

EXHIBIT A

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

-----X
IN RE: WORLD TRADE CENTER
DISASTER SITE LITIGATION
-----X

Docket No.: 21 MC 100 (AKH)

THIS DOCUMENT APPLIES TO ALL
WORLD TRADE CENTER DISASTER SITE
LITIGATION
-----X

STATE OF NEW YORK)
)s.s.:
COUNTY OF _____)

Anthony Sebok, being duly sworn, hereby deposes and says:

1. I am over the age of eighteen (18) and I am competent to make the statements contained herein.
2. I am a tenured Professor of Law at the Benjamin N. Cardozo School of Law. Prior to joining the faculty at Cardozo I was Centennial Professor of Law and Associate Dean for Research at Brooklyn Law School, where I had been on the faculty for fifteen years. Before beginning full-time teaching at Brooklyn, I was a judicial clerk for the Chief Judge of the U.S. District Court for the Eastern District of Pennsylvania. I received a B.A. from Cornell University, an M.Phil. from the University of Oxford, a J.D. from Yale Law School, and an LL.M. and a Ph.D. from Princeton University. Further biographical information is contained in my CV, attached as Exhibit A to this affidavit.
3. My area of research and teaching specialization is tort law and civil litigation. I have taught courses in torts, advanced torts, mass torts, insurance law and remedies every year since beginning full-time teaching in 1992. I am a co-author, along with John C.P. Goldberg and Benjamin Zipursky, of an Aspen Publishers casebook, *Tort Law: Responsibilities and Redress*. I

have published widely on tort law and mass torts, including a widely cited article on the 9/11 Victims Compensation Fund in the *DePaul Law Review*. My recent research has focused on Third Party Litigation Finance in the United States and overseas. My article on the history and theory of Third Party Litigation Finance, "The Inauthentic Claim," will be published in early 2011 by the *Vanderbilt Law Review*. Since 2009 I have served on the Advisory Committee for the RAND Law, Finance, and Capital Markets Program, which is, to my knowledge, the only independent research program studying litigation finance in the United States. I taught a CLE course on ethical issues in litigation funding for attorneys at the invitation of various bar associations New York State in the fall of 2009 and spring of 2010. My research and public service has brought me into contact with virtually all of the major figures in the litigation finance community in New York, the United States, and overseas.

4. In its order of June 25, 2010, the Court stated that it would allow expenses to be charged to the clients of services related to the conduct of the litigation if they were "reasonably-related to the advancement of any plaintiff's case; customarily expended on behalf of plaintiffs in personal injury cases; and, charged to plaintiffs at no greater rate than those customarily charged by outside vendors for such services." In my opinion the decision by Worby Groner Edelman & Napoli Bern to borrow funds to conduct the litigation was reasonably-related to the advancement of their clients' cases and the interest expense of the loans resulting from those loans is something which is customarily expended on behalf of plaintiffs in personal injury cases. Finally, in my opinion, the interest rate charged to the clients for these loans was not greater than those "customarily charged by outside vendors for such services"—in fact, it was less.

5. In my experience, Worby Groner Edelman & Napoli Bern's decision to borrow tens of millions of dollars in order to fund individual and common litigation expenses for their clients

was appropriate. While the affidavit supplied by Prof. W. Bradley Wendel accompanying my affidavit addresses the permissibility of the cost of such loans being charged to the client, this affidavit speaks directly to whether such loans were reasonably-related to the advancement of this case. I have followed the various phases of the litigation surrounding the events of 9/11 for years, as well as other recent mass torts involving allegations of personal injury arising from environmental hazards and pharmaceuticals.

6. The risks to plaintiffs firms of running out of funds to pursue meritorious suits cannot be understated. This was as true thirty years ago as it is today. In a 1995 newspaper article, Michael A. Pretl, a lawyer who conducted Dalkon Shield litigation between 1975 and 1995 noted:

We handled over 1,000 Dalkon cases, and it took 20 years before we showed a profit. We borrowed heavily at high interest rates to finance the litigation. Even though we settled \$ 55 million in claims, this year [1995] *will be the first year we'll be in the black.*

See Gregory C. Baumann, State Makes Casting Call for Counsel to Sue on Tobacco's Medicaid Bill, THE DAILY RECORD (Baltimore, MD.), November 17, 1995 (emphasis added). In mass tort litigation involving difficult issues of causation as well as difficult issues of law, the lawyers representing the plaintiffs must expend tens of millions of dollars early in the litigation in order to identify and resolve to the advantage of their clients multiple pre-trial issues. This is why the American Bar Association's Tort Trial & Insurance Practice Section Task Force on Contingent Fees stated in its final report that:

Mass tort litigation requires heavy expenditures in the beginning to get cases and develop the first ones for trial. . . That financial burden does not lift, however, once the cases are in the door. Plaintiffs' lawyers in a mass tort case, at least one worth litigating, will face a well-financed opposition. Proving these cases, at least at first, is expensive. Experts of various kinds may be needed, and discovery from the defendants may take a long time and much effort. One can expect a defendant early in the life cycle of a mass tort to expend enormous resources to defeat the first claimants in order to dampen the enthusiasm of later claimants and their lawyers. *Financing mass tort litigation is a central and inescapable concern.*

See Contingent Fees in Mass Tort Litigation, 42 TORT & INS. L.J. 105 (2006). In my opinion, in this case, the factual and legal issues in this case were as difficult as the factual and legal issues in the Dalkon Shield , tobacco, asbestos, and Vioxx litigation. Therefore, the decision to borrow was reasonable, given the obligation of the lawyers to vigorously pursue their clients' cases.

7. The decision to borrow is “customary” in that it is not unusual for attorneys to borrow funds from lenders, which explains why, as Prof. Wendel’s affidavit illustrates, the law of lawyering has explicitly provided for the possibility of borrowing by an attorney on behalf of a client. As reflected in this 2008 article from a bar journal in Missouri, it is not unusual for lawyers to borrow in individual cases:

A firm can also set up an individual line of credit for each case file. The firm's office building or a partner's home equity can be used as collateral for these secured loans. Then the interest payments can get easily charged to clients as part of the litigation expenses. The state legal ethics counsel has said that passing along interest charges to clients is permissible as long as they are reasonable, clearly communicated to clients and clients agree in writing ahead of time.

See Commentary: Attorney Options In Covering Costs, MISSOURI LAWYERS WEEKLY July 28, 2008. For similar reasons, it is not uncommon for lawyers in mass tort cases to borrow on behalf of their clients, especially when, as in this case, teams of plaintiffs firms did not form a complex network to share costs over time, as was the case in the asbestos and tobacco litigation in the 1980s and 1990s. Furthermore, given the inadequacy of the alternative, where an attorney refers their client to a non-lawyer who would provide “Third Party Litigation Funding” at a great expense to the client, it is easy to see why it has become customary for lawyers to borrow directly from a lending institution on behalf of their client. In the following paragraphs I will explain why Third Party Litigation Funding was not an adequate substitute for direct borrowing in this case.

8. Third Party Litigation Finance is a rapidly evolving practice in the United States.

Third Party Litigation Finance is commonly understood to be a form of champerty, although technically it is a form of maintenance as well. Maintenance and champerty are closely related but are not identical. “[P]ut simply, maintenance is helping another prosecute a suit; champerty is maintaining a suit in return for a financial interest in the outcome.” *Osprey, Inc. v. Cabana Limited Partnership*, 340 S.C. 367, 532 S.E.2d 269, 273 (2000) (quoting *In re Primus*, 436 U.S. 412, 424 n. 15, 98 S.Ct. 1893, 1900 n. 15, 56 L.Ed.2d 417, 429 n. 15 (1978)). For purposes of this affidavit, by “Third Party Litigation Finance” I will mean practice by non-lawyers of providing non-recourse loans to individuals in exchange for a partial assignments of the proceeds of litigation, in which the property interest of the funder is by definition contingent on an uncertain event happening in the future, that is, the positive resolution of a lawsuit by either judgment or settlement. Third Party Litigation Finance transactions do not result in either a loan or an assignment. For this reason, common law judges have treated them with some skepticism, although in a few states they have been codified by legislation.

