup> Even if an individual plaintiff or defendant gives no thought to the long-term impacts of a particular decision, lawyers steeped in an understanding of *stare decisis* and its impacts will appreciate the potential costs and benefits and will act accordingly.<sup>96</sup> This is especially true in those areas of the law where a plaintiff or defendant is virtually certain to always be on the same side of a particular type of dispute.

Medical malpractice claims, for example, will never be brought against a nonphysician, so nonphysician plaintiffs will likely not consider the long-term costs to doctors of expanded liability. Similarly, products liability claims will almost never be brought against individuals, so individual plaintiffs will likely not consider the long-term costs imposed on manufacturers by liability rules that limit defenses in those cases. In both cases, the plaintiff will bear some cost, albeit indirectly; the price of medical care and manufactured goods will rise because doing business in medicine and manufacturing will be higher as a result of the increased legal liability.<sup>97</sup> But the personal cost

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*Efficiency of the Common Law, Legal Origins, And Codification Movements*, 2012 U. ILL. L. REV. 1443.

94. Rubin argues that the trend may have begun as early as the Industrial Revolution because larger business entities had more to gain from influencing the long-term evolution of the law than individuals, although he declines to say whether that change was efficiency enhancing. Rubin, *supra* note 90, at 216–17.

95. Zywicki, *supra* note 72, at 1578–81.

96. Friedman argues that redistribution of wealth through judicial decisions is difficult because market forces (largely prices) will adjust to counter any judicially created change in the status quo between groups. DAVID D. FRIEDMAN, *LAW'S ORDER: WHAT ECONOMICS HAS TO DO WITH LAW AND WHY IT MATTERS* 298 (2000). As discussed *infra*, however, one important group of rent-seekers would be unaffected by these market adjustments—the lawyers who profit from the litigation itself.

97. It is estimated that, during 2007 alone, over \$120 billion in unnecessary health care procedures were performed by physicians hoping to avoid the threat of a medical malpractice lawsuit. MCQUILLAN ET AL., *supra* note 63, at 19. The U.S. Department of Health and Human Services reported that 79% of all physicians report ordering more tests than they believed were medically necessary because of litigation fears, 74% referred patients to specialists unnecessarily, 51% recommended unnecessary invasive procedures, and 41% prescribed more medication than was necessary. U.S. DEP'T OF HEALTH & HUMAN SERVS., *CONFRONTING THE NEW HEALTH CARE CRISIS* (2002), <http://aspe.hhs.gov/daltcp/reports/litrefm.pdf>. Products liability lawsuits

borne by the plaintiff will be far less than the amount promised by legal counsel pursuing the case. The plaintiffs will willingly go along with the rent-seeking of their lawyers, but it is the lawyers themselves who will be the driving force, seeking the continued rents that arise from expanded liability that they can utilize in future cases.<sup>98</sup>

As with legislative and regulatory rent-seeking, judicial rent-seeking is the pursuit of a transfer, rather than producing something of value. That transfer of wealth is wasted from a social perspective,<sup>99</sup> to say nothing of the costs imposed by flawed rules adopted in the wake of rent-seeking.<sup>100</sup> Rent-seeking can also harm public confidence in the judiciary, leading to an increase in rent-seeking masquerading as tort reform proposals.<sup>101</sup> Some have even argued that judicial rent-seeking leads to greater frivolous lawsuits.<sup>102</sup>

One way in which judicial rent-seeking is potentially more costly than other forms of rent-seeking is the particular susceptibility of the judiciary to agency capture.<sup>103</sup> Judges often have lifetime tenure, and even those who must face retention elections rarely face a serious challenge to their ongoing employment. In those jurisdictions where the judges must face regular elections, significant campaign contributions might allow a judge to retain employment even when biased towards

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may have made products safer, but they have raised the price of all products as a result. *See generally* Polinsky & Shavell, *supra* note 63 (noting the cost of product liability). Other products were kept from consumers out of fear of liability. Frank, *supra* note 63. Businesses lose out on billions of dollars of sales each year as a result and society suffers a loss of potential jobs those lost sales represent. MCQUILLAN ET AL., *supra* note 63, at 26–28.

98. Zywicki, *supra* note 73, at 1581.

99. *See generally* Tullock, *supra* note 83 (discussing social costs in terms of monopolies and tariffs). Resources expended to achieve compensation for legitimate legal injuries are substantively different from those expended to seek legal change. Correcting legal wrongs has additional justice and efficiency benefits that make the process different than a mere transfer.

100. Successful rent-seeking spawns imitation, which will multiply the costs. *See id.* at 231 (noting the increased protective measures and costs associated with imitation).

101. For a discussion of how legislative and regulatory rent-seeking can lead to distrust of the market system, which leads to more rent-seeking, and so on, see Kreuger, *supra* note 83, at 302.

102. *See* E. Donald Elliott, Twombly in Context: *Why Federal Rule of Civil Procedure 4(b) is Unconstitutional*, 64 FLA. L. REV. 895, 902–05 (2012) (arguing that FED. R. CIV. P. 4(d) allows frivolous lawsuits to succeed). Because judicial rules, as established by courts and some legislatures, require a defense against all claims, frivolous lawsuits have a positive value to potential plaintiffs and their lawyers. That value will rise as judges raise the de facto standards for dismissal or summary judgment; as the costs of defending against a frivolous claim rise, the amount of money that can be demanded in settlement rises, as well.

103. The term “capture” refers to regulatory or agency capture, a theory proposed by public choice economists to describe how special interests gain effective control over government actors. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

certain special interests. Even in this latter case, where the judge cannot be said to be truly captured (because “capturing” interests must continue to engage in supply-side rent-seeking to maintain the judge in office), decisions made by elected judges are often binding on future judges. Even the ghosts of electorally defeated judges can favor prior rent-seekers.

