CSDI Policy Brief

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The Effects of Third-Party Litigation Funding

Over the past twenty years the once-prohibited practice of third-party financing of lawsuits has become a niche industry in the United States and abroad. Large banks, hedge funds, and private investors often fund medical malpractice claims, class actions against corporations, and other tort claims so that they can share in the potential winnings.[1] While the practice is becoming more commonplace, it remains controversial.

The legal terms for such funding are "maintenance" and "champerty." Maintenance refers to assistance to a litigant pursuing or defending a lawsuit that is provided by someone who does not have an independent interest in the case. Champerty is a particular form of maintenance in which a nonparty advances a litigant's interest in a case in exchange for a share of a favorable judgment.[2] Current statutes often disallow the practices of maintenance and champerty because of the presumed negative effects of third-party funding on the incentives of legal parties to settle, which have broad consequences for the functioning of the legal system. In such cases, the legality of these practices seems to hinge on whether the financed support is considered to be an investment or a loan. In 2003, for example, the Ohio Supreme Court voided a nonrecourse funding agreement because it violated the state's usury laws, despite the financier's contention that the funds are investments and not loans, and that no statute exists that limits the return on an investment. (Nonrecourse means that the plaintiff is only required to pay back the funds if she receives a settlement or judgment at trial, and then only up to the amount received.) The Court ultimately ruled that:

> *…[A] contract making the repayment of funds advanced to a party to a pending case contingent upon the outcome of that case is void as champerty and maintenance. Such an advance constitutes champerty and maintenance because it gives a nonparty an impermissible interest in a suit, impedes the settlement of the underlying case, and promotes speculation in lawsuits.*[3]

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In contrast to the Ohio Court's ruling, in 2006 a Texas court of appeals upheld a nonrecourse funding agreement and argued that the lack of an absolute obligation to repay prevented usury laws from applying. Moreover, the Texas court noted that the Ohio case did not address the contention that the funding contracts were loans rather than investments.[4] Needless to say, third-party litigation financing is not settled as a matter of law.

Independent of legal considerations, the pursuit of a civil case can be very expensive. A survey of attorneys in recently closed civil cases conducted by the Federal Judicial Center in May and June of 2009, for example, found the median plaintiffs' costs were

[1] Appelbaum, Binyamin. 2010. "Investors Bankroll Lawsuits to Profit From Payouts." *The New York Times*, November 14, sec. Business Day. Accessed February 22, 2013. http://www.nytimes.com/2010/11/15/business/15lawsuit.html.

[2] *Rancman v. Interim Settlement Funding Corp*. 2003, 99 Ohio St. 3d 121. Supreme Court.

[3] Ibid

[4] *Anglo-Dutch Petroleum Intern. v. Haskell.* 2006, 193 SW 3d 87. Court of Appeals.

$15,000, but some exceeded $500,000.[5] The costs of pursuing claims that deal with scientific evidence, like medical malpractice, often exceed $100,000.[6] Plaintiffs and their lawyers usually have a contingent fee arrangement, which means that the lawyer will cover any costs relating to trial preparation or the trial itself, and she is only paid if the plaintiff receives a settlement or judgment. In addition to trial costs, however, plaintiffs are likely to have immediate and unusual injury-related expenses, such as medical costs—and in such cases, loans paid directly to plaintiffs can help them overcome barriers to accessing the legal system. On this point, Alan Zimmerman, founder of one of the first litigation finance companies has said:

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Putting aside the question of whether third-party financing is a loan or an investment, opposition to the practice is often based on the presumed negative effects of these practices on the incentives for the parties to settle lawsuits. The theoretical rationales underlying such claims, however, are not entirely clear. In a new CSDI Working Paper, CSDI Affiliates Andrew F. Daughety, the Gertrude Conaway Vanderbilt Professor of Economics, and Jennifer F. Reinganum, the E. Bronson Ingram Professor of Economics at Vanderbilt University, engage these questions by developing a theoretical model that allows them to analyze the effect of nonrecourse funding on incentives for settlement. Consistent with the Ohio Court's argument, such funding can increase the likelihood of settlement negotiation failure. However, contrary to the Ohio Court's argument, they are able to identify conditions under which nonrecourse loans should actually make settlement more likely, rather than impede it. While their analysis does not speak directly to questions of law and doctrine, their results provide guidance about the likely policy implications of banning nonrecourse funding.