9. Twenty-eight of fifty-one U.S. jurisdictions (including the District of Columbia) explicitly permit Third Party Litigation Finance, albeit with varying limitations.¹ Fourteen jurisdictions explicitly prohibit most forms of maintenance, including champerty.²

¹ AZ, *Landi v. Arkules*, 835 P.2d 458 (Ariz. App. 1992); CA, *Abbott Ford, Inc. v. Superior Court*, 741 P.2d 124 (Cal. 1987); CO, *Fastenau v. Engel*, 240 P.2d 1173 (COL. 1952); CT, *Robertson v. Town of Stonington*, 750 A.2d 460 (Conn. 2000); FL, *Kraft v. Mason*, 668 So.2d 679 (Fla. 1996); HI, *TMJ Hawaii, Inc. v. Nippon Trust Bank*, 153 P.3d 444 (Haw. 2007); IA, *Wright v. Meek*, 3 Greene 472 (Iowa 1852); KS, *Boettcher v. Criscione*, 299 P.2d 806 (Kan. 1956); LA, *Martin v. Morgan Drive Away, Inc.*, 665 F.2d 598 (6th Cir. 1982); ME, ME. REV. STAT. tit. 9A §12-101 (2009) (partially amending ME. REV. STAT. 17A §516(1) (2009)); MD, *Son v. Margolius, Mallios, Davis, Rider & Tomar*, 709 A.2d 112 (Md. 1998); MA, *Saladini v. Righellis*, 687 N.E.2d 1224 (Mass. 1997); MI, *Smith v. Childs*, 497 N.W.2d 538 (Mich. App. 1993); MO, *Schnabel v. Taft Broad. Co.*, 525 S.W.2d 819 (Mo. App. 1975); MT, *Green v. Gremaux*, 945 P.2d 903 (Mont. 1997); NH, *Adkin Plumbing & Heating Supply Co. v. Harwell*, 606 A.2d 802 (N.H. 1992); NJ, *Polo v. Gotchel*, 542 A.2d 947 (N.J. Super. Ct. Law Div. 1987); NY, *Leon v. Martinez*, 638 N.E.2d 511 (N.Y. 1994); NC, *Odell v. Legal Bucks, LLC*, 665 S.E.2d 767 (N.C. App. 2008); ND, *Interstate Collection Agency v. Kuntz*, 181 N.W.2d 234 (N.D. 1970); OH, ORC ANN. 1349.55 (2009) (reversing *Rancman v. Interim Settlement Funding Corp.* (99 Ohio St.3d 121(2003))), OK, *Mitchell v. Amerada Hess Corp.*, 638 P.2d 441 (Okl. 1981); OR, *Brown v. Bigne*, 28 P. 11 (Or. 1891); SC, *Osprey, Inc. v. Cabana Ltd.*, 532 S.E.2d

10. New York law permits Third Party Litigation Finance under certain circumstances. There is no common law prohibition of Third Party Litigation Finance (or maintenance in general) in New York. The only governing law is a statute, N.Y. Judiciary Law § 489.³ It prohibits, in relevant part:

[A] person or co-partnership, engaged directly or indirectly in the business of collection and adjustment of claims, and [any] corporation or association, directly or indirectly, . . . [to] solicit, buy or take an assignment of . . . a bond, promissory note . . . or other thing in action, or any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon

11. The statute is violated if “the foundational intent to sue on the claim [was] at least . . . the primary purpose . . . , if not the sole motivation behind, entering into the transaction.” *Bluebird Partners, L.P. v. First Fidelity Bank, N.A.*, 94 N.Y.2d 726, 736 (2000). Judiciary Law §489 is silent on the precise question of champerty—e.g. the support of the claim holder by the third party in exchange for something of value. This silence has been interpreted to be permissive by the New York courts. In *Leon v. Martinez*, 84 N.Y.2d 83 (1994) the N.Y. Court of Appeals upheld a contract by which a personal injury litigant gave a portion of the proceeds anticipated from his suit to third parties who were providing him with care. Therefore, a partial assignment of the proceeds of a lawsuit—whether for personal injury or otherwise—may be assigned in New York. However, at

269 (S.C. 2000); TN, *Record v. Ins. Co. of N. Am.*, 438 S.W.2d 743 (Tenn. 1969); TX, *Anglo-Dutch Petroleum Int'l, Inc. v. Haskell*, 193 S.W.3d 87 (Tex. App. 2006); WA, *Giambattista v. Nat'l Bank of Commerce of Seattle*, 586 P.2d 1180 (Wash. App. 1978); and WV, *Currence v. Ralphsnyder*, 151 S.E. 700 (W. Va. 1929). This is based upon the author's survey of the current state of the law. It is consistent with a survey published in Paul Bond, *Making Champerty Work: An Invitation To State Action*, 150 U. PA. L. REV. 1297 (2002) (Appendix).

² AL, *Wilson v. Harris* 688 S.2d 265 (Ala. Civ. App. 1996); DE, *Street Search Ptnrs., L.P. v. Ricon Int'l, L.L.C.*, 2006 Del. Super. LEXIS 200 (Del. Super. Ct. May 12, 2006); DC, *Design for Bus. Interiors, Inc. v. Herson's Inc.*, 659 F.Supp 1103 (D.C. 1986); GA, GA. CODE ANN. § 13-8-2 (2009); IL, §720 ILCS 5/32-12 (2009); KY, KY. REV. STAT. § 372.060 (2009); MN, *Johnson v. Wright*, 682 N.W.2d 671 (Minn. App. 2004); MS, MISS. CODE ANN. § 97-9-11 (2009); NV, *Schwartz v. Eliades*, 939 P.2d 1034 (Nev. 1997); PA, *Fleetwood Area School Dist. v. Berks County Board of Assessment*, 821 A.2d 1268 (Pa. Cmwlth. 2003); RI, *Toste Farm Corp. v. Hadbury, Inc.*, 798 A.2d 901 (R.I. 2002); SD, *McKellips v. Mackintosh*, 475 N.W.2d 926 (S.D. 1991); WI, *In re Estate of Katze-Miller*, 158 Wis.2d 559 (Wis. App. 1990); VA, *Allstate Ins. Co. v. Commonwealth*, 100 S.E.2d 31 (Va. 1957).

³ See NY CLS Jud § 489.

least one federal court has held that § 489 prohibits the assignment of the proceeds of a lawsuit before the suit has been filed, *Syigma Photo News v. Globe International*, 616 F.Supp 1153 (S.D.N.Y., 1985).

12. Although Third Party Litigation Finance is widely available in New York, funds obtained by litigants through the sale of a contingent interest in their personal injury suits are not typically used for litigation costs, which is the only way that Third Party Litigation Finance could have substituted for the loans obtained by Worby Groner Edelman & Napoli Bern. This is for three reasons.

13. First, Third Party Litigation Finance transactions arising from personal injury litigation occur after the claim has been reviewed by the attorney who is handling the litigation, and presumably that attorney's offer of representation was made without any assumption (or promise) of outside funding of costs. As an empirical matter, I can attest that I have never spoken to a New York attorney who took a personal injury suit on the condition that the potential client obtained Third Party Litigation Finance to fund costs. In fact, if the holding in *Syigma Photo News*, 616 F.Supp 1, *supra*, were to be applied literally, the contract struck between the client and the funder would violate §489.

14. Second, while it is possible that an attorney who agreed to represent a client with the good faith intention of advancing all litigation costs might request a client to seek Third Party Litigation Finance to supplement certain litigation costs, I have never personally heard of it occurring. As a general matter, personal injury litigants in New York use Third Party Litigation Finance to "monetize" their existing claims to pay for current living expenses in anticipation of a future recovery. In my opinion, the most persuasive argument for permitting Third Party Litigation Finance is that it permits to litigants to resist settlement pressure by providing them with resources

to pay for non-litigation expenses, such as their mortgage or medical expenses, not litigation costs. This view is supported by the only empirical study of Third Party Litigation Finance published to date in the United States. See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns* (RAND Occasional Paper, 2010) at 11-12 (attached as Exhibit B to this affidavit).

15. Third, even if a New York investor were willing to provide Third Party Litigation Finance directly to the litigants in this case, given the constraints placed on them by New York law, it would have been impossible as a practical matter for the case to have been funded through this mechanism. It would be impossible, from a practical point of view, to coordinate 10,000 individual loans, which is what would have been necessary to replace the loans directly obtained by Worby Groner Edelman & Napoli Bern. To my knowledge, no Third Party Litigation Finance company has ever provided coordinated funding at this scale in the United States. In the next two paragraphs I explain why, as a theoretical matter, funding from non-traditional Third Party Litigation Finance companies (firms that do not typically invest in personal injury suits) would have been impossible. However, it is important to recognize that any effort by Worby Groner Edelman & Napoli Bern to obtain funding for their clients' personal injury suits from the traditional funders would have been impossible because of the number of plaintiffs and the capital requirements of the case.