### *C. Rent-Seeking Theory and Litigation Financing*

Liberalization of litigation financing introduces new actors into the judicial process, actors that have the means and incentives to engage in rent-seeking. Unlike lawyers, who have standards of professionalism and ethics to follow—as well as a duty as sworn agents of the court—financiers have fewer external forces mitigating their incentives to engage in rent-seeking.<sup>104</sup>

The process of financing litigation is, itself, a form of demand-side rent-seeking,<sup>105</sup> and as individuals seeking investment returns from the judicial process, financiers could benefit from successful supply-side rent-seeking, as well. Importantly, however, the incentives to engage in rent-seeking are not uniform, and any policy choices in this area should be tailored for the incentives faced by financiers. Specifically, rent-seeking is more likely under the following circumstances: (1) when one or both parties are unlikely to be repeat players; (2) when there is limited or no organized opposition to rent-seeking; (3) when the area of law is prone to highly complex factual or legal questions; and (4) when the likelihood of poaching is limited.

#### 1. Likelihood of Being a Repeat Player

One of the reasons the law evolved towards efficient rules is that neither side of the litigation had an incentive to push for systematically

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104. Financiers will, of course, want to minimize the likelihood of liability for fraud, and they may have some limitations imposed by their agreements with investors. Some scholars have argued that dramatically increasing the amount of financing available for litigation could also diminish lawyers' willingness to abide by professionalism standards. Abramowicz, *supra* note 50, 720.

The ethical rules provide incentives for lawyers to act honestly, but these incentives are balanced by opportunities for financial and reputational gain. Increasing the amount at stake for attorneys in a given suit may well increase their incentives to perform well . . . but it may induce them to go too far. Greater rewards could make the potential risks less weighty in the moral decisionmaking process.

*Id.*

105. Demand-side rent-seeking is accomplished by purchasing favorable decisions from government actors. Supply-side rent-seeking is accomplished by successfully placing favorable actors in decision-making positions in government.

expanded or reduced liability.<sup>106</sup> A plaintiff who pushed for increased liability was just as likely to be the one paying higher damages the next time around. A defendant who pushed for lower liability was just as likely to be the one undercompensated the next time around. At some point in our history, this ceased to be a general assumption applicable to the common law,<sup>107</sup> but the possibility of returning to the court in a similar case at some later date will certainly impact the parties' incentives to act strategically.<sup>108</sup>

Lawyers will often be repeat players on the same side of disputes, regardless of the area of law or type of litigation financing, due to the advantages of specialization. Financiers may have similar incentives to specialize, although the desire to diversify risk could counter those incentives by encouraging a wide range of investments. As a result, lawyers and financiers will often have incentives to push for greater liability and plaintiffs will have limited incentives to push back against those efforts, especially in certain categories of tort lawsuits—medical malpractice and products liability—where it is extremely unlikely that plaintiffs will ever find themselves sued for negligently performing a medical procedure or manufacturing a product.

Other areas of law pose less of this type of rent-seeking risk. Some areas of tort law, such as property torts, will experience more parties appearing as plaintiff and defendant over time,<sup>109</sup> reducing the danger of rent-seeking.<sup>110</sup> Similarly, contract claims will pose a lower level of risk, because almost every individual will enter into numerous contracts throughout their lifetime.<sup>111</sup> This is particularly true in the commercial

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106. See Paul H. Rubin, *Common Law and Statute Law*, 11 J. LEGAL STUD. 205, 211–12 (1982) (noting the differing interests between each side of the litigation, including willingness to litigate until receiving a favorable decision).

107. *Id.*

108. Of course, a positive discount rate will mean that parties to a lawsuit will place higher importance on the immediate payout, but they will still consider the impact of their litigation choices on any potential future payouts.

109. Large percentages of the population will, at various times in their lives, be both possessor of property and invitee (or licensee). The exception would be torts tied to commercial property, including environmental torts.

110. A countering incentive is that most property owners will have some amount of insurance, and the existence of a third-party payer almost defines the category of dispersed costs, potentially leading to a stronger push for liability. For a more comprehensive discussion of the similarities and differences between litigation financing and insurance that requires the insurer to defend against certain claims, see Michelle Boardman, *Insurers Defend and Third Parties Fund: A Comparison of Litigation Participation*, 8 J. LAW ECON. & POL'Y 673 (2012).

111. Most individuals sign contracts primarily as the purchaser, so there could be some incentive to push for expanded liability in favor of consumer plaintiffs.

arena, as with contract disputes between merchants, most of which will regularly sign contracts as both purchaser and seller.<sup>112</sup>

## 2. Organized Opposition

Litigants will also be more likely to engage in rent-seeking, and those efforts are more likely to be successful, if strategic choices are unopposed outside of the individual cases. The adversarial nature of our judicial system generally assures some pushback from the other party to the lawsuit,<sup>113</sup> but long-term, strategic efforts require an entirely different type of opposition. Because the litigation entrepreneur engages in litigation with specific strategic goals in mind, he may be willing to trade an obvious, short-term victory for a pivotal step towards the long-term goal. A short-term opponent will almost always take the short-term victory; only opposition organized with similar long-term goals in mind will be successful in curbing excessive rent-seeking.<sup>114</sup>

Existing opposition to litigation financing, generally, can mute off rent-seeking activities by litigation financiers but can do nothing to directly counter strategic choices by a financier. There are certain areas of law where it would be reasonable to expect organized opposition to increased liability. For example, the medical and business communities have had some success in enacting tort reform measures designed to limit damages, particularly in medical malpractice cases and for non-compensatory damages, where most products liability damages fall.<sup>115</sup> Although these efforts are a form of legislative rent-seeking, rather than judicial rent-seeking, it is an indication that there is organized opposition in these areas, making it less likely that rent-seeking will be successful.

More broadly, organized opposition could arise if a market is concentrated enough that the cost of organizing would be lower, as would the cost of enforcing any agreement to push back against judicial rent-seeking. Producers in a concentrated market are also more likely to

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112. Commercial litigants may occasionally push for large damages awards in a particular case, but they are far less likely than individual plaintiffs to push for entirely new avenues of liability.