In Daughety and Reinganum's model a plaintiff has a contingent fee arrangement with her lawyer, and the plaintiff may also negotiate with a third party for an immediate nonrecourse loan that is secured by the expected payout from the lawsuit. In other words, the plaintiff may negotiate for a loan that she is only required to repay if she receives a settlement or judgment at trial; and then she is only liable up to the amount of the payout, less lawyers' fees. After negotiating for a loan, the plaintiff and her attorney make a settlement offer to the defendant, where if a settlement is not reached, the case goes to trial and a judgment may be awarded. Finally, the plaintiff pays her lawyer, repays any loan, and keeps any excess.

Daughety and Reinganum find that the optimal loan, defined as the loan that is (jointly) best for the lender and plaintiff, extracts the largest possible payment from the defendant, and induces *all* suits to settle. Moreover, if plaintiffs do not receive a loan, then plaintiffs with different costs of injury make settlement offers that allow the defendant to infer the judgment that is likely to be awarded by the court. Hence, the defendant will reject higher demands and choose to take a chance at trial. In short, the loan removes a plaintiff's incentive to make a settlement offer that reveals the relative strength of her case, thereby ensuring settlement. This settlement-inducing effect has not been recognized previously in the extant economics or legal literatures.

[5]This considers only cases with at least one type of discovery. The $500,000 figure is the 95th percentile for cases with more than five types of discovery. Source: Lee III, Emery G. and Willging, Thomas E. October 2009. "Federal Judicial Center National, Case-Based Civil Rules Survey: Preliminary Report to the Judicial Conference Advisory Committee on Civil Rules" Accessed February 22, 2013. http://www.fjc.gov/public/pdf.nsf/lookup/dissurv1.pdf/$file/dissurv1.pdf

[6]See footnote 1

[7]See footnote 1

Having established the settlement-inducement finding, Daughety and Reinganum also explore how capping the interest rate might affect the market for litigation funding. Their findings demonstrate that the interest rate of the optimal loan may be quite high, which could have important (negative) implications beyond their analysis. That said, interest rate caps that are too low might result in some amount of settlement failure, or cause the market for nonrecourse funding to collapse.

The authors ultimately provide a discussion of the likely positive effects of third-party loans. First, the plaintiff's attorney benefits from reduced costs of trial preparation. Given that the optimal loan results in settlement of all cases, the attorney should never (theoretically) pay the cost of going to trial, which would normally be covered by the attorney under a contingent-fee arrangement. Reducing the cost to the plaintiff's attorney has two positive effects. If the market for lawyers is sufficiently competitive, the elimination of trial costs should reduce the contingent fee that is charged to clients with loans. Similarly, if attorneys never risk losing at trial, they are willing to take cases with relatively higher court costs, lower probability of success at trial, or lower expected payouts. Taken together, these effects should increase the overall access to the legal system. Finally, Daughety and Reinganum discuss the importance of a competitive litigation funding market. If the lender were a monopolist, any reduction in contingent fees would obviously just go to the lender. As the number of lenders increases, however, competition for borrowers also increases, which allows the benefits of reduced costs to flow to the plaintiffs.

Given the controversy and questions surrounding the practice of third-party litigation financing, Daughety and Reinganum's research is extremely constructive in that it suggests prescriptions for structuring the market for such financing. First, loans should be nonrecourse and the plaintiff should retain negotiating authority, rather than having the lender effectively *buy* the case. This is because if the lender has negotiating authority, she would be subject to the same incentive to make a revelatory offer as a plaintiff without a loan. If rate caps are implemented, regulators should be careful not to set the cap so low that it induces settlement failure; and a better solution than rate caps is likely facilitating a competitive lending market. Contrary to claims that loans increase incentives to go to trial, it appears that the that optimal nonrecourse loans should result in settlement of all cases, which is good for the plaintiff and her attorney—particularly in a competitive lending market. While questions remain regarding the empirical likelihood of these positive effects being realized, Daughety and Reinganum provide us with theoretical guidance which suggests that under the right conditions third-party financing of litigation should increase access to the legal system, rather than decreasing incentives to settle.

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The research summarized in this policy brief can be found can be found in CSDI Working Paper #01-2013, "The Effect of Third-Party Funding of Plaintiffs on Settlement." Andrew F. Daughety and Jennifer R. Reinganum.

http://www.vanderbilt.edu/csdi/research/CSDI_WP_01-2013.pdf

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