16. Personal injury litigants, if they can secure Third Party Litigation Finance in New York, can do so only by approaching companies that occupy what Dr. Steven Garber calls the "Consumer Legal Funding" sector. Garber, *Alternative Litigation Financing in the United States* at 9. The Consumer Legal Funding sector deals with small claims, almost all of which are personal injury. They are represented by a trade organization known as American Legal Finance Association ("ALFA"). Money provided by ALFA companies is not used to finance litigation costs. In

contrast, Third Party Litigation Finance transactions designed to fund litigation are much rarer, and when such transactions occur, they take place in a very different environment than the Consumer Legal Funding sector. Third Party Litigation Finance transactions that fund litigation occur in what Dr. Garber calls the “Commercial Claim” sector. Garber, *Alternative Litigation Financing in the United States, supra* at 13. My own research supports Dr. Garber’s dichotomy. In the Commercial Claim sector, money paid by the investor is often used to fund not only litigation costs, but often legal fees, since many of the lawsuits involved in this sector are brought by firms which do not operate on a contingency basis. As a matter of current business practice, the Commercial Claim sector does not invest in mass tort or personal injury litigation.⁴

17. Furthermore, as Dr. Garber has reported, the Commercial Claim sector is, for the moment, focused on making a few large investments, not many small ones. Garber, *Alternative Litigation Financing in the United States, supra* at 26. While the cases for which Worby Groner Edelman & Napoli Bern had to borrow were, in the aggregate worth a great deal of money, many of the 10,000 cases were individually not worth more than \$11,000. The firms in the Commercial Claim sector do not typically invest in cases worth less than \$1 million. As Dr. Garber put it, “the amounts of capital supplied in individual deals in this segment are often in the range of a few to several million dollars” *per case*. Garber, *Alternative Litigation Financing in the United States, supra* at 25. While it is conceivable that an enterprising lawyer could “bundle” multiple cases together and sell them as a portfolio to a member of the Commercial Claim sector in exchange for the promise of funds to be used by the lawyer to litigate the bundle of cases in the aggregate, it has never been done. Had Worby Groner Edelman & Napoli Bern attempted to sell such a bundle to a member of the Commercial Claim sector in order to avoid borrowing the funds needed to litigate the

⁴ This is in marked contrast to Canada and Australia, where the large commercial claims firms have invested in mass torts and class actions.

case, it would have been setting out into unknown territory—territory in which the legal and practical risks were very high.

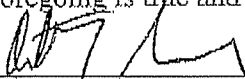
18. According to materials provided to me by Worby Groner Edelman & Napoli Bern which I have been able to review, the rates charged to the clients were better than those customarily charged by outside vendors for such services. The materials I reviewed indicate that the loans secured by the lawyers were negotiated at between 14%-18% *per annum* between 2001, when the case was first investigated, and 2010, when the settlement supervised by this court became likely. Lenders in general will charge higher rates to lawyers for loans in which the main source of repayment is a contingent outcome of a lawsuit, even if the loans are secured by the lawyers' own assets, as was the case here. Historically, loans to reputable plaintiffs' lawyers have cost as much as 20%-24% *per annum*. As a matter of comparison, if the funds for litigation costs had been obtained from an "outside vendor" by the clients themselves, the rates secured by Worby Groner Edelman & Napoli Bern clearly benefitted their clients.

19. The rates of return in the Consumer Legal Funding sector are difficult to state with precision, since the returns offered by Third Party Litigation Finance in this sector may depend in part on the quality of the investor as well as the case in which the investment occurs. However, Dr. Garber reports that the rate of return in the Consumer Legal Funding sector has been reported to vary between 24% - 60% *per annum*. Garber, *Alternative Litigation Financing in the United States*, *supra* at 12. Dr. Garber quotes Professor Jon Molot of Georgetown University School of Law as reporting that litigants can face "very high interest rates charged by cash advance firms—typically 3–5% monthly interest and often much higher." Garber, *Alternative Litigation Financing in the United States*, *supra* at 12. It is even harder to collect any data on the rate of return charged by the Commercial Claim sector, but in my opinion this is a moot point, since the Commercial Claim

sector has never to this date invested in the sort of lawsuits handled by Worby Groner Edelman & Napoli Bern in this case.

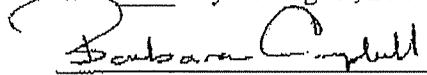
20. To conclude, in my opinion, the interest costs associated with the loans secured by Worby Groner Edelman & Napoli Bern on behalf of the litigants in this case were reasonably related to the advancement of their clients' cases, were a cost customarily expended on behalf of plaintiffs in personal injury cases (especially mass tort cases), and were clearly less expensive than alternative sources of funding available from "outside vendors" (e.g., Third Party Litigation Finance).

I swear under penalty of perjury that the foregoing is true and correct.



Anthony J. Sebok

Sworn to and subscribed before me
This 11 day of August, 2010



NOTARY PUBLIC
My Commission Expires:
Feb 23, 2014

BARBARA A. CAMPBELL
Notary Public, State of New York
Qualified in Rensselaer County
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EDUCATION

Princeton University, Ph.D. in Politics, 1993

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University of Oxford, M.Phil. in Politics, 1986

Cornell University, B.A. *magna cum laude* in Philosophy, 1984

EMPLOYMENT

Professor of Law, Benjamin N. Cardozo School of Law, New York, NY, 2007-present

Visiting Professor of Public and International Affairs, Princeton University, 2007-08

Associate Dean for Research, Brooklyn Law School, Brooklyn, NY, 2006-07

Fellow, Program in Law and Public Affairs and **Visiting Professor of Public and International Affairs**, Princeton University, 2005-06

Centennial Professor of Law, Brooklyn Law School, Brooklyn, NY, 2005-2007

Professor, Brooklyn Law School, Brooklyn, NY, 1997-2005

DAAD Visiting Professor, Freie Universität, Berlin, 2001

Berlin Prize Fellow, The American Academy in Berlin, 1999

Visiting Associate Professor, Benjamin N. Cardozo School of Law, New York, NY, Spring 1997

Assistant Professor, Brooklyn Law School, Brooklyn, NY, 1992-95

Law Clerk, Chief Judge Edward Cahn, U.S. District Court, Philadelphia, PA, 1991-1992

TEACHING

Torts, Jurisprudence, Advanced Torts, Remedies, Insurance Law, Mass Torts and Social Justice (seminar), Tort Theory (seminar), Comparative Products Liability, Constitutional Law,

**BOOKS AND
ESSAYS**

TORT LAW: GLOBAL PERSPECTIVES (with Mauro Bussani) (Oxford University Press, forthcoming 2010)

“Adversarial Legalism and the Emergence of a New European Legality: A Comparative Perspective” (with Lars Trägårdh) *in* IMAGINING NEW LEGALITIES, (Austin Sarat, ed., Stanford University Press, forthcoming 2010)

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TORT LAW: RESPONSIBILITIES AND REDRESS, SECOND EDITION (with John C.P. Goldberg & Benjamin Zipursky) (Aspen Law & Business, 2008)

“Legal Process and the Practices of Principle,” *in* TOPICS IN CONTEMPORARY PHILOSOPHY, VOL. 3 (Michael O’Rourke, ed., MIT Press, 2006)

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Alternative Litigation Financing in the United States

Issues, Knowns, and Unknowns

Steven Garber

Supported by Juridica Investments Limited and
the Kauffman-RAND Institute for Entrepreneurship Public Policy

Embargoed until May 17, 2010



Law, Finance, and Capital Markets

A RAND INSTITUTE FOR CIVIL JUSTICE PROGRAM

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Preface

Provision of capital by nontraditional sources to support litigation activity in the United States has received considerable attention of late and some calls for policymakers to intervene. Little is known, however, about the social benefits and costs of alternative litigation financing (ALF) currently, and even less is clear about the likely future effects. This paper describes—to the extent that available information allows—the only three segments of the U.S. ALF industry that appear to be fairly active as of early 2010, all of which provide support to plaintiffs or their lawyers. It also reviews policy issues related to the legal ethics, social morality, and, especially, the potential economic effects of ALF. The paper also provides thoughts about the implications of microeconomic principles for potential effects of ALF on litigation and its outcomes. The paper will be of interest to policymakers who may be faced with decisions related to ALF in the next five to ten years, including decisionmakers for bar associations as well as courts, legislatures, and state attorneys general. It will also be of interest to researchers who want to contribute to the development of knowledge about the effects of ALF and potential future developments.