113. *But see* John C. Coffee, Jr., *The Corruption of the Class Action: The New Technology of Collusion*, 80 CORNELL L. REV. 851, 851 (1995) (“Today, however, it is increasingly the corporate defendant that wishes to be sued in a class action and—with the help of a friendly plaintiffs’ attorney—that often arranges for such a suit to be brought by a nominal plaintiff.”).

114. To the extent that the opposition engages in counter-rent-seeking, the amount of wasteful spending will be higher. The only advantage will be that society will avoid the distortionary effects of the change in legal rules.

115. Zywicki & Kidd, *supra* note 89 (manuscript at 46–50).

find themselves facing lawsuits at the same time, providing additional incentives to organize. Each of these features would increase the likelihood of organized opposition. Of course, even the existence of organized opposition is not a guarantee against increased liability, as the tobacco industry discovered, but some industries seem inclined to fight.<sup>116</sup>

### 3. Complex Law and Facts

It should be expected that rent-seeking behavior will be more common where there is extreme complexity in the facts or law applicable to the area of law. When judicial rent-seeking occurs, it will be judges and juries that will have to resist the temptation to allow unjustified changes to the law. Setting aside the very real possibility that judges and juries may have their own preferences with regard to the state of the law,<sup>117</sup> it will be more difficult for judges and juries to discern and reject rent-seeking efforts when the complexity of the law or facts cloud the issues. Those areas of law without bright-line legal rules will typically experience higher levels of legal complexity.<sup>118</sup> Factual complexity, of a type that would increase the risks of litigation financing, will be that which goes well beyond the knowledge and experience of the average judge and jury; expert witnesses may simplify the facts of the case somewhat,<sup>119</sup> but many areas of law will remain outside the capacity of even well-educated judges and juries.

Product liability and medical malpractice claims again appear to exhibit higher levels of risk,<sup>120</sup> as the average judge or juror will be

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116. *E.g., In re Silica Prods. Liab. Litig.*, 398 F. Supp. 2d 563, 636 (S.D. Tex. 2005).

117. Zywicki & Kidd, *supra* note 89 (manuscript at 46–50).

118. Although avoidance of rent-seeking behavior is not typically listed as a benefit of clear rules, judges and juries are far more likely to be confused by clever legal arguments in favor of expanded liability when it is unclear exactly what the law requires. And, of course, there are costs associated with adoption of clear legal rules instead of standards; most importantly, standards afford greater flexibility to achieve just results. It is an unfortunate reality that they also afford greater opportunities for rent-seeking.

119. Good expert witnesses will be able to explain complex material in a way that a lay jury can understand, but not all expert witnesses are good. Likewise, regardless of how good an expert witness is, some areas of expertise are simply beyond the average judge's or jury's competence. An expert might have an impressive resume but have used inappropriate methodologies when conducting the analysis; a judge who doesn't have the capacity to appropriately judge reliability under FED. R. EVID. 702; *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579, 589 (1993); or under state evidentiary codes, could set the stage for rent-seeking if the faulty expert testimony further clouds an already murky issue.

120. *See generally* NEIL VIDMAR, *MEDICAL MALPRACTICE AND THE AMERICAN JURY* (1997) (exploring the myths and misconceptions about juries in medical malpractice trials).

incapable of accurately answering complex mechanical or medical questions.<sup>121</sup> And, even if the judge and jury were capable of understanding and properly weighing the reliability of the experts' testimonies, making a reasonable determination of the proper level of damages presents an additional problem. Patent law has presented another prime example of this possibility of having a jury that does not understand the factual complexities in the recent case between Apple and Samsung,<sup>122</sup> where the jury deliberated for only twenty-two hours over the 109 pages of jury instructions, all the evidence, and all the legal arguments, filled in the more than 250 boxes on the verdict form, and awarded \$1.05 billion to Apple.<sup>123</sup> Similar difficulties are likely to arise whenever the claim involves high levels of technological innovation outside the experience of the judge and jury.

#### 4. Litigation Poaching

The final consideration that any financier will have to consider is the ability of other lawyers or financiers to engage in litigation poaching. Litigation poaching is where a rival litigation entrepreneur observes an ongoing effort at judicial rent-seeking but does not compete immediately. Instead, the rival waits until the path manipulation is almost complete, thereby allowing the first litigation entrepreneur to incur almost all of the rent-seeking costs.<sup>124</sup> Only then will the rival enter the picture, hoping to achieve the final step of path manipulation and gain most of the benefits of the rent-seeking.<sup>125</sup> Alternatively, if

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121. Few judges or jurors, for example, would be likely to understand the mechanics of a quadruple bypass surgery or neurosurgery, or the effect of a particular seat design on the safety of an automobile passenger in a 50 Delta-V accident. Even if society were fortunate enough to have sufficient individuals in the venire who would be capable of correctly interpreting the facts as presented by expert witnesses, the probability that enough of them would make it through voir dire without being removed for cause or by a peremptory challenge—possibly because one side knows that its theory of the case cannot withstand an educated jury—such that they could influence the judgment must be quite low.

122. See generally *Apple, Inc. v. Samsung Elecs. Am., Inc.*, 888 F. Supp. 2d 976 (N.D. Cal. 2012) (involving complex patent infringement issues).

123. Cobus Jooste, *Inside Views: Patently Wrong—The Jury's Verdict In Apple v. Samsung*, INTELL. PROP. WATCH (Sept. 19, 2012), <http://www.ip-watch.org/2012/09/19/patently-wrong-the-jurys-verdict-in-apple-v-samsung/>. The jury also attempted to award Apple \$2 million in damages for inducement even though they had indicated that Samsung was not liable for inducement. *Id.*

124. Nudging the law in a desired direction over time can be expensive, especially if it requires the use of meritless lawsuits that provide zero short-term benefit.

125. Being seen as the first to achieve a shift in the law is important because reputational factors are what allow a law firm to capture a significant portion of the future stream of damages awards. Potential plaintiffs will have extra incentive to choose the firm that was at the forefront

there is a strong probability that those expenses will be wasted, the financier will shift resources to another venture.

A savvy reader, at this point, will be asking why the possibility of poaching does not completely eliminate the incentives to engage in demand-side rent-seeking. It is certainly true that the possibility of poaching will reduce the incentives to engage in path manipulation, but a reduction does not automatically mean the incentives disappear.<sup>126</sup> In essence, the potential for poaching reduces the value of any rent-seeking action; as a result, a financier will be less likely to take any given case. At some point, the potential for poaching will reduce the value of rent-seeking to zero, but many cases will still exhibit a positive value for  $E(\Delta_R)$ .

A financier can also take certain steps to limit the possibility of poaching. For example, steps can be taken to hide the nature of the long-term, strategic goals; doing so would likely require a longer time horizon for achieving those goals, but it would also cut down on poaching. If done correctly, the process of path manipulation could generate firm-specific efficiencies that reduce the per-claim cost and make it difficult for poachers to compete in pursuing the same line of claims.<sup>127</sup> These efficiencies would not be easily duplicated if the process is viewed only externally.<sup>128</sup> The cost savings to the firm

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in making sure the new claims were declared legitimate. To be certain, a firm that pushes the evolution in the long-term will establish some reputational factors, but without the crowning achievement of finally breaking through, a firm will see its share of future revenues significantly reduced. This is especially the case to the extent that the intermediate steps are not readily identifiable as playing a role in shifting the law, such as evidentiary or procedural changes.

126. A similar mistake is often made with regard to the Coase Theorem; many incorrectly assume that the mere existence of transaction costs render Coase's theories regarding externalities useless when, in fact, increased transaction costs merely reduce the likelihood of favorable transactions at the margin. See Jeremy Kidd, *Kindergarten Coase*, 17 GREEN BAG 2D 141, 151–53 (2014) (noting the benefits of bargaining, including innovation (citing Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960))).

127. An example might be a firm that brings a series of class actions, establishing itself as a reputable class counsel with the courts, increasing its chances of being selected in the event another firm attempts to join the party at a later date. With class actions, a firm can literally tie up most, if not all, potential plaintiffs. Outside of the class action setting, a firm might be able to monopolize all of the effective expert witnesses within a narrow field; without expert witnesses, a potential poacher might be deterred.

128. Only those within the firm know the ultimate goal; externally, potential poachers merely see each evolutionary step as it is achieved. As a result, only those within the firm know which potential clients must be cultivated in order to move towards the ultimate goal. Similarly, only those within the firm see the efficiencies in processing claims, preparing expert witnesses, facilitating the necessary medical exams, and so forth. For an example of a law firm using unethical means to achieve these economies of scale, see *In re Silica Products Liability Litigation*, 398 F. Supp. 2d 563, 603 (S.D. Tex. 2005), where the court criticized plaintiffs'



would grow over time,<sup>129</sup> but so would the rent-seeking costs that could be lost to a poacher, making the investment decision a complex and dynamic one.<sup>130</sup>

A financier might opt, instead, to develop reputational factors through marketing and public relations efforts. If a financier is able to generate positive buzz regarding her long-term goals, a form of brand recognition and loyalty might arise, which could, in turn, lessen the success of any competitor who attempts to poach. Secrecy and a public relations campaign can work against each other, but they can also be complementary, in that an initial strategy of secrecy can generate efficiencies; once those efficiencies are in place, expanded publicity efforts can generate reputational benefits.

Finally, it is worth considering that a financier could limit the potential for poaching by simply choosing a long-term strategic goal that is very novel; the less obvious the goal, the easier it will be for the financier to keep the goal a secret. Increasing the novelty of the goal will also increase the time horizon for achieving the goal, which could increase costs, as well.

##### 5. Consumer vs. Hedge Fund Litigation Financing

In addition to distinguishing those areas of law where the risk of path manipulation is lower, a distinction must be made between consumer financing and the hedge fund model. That distinction is important because it is easy to conflate the two but consumer financing presents a lower level of risk for three reasons. First, the compensation received by the consumer litigation financier may be partially based on the final amount received by the plaintiff, but only as part of a larger formula; separation of the financier's payout from the total damages award minimizes the financier's incentive to rent-seek. Second, because the consumer litigation financier funds only personal costs, the financier is separated from all legal decisions, limiting the ability to effectively rent-

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attorneys for using the same doctors, the same patients, and similar physical impairments to show injury from silica exposure as were used to show injury from asbestos exposure.

129. Subject, most likely, to diminishing marginal returns.

130. Whether the goal is worth pursuing will therefore be partially determined by the time horizon of the goal and whether costs or cost-savings are accelerating or decelerating through time, or whether the rate of change is constant. Other significant factors would likely include the transparency of the process and the enforceability of non-disclosure agreements, which all rent-seeking firms would, of necessity, require for all employees, expert witnesses, and the like. If the costs of pursuing the goal are constant over time, so that the rate of change is constant, accelerating savings would lead to low marginal costs and very low chances of poaching. If, on the other hand, the savings are decelerating, there will come a time when the costs of pursuing the goal will outweigh the economies of scale, making poaching a certainty.

seek. Third, consumer litigation financing is typically sought out only after a lawyer has agreed to take the case, decreasing (though not eliminating) the likelihood that the claim is motivated by rent-seeking.

## V. WHAT TO MAKE OF REFORM PROPOSALS?

What to do with litigation financing? One option is to continue the common-law prohibitions, but this option currently has few supporters. Some propose to regulate, rather than prohibit, in order to protect plaintiffs and the system as a whole.<sup>131</sup> The foregoing discussion regarding rent-seeking shows that there are reasons to be concerned, that it is not unreasonable to believe that something needs to be done in order to avoid the adverse consequences that could arise from a liberalized financing regime. The discussion—particularly the conclusions of the formal model and the differentiated analysis of the incentives leading to path manipulation—also gives us tools for determining what the likely impact will be of various reform proposals.