Questions and comments about this report should be sent to Steven Garber (Steven_Garber@rand.org).

The paper is a product of the RAND Institute for Civil Justice Law, Finance, and Capital Markets Program (<http://www.rand.org/icj/programs/law-finance/about/>). Financial support was provided by Juridica Investments Limited, a supplier of one type of alternative litigation financing discussed and analyzed here. Additional financial support was provided by the Kauffman-RAND Institute for Entrepreneurship Public Policy.

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The RAND Institute for Civil Justice is an independent research program within the RAND Corporation. The mission of the RAND Institute for Civil Justice (ICJ) is to improve private and public decisionmaking on civil legal issues by supplying policymakers and the public with the results of objective, empirically based, analytic research. ICJ facilitates change in the civil justice system by analyzing trends and outcomes, identifying and evaluating policy options, and bringing together representatives of different interests to debate alternative solutions to policy problems. ICJ builds on a long tradition of RAND research characterized by an interdisciplinary, empirical approach to public policy issues and rigorous standards of quality, objectivity, and independence.

ICJ research is supported by pooled grants from corporations, trade and professional associations, and individuals; by government grants and contracts; and by private foundations. ICJ disseminates its work widely to the legal, business, and research communities and to the general public. In accordance with RAND policy, all ICJ research products are subject to peer review before publication. ICJ publications do not necessarily reflect the opinions or policies of the research sponsors or of the ICJ Board of Overseers.

The Law, Finance, and Capital Markets Program

The Law, Finance, and Capital Markets Program (LFCMP) is a research initiative of the ICJ. Its purpose is to analyze an emerging development in civil dispute resolution in the United States, namely, the provision of capital and capital market products for legal claim holders, those defending such claims, and their respective lawyers. The program will explore issues such as (1) the convergence of law, finance, and capital markets in the United States, including phenomena such as outside capital invested in law firms and “alternative” or “third-party” litigation funding; (2) the effects of outside capital on the American legal system and on the efficiency, fairness, and transparency of the civil justice system in the United States and how these effects differ across segments of the litigation-financing industry; and (3) the advantages and disadvantages of potential public-policy responses as applied to different industry segments. The LFCMP program benefits greatly from ideas, suggestions, and information provided by a distinguished advisory committee whose members are listed at <http://www.rand.org/icj/programs/law-finance/about/advisory-board.html>.

The Kauffman-RAND Institute for Entrepreneurship Public Policy

The Kauffman-RAND Institute for Entrepreneurship Public Policy (KRI), which is housed within ICJ, is dedicated to assessing and improving legal and regulatory policymaking as it relates to small businesses and entrepreneurship in a wide range of settings, including corporate governance, employment law, consumer law, securities regulation, and business ethics. KRI’s work is supported by a grant from the Ewing Marion Kauffman Foundation.

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Summary

Provision of capital by nontraditional sources to support litigation activity in the United States has received considerable attention of late from journalists, researchers, and policy advocates. This phenomenon is often referred to as *third-party financing* of litigation. This term, however, mischaracterizes the phenomenon in the United States because, viewing the plaintiff and the defendant as the first two parties, it has become common for there to be at least a third, and often a fourth, party involved in financing litigation activity. Specifically, in almost all personal-injury lawsuits brought by individuals and many lawsuits brought by businesses, plaintiffs' efforts are financed by contingency-fee lawyers who pay expenses during the course of a lawsuit and are reimbursed for expenses only if the plaintiff receives a recovery. In addition, in many lawsuits, much (and sometimes all) of defendants' legal costs are paid by an insurer under "duty to defend" arrangements. Thus, in this paper I propose and use the term *alternative litigation financing* (ALF) to describe the phenomenon under study, namely, litigation financing by entities other than plaintiffs, defendants, their lawyers, or defendants' insurers.

Although ALF is fairly new in the United States, some have already called for banning or heavily regulating it. Very little is known, however, about current ALF activity and its effects, and even less about how ALF activity and ALF markets will evolve in the near and longer terms. A main purpose of this paper is to provide policymakers with information that could help them make socially advantageous decisions about ALF in the next five to ten years. Several kinds of state-level policymaking institutions—bar associations, courts, legislatures, and state attorneys general—could play important roles in how ALF develops in the United States. The other main purpose of the paper is to provide researchers with background and ideas that could help them contribute to the effort to develop information that could help policymakers make wise decisions.

To further these goals, I synthesize and interpret publicly available information from many sources, such as descriptive and analytical articles about ALF, websites of ALF suppliers and law firms, and literature on contingency-fee lawyers, the economics of U.S. civil litigation, access to justice for civil litigants, and corporate law firms. Much of the analysis is conceptual, but empirically grounded, and applies standard perspectives from microeconomics. The discussion and analyses also benefit greatly from 17 semistructured interviews I conducted with participants in ALF markets, attorneys at law firms and corporations, and experts on the objectives and management of corporate law firms and corporate legal departments.

The paper considers economic, legal, and ethical issues related to ALF in the United States. The author is an economist, not a lawyer or philosopher. To aid readers who are particularly interested in legal issues, I provide cites to what appears to be useful recent literature.

In Section 2, I argue that the policy debate and much of the writing about ALF is confusing because of failure to appreciate five crucial distinctions, namely, distinctions between

- legal ethics and social morality
- ethical and instrumental policy considerations
- different forms of ALF
- the effects of ALF in the near and longer terms
- activities that are intrinsic to ALF and activities that might accompany ALF.

In Section 3, I provide—to the extent that available information allows—a description of ALF activity in the United States as of early 2010. There are three fairly active segments of the U.S. ALF industry, all of them providing support for plaintiff-side efforts. These three segments—on which my analyses focus—involve the following:

- consumer legal funding (non-recourse loans) to individual, usually personal-injury, plaintiffs
- loans and lines of credit for plaintiffs' law firms
- investments in commercial (business against business) lawsuits.

As repeatedly illustrated in Sections 5 and 6, these three types of ALF differ in several ways that are relevant to their social (including economic) effects.

I consider in Section 4 whether policymakers should focus on ethical considerations, as some have advocated, on the grounds that ALF is “unethical” and, therefore, just shouldn't be allowed. Here I distinguish between legal ethics, as exemplified by laws governing lawyers and the American Bar Association's (ABA's) *Model Rules of Professional Conduct*, and morality, as that term is understood by moral philosophers and intuitively by many others. Regarding legal ethics, I briefly discuss laws and professional rules that might proscribe ALF in some jurisdictions (maintenance and champerty) and laws and rules that might limit ALF-related activities in some jurisdictions (pertaining to intermeddling, fee splitting with nonlawyers, and unintentional waiver of attorney-client and work-product privileges). I conclude that in some states laws and professional rules and uncertainty about their application by courts in ALF contexts could deter some forms of ALF entirely, substantially constrain activities related to ALF, or increase costs of ALF. Regarding social morality, I argue—using access to justice and property rights as examples of moral principles—that there is no compelling argument for *either allowing or banning* ALF.

Sections 5 and 6 make up the heart of the paper and apply microeconomic principles to explore likely effects of ALF on outcomes of social concern. Section 5 focuses on the present and the near future (five to ten years, say) and discusses the plausibility of various claims about the effects of ALF on litigation as well as potential effects that have not received much attention. Specifically, I consider the potential effects of ALF on the quantity and quality of civil litigation, the likelihood and timing of settlements, the fairness of settlements, and the transaction costs of litigation. In many instances, I conclude and illustrate that these effects are likely to differ substantially across the three active segments of the ALF industry. I also comment on special issues raised by class-action and patent-infringement litigation.