### A. Chamber Report

There is no more vocal opponent of litigation financing than the United States Chamber of Commerce, through its Institute for Legal Reform. In 2012, the Chamber released its report detailing, as it saw it, the dangers of litigation financing and proposing a number of regulations designed to mitigate the harms of financing.<sup>132</sup> The report distinguished between consumer litigation financing and the hedge fund model and confined its analysis to the latter.<sup>133</sup> Importantly, the Chamber's primary concerns were that financing would disrupt the relationship between lawyer and client, and that it would lead to greater litigation;<sup>134</sup> nowhere did the Chamber express a concern over path manipulation. Nevertheless, a thorough analysis of the report's proposals should address the likely results of those proposals on both quantity-of-litigation grounds and the impact on rent-seeking behavior by financiers.

The report first proposes regulating those who invest in a litigation financing firm,<sup>135</sup> followed by a list of regulations that the Chamber

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131. Martin, *supra* note 2, at 55. A cynic might suppose that calls for “regulation” are nothing more than thinly veiled calls for prohibition.

132. BEISNER & RUBIN, *supra* note 2, at 7.

133. *Id.* at 3.

134. *Id.* at 4–6.

135. *Id.* at 7.

believes should be imposed on the firms, themselves: (1) licensure requirements for all financing firms, including a \$1 million licensing fee; (2) requirement that ownership of law firms and financing firms be kept strictly separate, both in practice and in public perception; (3) prohibition on contracts between lawyers and financiers; (4) requirement that control over the case remain exclusively with the client; (5) requirement that the financier post a bond equal to twenty-five percent of the damages claim; (6) joint and several liability between plaintiff and financier for any costs awarded against the plaintiff; (7) adoption of a loser-pay rule for financiers; (8) requirement that financiers bear defendants' discovery costs; (9) prohibition of litigation financing in class actions; and (10) mandatory disclosure of any financing agreement.<sup>136</sup> Considering their likely impact on volume of litigation, rent-seeking behavior, and other miscellaneous concerns, these proposals can be more generally grouped into those designed to increase costs and uncertainty to the financier, those designed to specifically address professionalism concerns, the proposal to ban financing in class actions, and the proposal to mandate disclosure.

### 1. Cost Shifters

The licensure requirement and \$1 million fee, along with discovery cost shifting, increases the cost to the financier; others increase costs in the event that the lawsuit fails. Recall from the formal model that, given the possibility of path manipulation, the financier agrees to the transaction only if her share of the expected award, plus any long-term, strategic benefit, outweighs the outlays of funds to the plaintiff.<sup>137</sup> Any new cost will require the financier to raise prices—the portion of the expected award—in order to break even. Whether the costs are guaranteed or whether they are based on the probability of losing the case, the cost to the financier will increase on the margin and reduce the likelihood of a voluntary financing arrangement arising.

Because it is not tied to the likely merits of the case, the licensure requirement<sup>138</sup> raises the cost to the financier in every case financed.<sup>139</sup>

136. *Id.* at 10–14. The manner of implementation would differ between proposals, with proposal (1) being implemented through a new regulatory body (complete with promulgation of as-yet-unknown rules), (2)–(9) through statute, and (10) through civil procedure rules.

137. In the mathematical terms of the model:  $(\sum_1^n \rho_k \pi_k) * f_2 + E(\Delta_R) - c_p^{1+r} > 0$ .

138. The obvious increase is the \$1 million licensure fee, but the process of complying with licensure requirements will add some additional amount of cost, which must also be considered. A regulatory regime can be implemented with minimal additional costs, but it is also possible to implement a regulatory regime with high compliance costs.

139. A new term,  $c_f^{1+r}$ , representing the pro rata portion of the licensure fee that is imposed

The discovery cost shifting rules are similar yet different in important ways: the discovery costs of the defendant are, to some extent, dependent on the choices of the plaintiff;<sup>140</sup> and discovery costs will be case-specific.<sup>141</sup> In either situation, some litigation will be deterred because plaintiffs will be unable to find financing. This deterrence will preclude some legitimate claims that will not be brought only because the plaintiff cannot afford the personal costs,<sup>142</sup> but also some claims that are only brought because the financier sees a long-term, strategic value to the case. Interestingly, while each imposition of costs on the financier will force some plaintiffs to settle based on unequal capacity to bear the costs of bargaining,<sup>143</sup> shifting defendants' discovery costs to the financier actually lessens the likelihood of a settlement.<sup>144</sup> It does this by reducing the pretrial legal costs to the defendant.

The bond requirement, loser-pays rule, and joint and several liability all increase the expected cost of litigation, but only if the case is lost. They do so in a way that is technically different from the licensure and discovery cost shifting approaches, however. In the event that the case is lost without these provisions in place, the plaintiff receives nothing, the lawyer is unable to recover anything to cover the legal expenditures, and the financier is unable to recover anything to cover the personal expenditures. As a result, a loss has zero value.<sup>145</sup> Now, impose the Chamber proposals—individually or collectively—and there is a

on the financier as a result of the case, can be added to the equation:  $(\sum_1^n \rho_k \pi_k) * f_2 + E(\Delta_R) - c_p^{1+r} - c_f^{1+r} > 0$ . It is clear that the financier will have to increase the value of  $f_2$  in order to make a profit.

140. The financier is not typically in control of the case, thus her ability to affect any change in trial strategy to minimize discovery costs is limited. It is therefore not entirely clear how effective the Chamber's proposal would be in achieving its implied goal of making financiers internalize the costs of their investment choices.

141. The financier's equation—excluding licensure costs for the sake of simplicity—becomes:  $(\sum_1^n \rho_k \pi_k) * f_2 + E(\Delta_R) - c_p^{1+r} - E(c_D^{1+r}) > 0$ , where  $E(c_D^{1+r})$  is the expected discovery costs, given what the financier knows about the case.

142. See *supra* Part II.C (discussing whether financing helps plaintiffs with negative expected value).

143. As opposed to settlements that are quickly resolved because the parties agree regarding the merits of the claims.

144. The Chamber claims to be concerned that third-party litigation financing will decrease settlements. BEISNER & RUBIN, *supra* note 2, at 5–6. It is therefore particularly interesting for the Chamber to propose regulations that will clearly inhibit settlements.

145. If that outcome is realized, the actual value of the claim to the lawyer and the financier will be negative, of course, because they must account for the expenditures. Nevertheless, at the time a financing decision must be made, the value of that probability is zero, with costs being considered separately.

significant cost associated with a loss, thereby making the value of a loss negative.<sup>146</sup>

Each of these three provisions shares the characteristic that it is imposed only if the case is lost, but they are not identical in their effect, as they vary slightly in the magnitude and certainty of the cost they impose. If the case is lost, the bond is lost, so the requirement imposes a certain cost with a certain magnitude. The loser-pays rule imposes a certain cost but the magnitude is uncertain, *ex ante*, because neither party knows how much the case will cost before it has ended. And, finally, joint and several liability imposes an uncertain cost with uncertain magnitude; the door is open to costs upon a loss, but the court must decide that an award of costs is warranted. Both the decision of the court regarding costs and the amount of those potential costs are unknowable by either of the parties, *ex ante*.

These three latter provisions have one more thing in common. Similar to the licensure requirements and discovery cost shifting, they reduce the expected gain to the financier, requiring the financier to charge a higher price in order to achieve the same expected profit from the investment,<sup>147</sup> but they also deter lawsuits that are more likely to lose. The first characteristic reduces the total amount of litigation financed but, as shown by the formal model, financing has likely yielded only a small increase in total litigation. Without more evidence, therefore, it is impossible to know whether the Chamber's proposals will reduce the total amount of litigation, generally, and whether they will curb more meritorious claims than they do frivolous ones. The second characteristic arises because the latter three proposals are tied to the likelihood that the claims will be losers, so they will deter some rent-seeking attempts, which rely on being able to cost-effectively bring claims that are presently without merit.

There is some potential for both good and bad within the Chamber's cost shifting proposals. They will reduce financing, to be certain, and that can reduce litigation, although the effect will likely be very small. Reducing litigation also has potential costs, because some claims are

146. From the model, this impacts only the expectations equation from (3''),  $(\sum_1^n \rho_k \pi_k) * f_2 + E(\Delta_R) - c_p^{1+r}$ . If we define  $k = 1$  as the scenario of the case being lost,  $\pi_1 < 0$ . Note that the expectations equations for both the plaintiff and the lawyer have not changed, as these proposals only impose costs on the financier.

147. If  $(\sum_1^n \rho_k \pi_k) * f_2 + E(\Delta_R) - c_p^{1+r} = x$ , where  $x$  is the profit needed for the financier to invest in the claims, a reduction in  $(\sum_1^n \rho_k \pi_k)$ , which is accomplished with any or all of the three provisions, must be countered by an increase elsewhere in the equation if the result is still to be  $x$ . Increasing  $f_2$  is the most straightforward way of doing so, although a decrease in outlays to the plaintiff could also yield the same result.

meritorious and necessary to a just and efficient society. The proposals for licensure and discovery cost shifting might be able to deter rent-seeking, but they would do so only accidentally. The proposals that tie costs to financiers with losing a case, on the other hand, directly target rent-seeking. They could potentially go too far, but they at least present an opportunity for eliminating the more serious threats to justice and efficiency that arise from path manipulation. The licensure and cost shifting proposals have no such benefit.

## 2. Professionalism Fixes

Next in line are those provisions that address the potential ethical issues that can arise from litigation financing, most of which would merely codify the status quo. For example, professionalism rules already dictate that the client is to be in control of the case,<sup>148</sup> which would seem to obviate the Chamber's proposal to expressly restate that requirement and at least partially obviate the need to expressly preclude contracts between lawyers and financiers. Likewise, some states continue to maintain prohibitions on ownership of law firms by non-lawyers, which limits the need for more restrictions on joint ownership between financiers and lawyers. Nonetheless, the Chamber could be concerned about the trend of liberalization and the proposals are an attempt to slow that trend in ways that implicate ethical concerns.

As it pertains to the conclusions of the formal model and the potential for rent-seeking behavior, the provisions are mostly—but not entirely—tangential. The proposals do not change the financial decisions that must be made by the plaintiff, the lawyer, and the financier, and therefore they are unlikely to have any impact on the amount of litigation. Importantly, however, they might have some impact on rent-seeking behavior.

As discussed *supra*, plaintiffs are not as likely as lawyers and financiers to be repeat players. Lawyers and financiers are also more likely to specialize, leading to an increased incentive to act strategically in favor of long-term goals. Allowing greater control over the case by lawyers and financiers would increase the likelihood of path manipulation. That control could be direct or indirect, the latter resulting from greater intertwining of lawyering and financing, particularly if joint-ownership led to a lawyer-financier hybrid who felt only partial loyalty to the rules of professionalism for one-half of his

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148. MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (AM. BAR ASS'N 1983).

career. When considered in conjunction with the ethical concerns that others raise, these Chamber proposals may be wise.

### 3. Class Action Ban

The Chamber's proposal to ban financing in class actions does not directly affect the financing decisions of the plaintiff, the lawyer, and the financier as to whether a financing arrangement is completed. Instead, the financier is simply prohibited from entering such an agreement if the action is a class action, leaving the plaintiff without one option to obtain financing. According to the formal model, this will lead to some plaintiffs with valid claims being unable to have their day in court, but the total impact is likely to be small due to the nature of many class actions. Specifically, class action plaintiffs often are not aware of their membership in a class until after a settlement has been reached. They may have an inkling that something untoward has happened, but the individual impact on them is likely quite small.<sup>149</sup> As a result, the existence of class actions as an option seemingly protects their right to justice far better than litigation financing would.

There is also a serious concern regarding control over the case and the impact it would have on rent-seeking behavior. Named plaintiffs are often chosen by the lawyers who are representing the class and it is the lawyers that largely control the case. Combining that fact with the specialization that occurs with class action lawyers, there is a strong incentive to engage in rent-seeking already in the class action setting. Adding financiers and their strategic goals to the mix could generate additional attempts at path manipulation, lending some support to this proposal.