In Section 6, I argue that the longer-term effects of ALF might properly dominate policy assessments, and, for that reason, I consider how the markets for ALF may grow and evolve

over the longer term. I comment briefly on the potential longer-term effects of ALF on fairness to plaintiffs and defendants and then focus on the social goal of economic efficiency. That discussion highlights the potential for competition to promote economic efficiency, points out what seem to me to be key challenges for markets to achieve nearly efficient outcomes, and discusses possibilities for market developments—such as the emergence of brokers and the development and wide diffusion of expertise in case evaluation—to address those challenges.

The concluding section focuses on lessons for policymakers for the next five to ten years or so. In my view, the key lessons for the short term are as follows:

- Do not accept uncritically arguments about ethics compelling anything about ALF policy.
- Always keep in mind that the economic effects of ALF almost surely differ substantially across the three active segments, as well as across new segments that may emerge based on other business models of ALF suppliers.
- Be doubtful about any claims about “effects of ALF” that purportedly apply broadly over various types of ALF.
- Be skeptical of one-size-fits-all policy prescriptions, because context matters, and it seems implausible, for example, that policies affecting all kinds of ALF will be broadly effective in promoting social objectives.
- Be wary of claims about the effects of ALF in other countries providing simple lessons for the United States, because the effects of ALF—and, indeed, forms of ALF—in other countries (such as Australia and the United Kingdom) reflect to large degrees institutional features of legal rules abroad that differ from those in the United States, such as not allowing lawyers to work under contingency-fee agreements and requiring the losing side to pay the winning side’s legal expenses.
- Because of massive uncertainties about even recent effects of ALF, and more importantly, future effects of ALF, policymakers might best limit their interventions in ALF activity to “robust” policies—policies whose outcomes are likely to be satisfactory, or at least not too unsatisfactory, no matter what the truth is pertaining to these massive uncertainties.

I conclude by suggesting and discussing two key characteristics of robust policy in the present context. These are (1) *light-handedness* (avoiding policies that could fundamentally impede development of effective competition in ALF markets) and (2) *precision* (avoiding policies that apply more broadly than necessary to alleviate problems that are viewed as too pressing to wait to see whether market developments will alleviate them).

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I am solely responsible for opinions expressed and any shortcomings in the paper.

Abbreviations

ABA	American Bar Association
AFA	alternative fee arrangement
ALF	alternative litigation financing
ALFA	American Legal Finance Association
HNWI	high-net-worth individual
ICJ	RAND Institute for Civil Justice
LFCMP	RAND Law, Finance, and Capital Markets Program
NPE	nonpracticing entity

Introduction

During the past few years, “third-party” financing of litigation activity in the United States has grown considerably and attracted attention from journalists, researchers, and policy advocates. The phenomenon of interest is provision of capital (money) by nontraditional sources to civil plaintiffs, defendants, or their lawyers to support litigation-related activities. Because *third-party financing* does not accurately describe the phenomenon of interest, particularly in the United States, in this paper I propose and use a new term that is more descriptive of the phenomenon: *alternative litigation financing* (ALF).

The term *third-party financing* invites confusion, particularly in the U.S. context, for the following reasons. The first two parties in a civil lawsuit are the plaintiff and the defendant. In the United States, it has become traditional for other parties to be involved in financing civil litigation. Most important in this regard are funding of plaintiffs’ legal costs by their attorneys under contingency-fee agreements¹ and funding of defendants’ legal costs by insurers.² In short, some forms of “third-party” financing are so familiar and ubiquitous that they have come to be widely accepted and in many cases not even recognized as litigation financing by nonparties to the litigation. The subject of this paper is litigation financing in the United States³ by entities other than plaintiffs, defendants, their lawyers, and defendants’ insurers.

As emphasized and elaborated in this paper, ALF in the United States involves diverse types of litigation financing.⁴ More specifically, there are three forms of ALF that are currently fairly common in the United States. These are (1) consumer legal funding, which involves provision of non-recourse loans directly to consumer (i.e., individual) plaintiffs with pending lawsuits; (2) subprime lending to plaintiffs’ law firms (i.e., firms whose litigation work is largely concentrated in representing individuals with personal-injury claims); and (3) investments in commercial (i.e., business-against-business) lawsuits or their proceeds.⁵

There is almost no systematic empirical information about U.S. ALF activities or their effects on outcomes of social concern. Nonetheless, some have argued that ALF is unethical,

¹ An excellent source on plaintiffs’ law firms in the United States is Kritzer (2004).

² See Yeazell (2001) for a history of civil litigation financing in the United States.

³ Developments in other countries are not addressed in this paper.

⁴ The term *litigation* is used throughout this paper to refer to legal disputes even if they might be or are destined to be resolved through forms of alternative dispute resolution, such as arbitration.

⁵ This paper focuses on these three types of ALF. I do not consider other business models that may emerge for companies that finance litigation. I also do not consider other types of transactions that might be viewed as nontraditional or alternative means of financing pursuit of legal claims, such as plaintiffs’ attorneys pooling their resources to pursue a large class action or a mass tort, or transfer of legal claims as part of a bankruptcy proceeding.

have predicted that ALF will lead to various socially undesirable outcomes, or both. Accordingly, they have called for extensive regulation or prohibition of ALF (e.g., Beisner, Miller, and Rubin, 2009; Presser, 2009; Rubin, 2009).

In this paper, I consider ethical and economic issues related to ALF in the United States and provide an overview of its current status and potential futures. My main goals are to help public policymakers,⁶ legal practitioners, legal scholars, and social scientists understand the current status of ALF in the United States, the growing literature, and the emerging policy debate. More specifically, this paper provides perspectives and analyses of (1) the ethics (a term with various meanings) of ALF, (2) the ethics of litigation-related activities that might accompany ALF, (3) the plausibility of various claims about the effects of ALF to date, and (4) how future developments in ALF markets—such as growth and increasing competition—may affect its social costs and benefits.

⁶ Several types of policymaking institutions seem important in shaping the future of ALF in the United States, namely, bar associations; courts; legislatures; law-enforcement officials, such as state attorneys general; and regulators of companies that might wish to supply capital to finance litigation, such as banks and insurance companies.

Overview of This Paper

In this section, I describe the nature of the analysis, introduce five distinctions that many apparently fail to appreciate, and provide an overview of the organization of the remainder of the paper.

Nature of the Analyses, Information Sources, and Methods

This paper interprets and synthesizes information from many sources and offers opinions as well as analyses. Due to a dearth of systematic empirical information, much of the analyses is conceptual (theoretical) and applies standard microeconomic principles and perspectives. The conceptual analyses, however, are grounded in empirical information of various types and from various sources.

My sources of empirical information are diverse. They include descriptive and analytical articles focusing on ALF in the United States and abroad published in scholarly, trade, and popular media¹ as well as publicly available, unpublished scholarly papers located by searching the Internet and the Social Science Research Network database (Social Science Research Network, 2010).² Other sources of empirical information include 17 semistructured interviews I conducted (most often by telephone) with participants in ALF markets, lawyers at law firms and corporate legal departments, and experts in the objectives and management of corporate law firms and corporate legal departments.³ Additional information was obtained from the websites of ALF companies, a trade association of providers of consumer legal funding, and corporate law firms. The analyses also rely on conceptual and empirical literature as well as advocacy pieces related to contingency-fee lawyers and their behavior, the economics of civil litigation in the United States, access to justice for civil litigants, and the future of the U.S. legal-services industry.

¹ Generally, I treat as accurate information reported by journalists (for trade or popular media) as long as that information seems consistent with other information reviewed. I cannot, of course, verify the accuracy of information reported by journalists.

² Last searched on February 19, 2010.

³ Whom I interviewed and specifics of what they told me are confidential. In the analyses that follow, I rely primarily on publicly available information. In some instances, I use information from interviews and some informal conversations and support it merely by writing “I have been told that . . .” or other vague phrases to indicate that I cannot be more specific about my source. The interviews were invaluable in alerting me to and helping me understand issues, providing food for thought, and identifying sources of information.