### 4. Disclosure Requirements

Finally, the Chamber report proposes to mandate full disclosure of all litigation-financing agreements in court. While most of the Chamber's arguments in favor seem overblown,<sup>150</sup> it is still a proposal worth considering. Disclosure should not meaningfully change the financial decisions faced by the plaintiff, the lawyer, or the financier, and

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149. If the impact on the plaintiff were higher, there would be a better chance of succeeding on an individual claim. The primary justification for class actions, generally, is that they are claims that could not feasibly be brought individually because the individual damages award would never be high enough to justify the legal fees.

150. BEISNER & RUBIN, *supra* note 2, at 14. The Chamber complains that defendants cannot know who is really in charge of the case. Those complaints are both irrelevant to the merits of the case and largely incorrect, at least outside of the class action context.

therefore its impact on the decision to enter into a financing agreement would most likely be based on a successful demonization of the financing industry by the Chamber. In that case, financiers might be more wary of financing claims because their long-term strategic interests would be harmed by the reputational effects of a negative public relations campaign. Yet, disclosure would have one very important positive impact in reducing rent-seeking behavior—it would marginally increase the likelihood of poaching, which would decrease the benefits from path manipulation.<sup>151</sup>

### B. Chamber-Sponsored Litigation

As a secondary line of attack, the Chamber has also been advocating for state-based regulations to the consumer litigation financing industry. Previously, these companies operated under general consumer-protection regulations, but without regulations designed for the industry. In the past three years, however, the Chamber has encouraged state legislatures to pass laws applying state usury laws to consumer litigation-financing firms.<sup>152</sup> Each state law is slightly different, but they have some similarities; first, they impose a cap on the interest rate that consumer litigation-finance companies may charge; second, they mandate disclosure of various elements of the finance agreement, but specifically the annual percentage rate.

Disclosure requirements, as noted, are often helpful because they improve information in the market, allowing consumers to make better decisions.<sup>153</sup> However, in this case, the information that is demanded may simply not be available due to the highly uncertain nature regarding repayment.<sup>154</sup> More to the point, a cap on interest rates, to the extent there is a meaningful definition of the term in this context, means that individuals who need help paying personal costs will find it harder to afford a lawsuit. If their claims are frivolous, society is better off; if their claims are meritorious, society is worse off. There is no way to know whether there will be more frivolous or meritorious claims

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151. Disclosure has the additional benefit of improving the information in the marketplace. Improved information usually—though not always—improves the efficiency of the market.

152. See, e.g., H.B. 3454, 84th Leg., Reg. Sess. (Tex. 2015) (proposed); S.B. 882, 90th Gen. Assemb., Reg. Sess. (Ark. 2015) (passed).

153. One word of caution is appropriate here—information is costly, and saying that information provides benefits is not the same as concluding that the *net* benefit of information requirements is positive; regulations may require information that imposes higher collection costs than the benefits provided.

154. BEISNER & RUBIN, *supra* note 2, at 4–6; Martin, *supra* note 2, at 67–68.



deterred, but given (1) the largely benign nature of consumer litigation financing, in terms of rent-seeking, and (2) the minimal impact that litigation financing has, in general, on total volume of litigation, it seems a provision designed more to inconvenience an industry that creates costs—legitimate or not—for the Chamber’s members. In other words, it appears to be an independent example of rent-seeking by the Chamber.

### C. Academic Proposals

Perhaps unsurprisingly, legal academics have their own opinions to offer on this issue. Many of the proposals mirror the better portions of the Chamber’s recommendations, although they are likely to rest on different foundations. For example, academics have also proposed requiring disclosure of the existence of financing agreements.<sup>155</sup> Instead of justifying disclosure on the hope that it will police violations of legal ethics rules, as the Chamber does,<sup>156</sup> one academic proposal is based on the argument that the terms of the agreement would signal to court and opposing parties the real nature of the claims and that disclosure would improve competition in the market.<sup>157</sup> Another justifies the regulation on consumer protection grounds.<sup>158</sup>

The most detailed reform proposal is the Litigation Lending for Personal Needs Act (“LLPNA”), proposed largely as a consumer protection measure.<sup>159</sup> If adopted, it would require licensing and bonding of financiers, provide a cooling-off period for borrowers, allow repayment of the loan at any time, and mandate a host of disclosures.<sup>160</sup> The LLPNA would also prohibit fraud and coercion by financiers,

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155. Avraham & Wickelgren, *supra* note 55, at 235. Although Avraham and Wickelgren’s proposal would make financing agreements admissible, rather than mandating their disclosure, the effect would likely be the same, as evidence of their existence would become a standard discovery request.

156. BEISNER & RUBIN, *supra* note 2, at 14 (“[Third-party litigation financing] undermines the bedrock principle that a party to a lawsuit has the ultimate decision-making authority with respect to that suit. . . . Strong disclosure requirements will correct this problem.”).

157. Avraham & Wickelgren, *supra* note 55, at 235 (“Not only will admitting these [financing] contracts in court improve the accuracy of adjudication, it will also cause funders to charge lower interest rates in an effort to demonstrate to courts the strength of the plaintiff’s claim.”).

158. See Martin, *supra* note 2, at 69 (suggesting that litigation financing be brought under the purview of the Truth in Lending Act, 15 §§ 1601–1667f (2012)).

159. Yifat Shaltiel & John Cofresi, *Litigation Lending for Personal Needs Act: A Regulatory Framework to Legitimize Third Party Litigation Finance*, 58 CONSUMER FIN. L.Q. REP. 347, 351 (2004).

160. *Id.* at 351–53.

referrals by lawyers to specific financiers, and certain waiver and hold-harmless provisions in the financing agreement.<sup>161</sup> Fees and interest are capped, and financiers are paid last and possibly never if the money runs out before attorneys and outstanding personal costs are covered.<sup>162</sup> One commentator laments that the LLPNA has not passed,<sup>163</sup> but what would have been the impact if it had?