Finally, this paper also benefits from my attending and reading materials distributed at two recent conferences on ALF—one at the RAND Corporation in Santa Monica, California, on June 2, 2009,⁴ and another at the Northwestern University Law School in Chicago on September 24–25, 2009⁵—and reading materials distributed at the U.S. Chamber Institute for Legal Reform’s 10th Annual Legal Reform Summit, held in Washington, D.C., on October 28, 2009.⁶

Five Underappreciated Distinctions

There are five important, policy-relevant distinctions for thinking clearly about ALF and its public-policy implications. Failure to attend to these distinctions causes considerable confusion in the policy debate and in the literature. These distinctions are between

1. Legal ethics and morality as the latter is understood by moral philosophers, for example. This distinction and its importance are discussed in Section 4.
2. Ethical and instrumental considerations, where *instrumental* refers to considerations pertaining to social concerns other than legal ethics and social morality. Most of what follows addresses instrumental considerations.
3. Different types of ALF, such as the three that appear to account for the lion’s share—and, perhaps, almost all—of current ALF activity in the United States. These types of ALF are described in Section 3 and are distinguished in the many instances below in which an issue or idea does not pertain to all three of them.
4. Effects of ALF in the near and longer terms. As elaborated in Section 6, the near-term effects of ALF of various kinds are relevant to public policymakers, but effects over the longer time term are also policy-relevant, and the latter effects may differ greatly from the former.
5. Activities that are intrinsic to ALF—that is, are defining characteristics of ALF—and activities that might accompany ALF but are not necessary for ALF to exist in some forms. This distinction is important because, at least in principle, the latter kinds of behavior could be controlled or limited—for example, by well-designed regulations—without banning ALF in its entirety, as some have proposed.

Organization of This Paper

The remainder of this paper is organized as follows. The next section provides an overview of the U.S. ALF industry as of early 2010. The focus is the three major active segments of the U.S. ALF industry, which comprise three largely independent markets that differ in many important ways. The information in this section provides essential background for what follows.

⁴ See McGovern et al. (2010) for an extensive account of the conference.

⁵ The papers presented and discussed were Abramowicz (2009), Dana and Schanzenbach (2009), Molot (2009b), Presser (2009), and Rubin (2009).

⁶ The papers presented were Beisner, Miller, and Rubin (2009), Molot (2009b), Presser (2009), and Rubin (2009).

Section 4 discusses the ethics of ALF and ALF-related activities from the perspectives of both legal ethics and social morality. The considerations discussed there lead me to conclude that there is no compelling moral argument for either banning or for allowing ALF, and thus economic and other social effects of ALF should be of interest to makers of public policy.

In Section 5, I apply standard microeconomic perspectives to consider how ALF is likely to affect civil litigation and its outcomes currently and in the near future. More specifically, I consider potential effects of ALF on the quantity and quality (degree of legal merit) of litigation, likelihood and timing of settlements, fairness of settlements, and transaction costs of litigation. I also comment on special considerations related to class-action and patent-infringement litigation.

In Section 6, I look further into the future, because longer-term effects of ALF might appropriately dominate public policy evaluations of various forms of ALF and because future effects may be very different from current and near-term effects. The discussion in this section emphasizes the social goals of fairness and economic efficiency. I pay particular attention to how markets for the three currently prominent types of ALF may grow and otherwise evolve, the extent to which we can rely on competition and other market forces to promote economic efficiency, and what appear to me to be important impediments to achieving efficiency if we rely entirely on market forces. Section 7, which concludes, focuses on lessons for policymakers for the near term.

A Snapshot of the U.S. ALF Industry, as of Early 2010

In this section, I describe—to the extent that available information allows—the state of ALF in the United States during the first few months of 2010. It appears that, at the present time, there is very little ALF for defendants, and, accordingly, the discussion here focuses on ALF that provides capital to plaintiffs or their attorneys.¹

Key Terms

For clarity and economy in exposition, let us start by defining several terms:

- *ALF demanders* (or *potential recipients*) of ALF are individuals or organizations that might be willing to pay money for litigation-related financing.² ALF demanders may or may not actually receive ALF—this depends on what financing opportunities are available to them and whether they are willing to pay what ALF suppliers require to make a deal.
- *ALF suppliers* are individuals or organizations that provide capital to be used to support litigation-related activities, whether they contract directly with ALF demanders or supply capital to demanders indirectly.
- *ALF companies*—a subset of ALF suppliers—are business organizations that supply ALF directly to ALF demanders (or recipients) *and* for which supplying ALF is their only or primary business activity.
- The *ALF industry* is the collection of all ALF suppliers.
- *ALF industry segments* are collections of ALF suppliers that provide different forms of ALF, provide capital to ALF demanders of different types, or both.

¹ Molot (2009a) discusses many issues related to developing markets for litigation risk of corporate defendants, including sources of demand for ALF by corporate defendants and obstacles to ALF contracting, such as the unlimited downside litigation risk of defendants, adverse selection, and moral hazard. One particularly interesting insight is that many people believe that markets for litigation risk are not feasible because of difficulties in pricing litigation risk, but Molot (2009a, p. 385) argues intriguingly that “It is the absence of a market that makes pricing difficult, not the other way around.” Other reasons that defense-side ALF is currently rare in the United States might include that (1) defendants and their lawyers may typically have better access to capital than do individual plaintiffs and their lawyers, and (2) many corporate defendants have insurance (such as general liability insurance) that covers legal costs. Lindeman (2010, p. 3) reports that some providers of plaintiff-side ALF are also interested in providing defendant-side ALF.

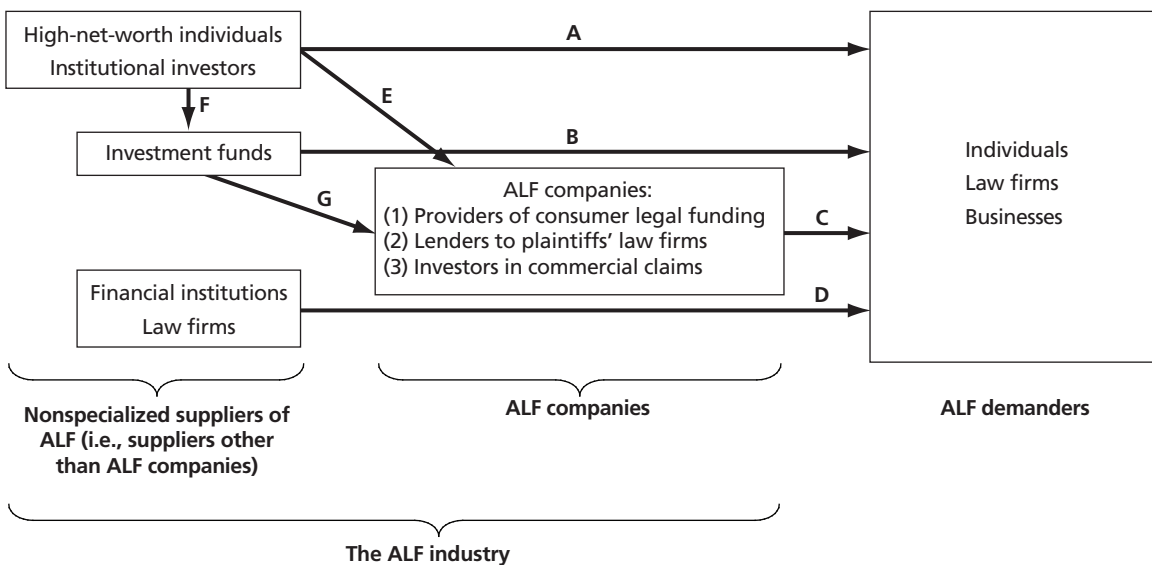
² The term *demanders* is used here as it is commonly used in microeconomics, namely, to refer to potential purchasers of a good or service, and this term is not intended to imply how valuable ALF might be to such potential recipients or whether they seek out ALF.

Overview of the U.S. ALF Industry in Early 2010

Figure 1 provides a visual overview of the ALF industry and ALF demanders. On the right side of the diagram are ALF demanders. As indicated in the figure, there are three (main) types of demanders who currently receive ALF in the United States: individuals with pending legal claims, law firms, and businesses with legal claims. As also indicated in the figure, demanders of ALF may receive capital directly from or contract with high-net-worth individuals (HNWIs) and institutional investors³ (arrow A); investment funds, such as hedge funds⁴ (arrow B); ALF companies (arrow C); and business organizations, such as financial institutions and law firms⁵ (arrow D).

As shown in Figure 1, there are three main kinds of ALF companies currently active in supplying ALF: (1) companies that provide consumers with legal funding, (2) companies that lend to plaintiffs' law firms, and (3) companies that invest in commercial (i.e., business-against-business) claims on the plaintiff side. Figure 1 also indicates the main sources of capital for ALF companies, namely, HNWIs and institutional investors, either directly (arrow E) or indirectly through investment funds (arrows F and G).⁶

Figure 1
Routes from Suppliers of Capital to Demanders of ALF



RAND OP306-1

³ There is very little publicly available information about such funding, which does not imply that there is very little such activity. More specifically, such financing arrangements would involve private contracts between HNWIs or institutional investors and individual or organizational demanders of ALF. (Organizational demanders of ALF include law firms and businesses.) HNWIs and institutional investors generally have no desire or obligation to inform the public about their activities.

⁴ A caveat: In this paper, I use terms such as *investment funds* and *hedge funds* as descriptions of the main functions of organizations, not as labels describing their legal forms as they relate, for example, to tax and regulatory treatment.

⁵ These organizations supply ALF but are not ALF companies (as defined) because supplying ALF is not their primary business.

⁶ The names of individuals and institutions that supply capital to privately held ALF companies are typically proprietary.

The following three subsections describe the three types of ALF that are most common in the United States at the present time.⁷ These three types of ALF involve different types of ALF companies, ALF demanders, and contracts between ALF suppliers and ALF demanders.⁸ It is crucial to distinguish these segments, because activities in the different segments raise different ethical and economic issues, despite some prominent recent suggestions to the contrary.⁹

Consumer Legal Funding

In this segment of the ALF industry, several dozen ALF companies provide money to consumers (individuals) with pending legal—typically, personal-injury—claims.¹⁰ To be eligible for such funding, it appears that a consumer must have an attorney who has agreed to represent him or her in pursuing the claim. And, since almost all of the underlying lawsuits involve personal-injury claims, it is likely that almost all consumers receiving this form of litigation funding are being represented on a contingency-fee basis. In what follows, I assume (often implicitly) that recipients of consumer legal funding have engaged their attorneys on a contingency-fee basis.

In a typical transaction in this segment, an ALF company contracts with a consumer—sometimes before and sometimes after his or her case is settled.^{11,12} The ALF company provides funds to the consumer, and, in return, the consumer agrees to pay the ALF company—subject to a crucial proviso explained presently—the funds received plus fees detailed in the contract. These financing fees seem typically to increase with the elapsed time from the provision of the funds to the date on which the consumer pays the funder, but the contracted fees do not depend on the total recovery in the underlying lawsuit or the amount of the recovery received by the consumer plaintiff. Contractually specified fees may, for example, be (1) detailed in a schedule containing payment dates and the total fees or total amount owed by the consumer on those dates, or (2) determined using a formula involving a percentage applied monthly (for example) to the amount of funding provided. Crucially for both legal and analytic reasons, these contracts are typically *non-recourse loans*, meaning that consumers are obligated to pay their ALF suppliers the *minimum* of (1) the amount specified in the contract (given the time

⁷ Molot (2009b, p. 21) refers to these three segments as “the limited markets in litigation claims that already exist.”

⁸ It appears that most of the ALF companies in the three ALF industry segments described presently (whose names are listed in Tables 1, 2, and 3) specialize in only one of the segments. The exceptions appear to be companies that provide both consumer legal funding and loans to plaintiffs’ law firms.

⁹ For example, Beisner, Miller, and Rubin (2009), Presser (2009), and Rubin (2009) argue for banning or limiting ALF without distinguishing among types of ALF.

¹⁰ Unlike the other two segments of the ALF industry discussed in the next two subsections, the consumer-legal-funding segment has received substantial attention in law review articles, such as Barksdale (2007), Grous (2006), Hananel and Staubitz (2004), Martin (2004, 2008), Richmond (2005)—who also considers loans to plaintiffs’ law firms—and Swan (2001). All of these articles discuss legal issues related to this type of litigation financing.

¹¹ Even after a claim is settled, it can take several months for the settlement payment to be made and the consumer to receive his or her share of the recovery.

¹² Grous (2006) provides a fairly extensive description of the processes involved in consumer legal funding and how transactions are often structured, with an emphasis on a particular funder (Oasis Legal Finance). She also notes that processes vary considerably across funders and provides some unsystematic empirical information related to that point. See also Barksdale (2007, sec. II).

of payment) and (2) the consumers' proceeds from the underlying lawsuit. Thus, by contract, a consumer is obligated to pay his or her ALF company no more than what he or she receives as proceeds from the underlying lawsuit, and any excess amount specified in the contract is forgiven.

Besides *consumer legal funding* and *non-recourse loans*, many terms are used by ALF companies and industry outsiders to describe transactions in this segment. Such terms include *cash advances*, *legal funding*, *plaintiff funding*, and *pre-settlement funding*. Terminology is a sensitive issue because some imprecise terms could be inappropriately interpreted as legal terms of art. For example, a contentious issue in the literature and in some states is whether consumer-legal-funding transactions should be treated for legal purposes as loans and consequently whether laws or regulations applicable to loans—such as usury or truth-in-lending laws—apply as a legal matter to these transactions. I have been told by segment insiders that the term they prefer is *consumer legal funding*.¹³

In this paper, for expositional convenience, I use interchangeably three terms to refer to ALF transactions in this segment of the ALF industry: *consumer legal funding*, *cash advances*, and *non-recourse loans*. All of these terms are useful for the purposes of this paper because they help readers remember what activities are involved in this segment and none of them is descriptive of transactions in either of the other two segments. I emphasize that my terminology is chosen solely for the purposes of this paper, and *no legal or regulatory implications are intended or should be inferred by my choice of terms*.

Table 1 lists the names and websites of 29 ALF companies that apparently were providing consumer legal funding in the United States during the first few months of 2010. In the table, these companies are distinguished according to whether they were members of the American Legal Finance Association (ALFA), a trade group (American Legal Finance Association 2010a). These 16 companies are listed in the top panel of Table 1, while 13 other ALF companies that also apparently provide funding to consumers with pending legal claims are listed in the bottom panel.¹⁴

Several of the companies listed in Table 1 report on their websites the kinds of legal claims for which non-recourse loans are available. Broadly, personal-injury claims are most prominent in these lists, with some companies apparently specializing in personal-injury claims, generally or of specific types. Several companies also mention employment-liability claims. I have been told that most of the underlying lawsuits, in fact, involve auto accidents.¹⁵

A demander of consumer legal funding—again, an individual with a pending lawsuit who is represented by an attorney working on a contingency-fee basis—may have various motives for applying for and accepting non-recourse loans. These motives range from avoiding homelessness to assuring receipt of at least some money from (i.e., partially *monetizing*) their legal claims even if the underlying lawsuit results in no recovery. Apparently, as discussed below, if expressed as a monthly percentage of the amount advanced, financing fees can substantially exceed interest rates on credit card balances or consumer bank loans. Presumably, then, most recipients of non-recourse loans either have exhausted their ability to obtain financing from more common sources or they are attracted to legal funding because they like the fact

¹³ As reported to the author in a private email from Harvey Hirschfeld, Chairman of the American Legal Finance Association (ALFA), April 4, 2010. This source also reports that most often, as a legal matter, these transactions are structured as “purchase agreements,” which themselves have at least somewhat different legal definitions in different states.

¹⁴ I have been told that there are perhaps 80 or so such nonmember companies.

¹⁵ Private email from Harvey Hirschfeld, Chairman of ALFA, April 4, 2010.

Table 1
ALF Companies Offering Consumer Legal Funding to U.S. Plaintiffs,
as of Early 2010

Company Name	Website
ALFA members (as of February 2010)	
Allied Legal Funding	www.alliedlegalfunding.com
Barrister Capital Group, LLC	www.barristercapitalgroup.com
Cambridge Management Group, LLC	www.cmgcash.com
Case Funding	www.casefunding.com
Global Financial Credit, LLC	www.glofin.com
Golden Pear Funding	www.goldenpearfunding.com
LawCash	www.lawcash.net
Lawsuit Cash Advance	www.lawsuitcashadvance.com
Magnolia Legal Funding	www.magnoliafunding.com
Oasis Legal Finance, LLC	www.oasislegal.com
Plaintiff Investment Funding, LLC	www.legalfundingnow.com
Plaintiff Support	www.plaintiffsupport.com
Preferred Capital Funding	www.preferredcapitalfunding.com
PS Finance	www.psfinance.com
The Law Funder	www.lawfunder.com
USClaims	www.usclaims.com
Selected other cash-advance companies	
American Legal Funding	www.americanlegalfunding.com
Bridge Funds	www.bridge-funds.com
Case Advance	www.caseadvance.com
Chestnut Hill Funding	www.chestnuthillfunding.com
Fair Rate Funding	www.fairratefunding.com
Interim Funding, Inc.	www.interimfundinginc.com
Law Capital Enterprises, LLC	www.lawcapital.com
LawMax Legal Finance	www.fundmycase.com/en/index.php4
Legal Funding Group, LLC	www.legalfundinggroup.com
Litigation Capital Investors	www.cash-now-for-accident-cases.com
Plaintiff Funding Service	www.PlaintiffFunding.com
SMP Advance Funding, LLC	www.smpadvance.com
Whitehaven	www.whitehavenplantiffunding.com

that the amount they must repay can be no larger than the amount they recover from their lawsuits. For some consumers, accepting legal funding may be necessary to pay their rent, mortgage, or medical bills. For others, the need for cash may be less pressing—for example, I have been told by a plaintiffs’ attorney that clients with pending lawsuits have been known to use non-recourse loans to take a vacation or buy Christmas presents.