Licensure would merely increase the cost to the financier, reducing the amount of litigation financed with only minimal impact on total litigation and path manipulation.<sup>164</sup> The cooling-off period, disclosures—largely those disclosures one might see when applying for a loan or a credit card—and prohibited clauses might deter some hasty decisions by plaintiffs, but they would leave unchanged the analysis of the formal model, meaning that they would likely have negligible impact on total litigation. Allowing repayment of the loan prior to judgment allows the financier to receive a payoff early, although it might reduce the total amount received. This provision would have negligible impact on rent-seeking but it would make the financier's decision more complicated, requiring the payoff equation to include the possibility of early repayment. That added complexity increases uncertainty, which is the same as increasing costs, so total financing of litigation would decrease without having a large impact on total litigation, overall.

It is unclear why the authors of the LLPNA believed that prohibitions on fraud and coercion would be necessary, as financing arrangements are contracts, subject to all contractual defenses, including fraud and coercion.<sup>165</sup> The prohibition of referrals by lawyers to specific financiers, however, seems like a useful proposition, as it would limit the possibility of collusion by lawyers and financiers. Collusion could lead to the type of innovation—path manipulation—that should be avoided, so this provision is a useful extension to the Chamber's proposal to prohibit contracts or co-ownership between lawyers and financiers.

The final proposal in the LLPNA is to establish a priority that would guarantee that the plaintiff was not left with any outstanding debts after

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161. *Id.* at 354.

162. *Id.* at 354–55.

163. Hashaway, *supra* note 16, at 774.

164. *See supra* Part V.A.1 (discussing discovery cost shifting rules).

165. If the authors were so worried about extra protection for the plaintiff, it is not clear why they did not also make mention of contract defenses like infancy, incompetence, intoxication, and so forth.

trial, should attorney fees and unpaid personal expenses deplete any damages award or settlement. This proposal is more complicated than it might appear, initially. The payoff equation for the lawyer remains the same and the payoff equations for the plaintiff and financier readjust in favor of the plaintiff. However, the readjustment is not a simple one, as it changes the portion received by the financier from a fixed percentage of the total damages award into a fluctuating amount. The maximum value remains the same, but it represents a range of values, with the exact formula being based on time duration and complexity of the claims,<sup>166</sup> the percentage demanded by the contingent-fee lawyer, and the level of personal costs.

The potentially lower payment to the financier would increase the willingness of plaintiffs to enter into financing agreements but the additional uncertainty would deter many financiers from agreeing to finance claims, especially those that will be longer and more complex. With increasing demand and decreasing supply, it is impossible to know whether total litigation will be increased or decreased; the only known fact is that prices will increase dramatically, leaving those plaintiffs who receive financing paying a higher percentage of their damages awards than would otherwise be the case.<sup>167</sup> It is true that complex cases—one hallmark of path manipulation—are more likely to go without financing as a result, but nothing in this proposal has any impact on the strategic value of the claim, which may have nothing to do with the likelihood of success. As a result, it is unlikely that this will deter path manipulation.

## VI. A MEANINGFUL PATH FORWARD

If liberalization of litigation funding is neither the road to salvation nor the gateway to hell, what is it? The answer, it seems, is that it is one of many tools that are available to make adjustments to our system of justice. Like all tools, it has appropriate uses and inappropriate ones; it can be useful and destructive, depending on the methods of its use. If used to facilitate just compensation for those with valid legal claims, it improves our society; if used to facilitate frivolous litigation or the long-term, rent-seeking goals of financiers, it can impose significant costs.

This research has shown that liberalization of third-party litigation financing presents less risk and less promise in terms of increasing the

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166. These factors being the primary determinants of total cost of the case.

167. Rising demand increases price and increases quantity, while falling supply increases price and decreases quantity. Both factors reinforce an increase in price but, without additional information, it is impossible to know which quantity effect will dominate.

total amount of litigation. It has also shown that the forms of litigation most likely to increase fall into one of two categories: litigation that advances the long-term, rent-seeking goals of financiers, and litigation that hinges on the ability of individual plaintiffs to meet their basic living expenses while pursuing their claims. Increases in the latter category would be largely beneficial for achieving justice and efficiency goals; increases in the former would be largely destructive of both types of goals.

The question therefore remains: what to do? How can we have more of the good and less of the bad? Proposals for reform and regulation are varied and encompass useful and less-than-useful options. Most useful are those proposals that prohibit collusion between lawyers and financiers, as that collusion would facilitate rent-seeking. Also useful are calls for greater disclosure, both in terms of disclosing to potential plaintiffs the full context of the contracts they are considering and in terms of disclosing to the court the existence of a financing agreement. Basic disclosure will aid plaintiffs in making informed decisions, while broader admissibility standards will increase the likelihood of poaching and decrease rent-seeking behavior. Less useful are those proposals that impose additional costs on financiers, those that seek to limit the fees that financiers can recover, and any proposals that increase the complexity of the financing agreement—simplicity and transparency present the greatest opportunities to curb abuses while allowing beneficial voluntary transactions.

Given the fact that legal claims differ by area of law and the underlying facts of the case, it is also unsurprising that the appropriate use for litigation financing tools differs according to these criteria. Individual claims, for example, pose far less risk than class actions, so litigation financing can be expected to yield higher net benefits when applied to individual claimants. Similarly, we should expect less rent-seeking in contract disputes, as opposed to tort claims, and in disputes between commercial entities, as opposed to disputes where only one party has deep pockets. Finally, we should expect greater rent-seeking in medical malpractice, products liability, and other areas of law where the parties tend to be repeat players on one side of the dispute and the claims exhibit legal or factual complexity beyond the capacity of the average judge and jury.

There is great diversity in the legal realm, and it makes sense to differentiate; rules based on an incorrect characterization of lawsuits as uniform will almost certainly be disastrous. Instead, the policy should be to liberalize in those areas where risk is low and be constantly

vigilant for unforeseen impacts that harm our justice and efficiency goals, revisiting litigation-financing rules as needed. Much of the assumptions that have been used up to now are, to a greater or lesser extent, incorrect. Adopting more precise assumptions regarding the actions of plaintiffs, lawyers, and financiers, and differentiating appropriately between diverse areas of law, we can improve justice and efficiency in our legal system through informed litigation-financing liberalization.