There is no systematic empirical information about typical sizes of transactions in this segment. I have been told, however, that two industry leaders estimate the average sizes of their cash advances to be \$1,750 and \$4,500, and that advances average less than 10 percent of conservatively estimated values of the underlying legal claims.¹⁶ Swan (2001, p. 824) reports that most funders “advance a maximum of \$20,000 to individual plaintiffs.”

Similarly, there is no systematic empirical information about the sizes of financing fees. The information that is available suggests a fairly wide range, at least some of which is likely to be attributable to differences across underlying lawsuits (e.g., the likelihood of success and plausible range of consumer recovery), the amount of the funding relative to the likely levels of recovery by the consumer, and how long it is likely to take for the underlying lawsuit to be resolved. Molot (2009b, p. 24) refers to “the very high interest rates charged by cash advance firms—typically 3–5% monthly interest and often much higher.” In a recent television interview the president of a cash-advance company indicated that monthly fees of 2 to 4 percent are fairly common (CNN transcript, 2010). Finally, I have been told that currently some companies charge less than 2 percent per month.¹⁷

It appears that many consumer-funding companies advertise to generate applications. For example, many of them advertise through sponsored links on such search engines as Google, as is apparent from “Googling” terms such as *litigation financing* or *litigation funding*. I have also been told that many of the companies promote their services at meetings of plaintiffs’ attorneys and through advertisements in publications read by plaintiffs’ attorneys, such as *Trial*. In addition, at least one consumer-funding company advertises on television (CNN transcript, 2010).

Finally, many legal scholars and commentators have expressed concerns about the ethical or practical implications of consumer legal funding. Concerns they express include the level of fees and whether recipients truly understand the implications of the contracts they sign.¹⁸ Moreover, I have been told that many plaintiffs’ attorneys are concerned that clients who have agreed to non-recourse loans might refuse reasonable settlement offers because these offers would leave the clients with little or no money after paying the funding company.¹⁹ (Potential effects of consumer legal funding on settlement behavior and settlements are considered later in this paper.)

¹⁶ As reported to the author in a private email from Harvey Hirschfeld, Chairman of ALFA, April 11, 2010.

¹⁷ Private email from Harvey Hirschfeld, Chairman of ALFA, April 4, 2010. Websites of ALF companies in this segment typically do not report levels or ranges of financing fees. An exception is <http://www.advancelawsuitfunding.com/terms.html> (visited April 7, 2010), which suggests that fees charged by some ALF suppliers in this segment can be considerably more than 2 percent per month.

¹⁸ See, for example, Barksdale (2007), Hananel and Staubit (2004), and Shaltiel and Cofresi (2004). ALFA members agree to abide by a code of conduct—see American Legal Finance Association (2010b)—that addresses various consumer-protection concerns (no deceptive advertising, no intentional overfunding, no referral fees paid to applicants’ attorneys or law-firm employees) and legal-ethics concerns (no acquisition of the claim, no interference with or participation in the litigation). The only element of the code that seems to address concerns about whether applicants understand their contracts and their financial implications requires “written acknowledgment from the consumer’s attorney.” The code is silent on the levels of financing fees.

¹⁹ A real-life example of this possibility is described in CNN transcript (2010).

Loans to Plaintiffs' Law Firms

In this segment of the ALF industry, nine ALF companies that I have been able to identify provide loans and lines of credit to plaintiffs' law firms.²⁰ It appears that, typically, law firms' debts to ALF suppliers are secured by all of the assets of the firms, including future fees from their cases and real property, such as land, buildings, and equipment. Transactions in this segment, then, are not non-recourse loans, and financing costs are typically expressed as rates of interest.

Table 2 lists the names and websites of nine ALF companies that appear to be active in providing loans to plaintiffs' law firms. The final column of the table provides information about the kinds of credit that these firms offer, in the form of selected quotations from their websites found during February 2010. These quotations suggest that the major motives of ALF-applicant law firms are maintaining solvency or alleviating cash-flow problems.

The range of interest rates charged by ALF companies in this segment is unknown. Some hints suggest, however, that interest rates in the vicinity of 20 percent per year are not uncommon. Thus, presumably, plaintiffs' law firms that demand this form of ALF are unable to borrow from traditional lenders, such as banks or subprime lenders charging lower rates. In addition, using internal capital can be fairly unattractive to law firms because it involves using funds on which partners or equity-holders have already paid taxes.

I have no systematic information bearing on the typical sizes of loans or lines of credit in this industry segment. Nor is there systematic information about how demanders and ALF companies find each other, although there are hints that word-of-mouth among plaintiffs' attorneys; Internet advertisements, including sponsored links; ALF company websites; direct marketing to plaintiffs' lawyers; and activities by brokers all play some roles in this regard.

Investments in Commercial Claims

In this segment of the ALF industry, I've identified six ALF companies that are willing to provide capital directly to businesses or their outside counsel to finance costs of pending plaintiff-side commercial (business-against-business) claims. It appears that these ALF companies typically provide capital in exchange for a share of the eventual recovery by a corporate plaintiff,²¹ and the term *investment* is typically used to describe such transactions. Based on information on company websites, interviews, and public documents, such as official reports to shareholders by the two publicly held ALF companies in this segment, the types of legal disputes that seem to be the most commonly financed are antitrust, intellectual property, and contracts.²²

²⁰ In principle, such loans or lines of credit could also be provided to corporate law firms. It appears, however, that such financing is rare and perhaps nonexistent, possibly because corporate law firms typically have preferable financing options. In this paper, I emphasize loans to plaintiffs' firms by nontraditional lenders because there is a substantial amount of such activity.

²¹ A distinction that can be important in determining what laws or regulations, if any, do or should apply to these investments is whether they are, from a legal standpoint, investments in "claims" or investments in the "proceeds of claims." A key issue here is the extent to which ALF suppliers are or should be permitted to influence or control how the litigation is pursued. This distinction, however, is not important for the economic issues addressed later in this paper, and, thus, I do not elaborate on its legal or regulatory implications (which, in any case, are best left to lawyers).

²² According to Juridica Investments Limited (2010), as of February 1, 2010, its portfolio included 15 investments in a total of 23 cases comprising a total commitment of \$121.3 million; almost all of these investment dollars were committed to five antitrust cases (\$79 million) and 12 patent cases (\$36.6 million).

Table 2
ALF Companies That Provide Loans to Plaintiffs' Law Firms and Their Descriptions of Available Financing, as of Early 2010

Company Name	Website (homepage)	Description of Financing Offered (excerpted from company website, February 2010 ^a)
Advanced Legal Capital	http://advancedlegalcapital.com	"Our recourse financing in the form of loans or lines of credit are custom-designed for law offices . . . including contingency fee-based practices . . . Lines can range from \$100,000 to over \$10 million. Most importantly, your portfolio of cases is accepted as the main collateral." (http://advancedlegalcapital.com/NonRecourseAttorneyFunding.aspx)
Advocate Capital, Inc.	www.advocatecapital.com	"We provide innovative financial products designed to improve the profitability and cash flow of law firms."
Counsel Financial	www.counselfin.com	"We provide attorneys with flexible revolving credit lines up to \$25 million using the value of your contingent cases as collateral."
Evergreen Funding Group	www.evergreenfundinggroup.com	"Evergreen Funding Group provides a full range of litigation funding services for cases where a settlement of at least \$20,000 is expected so you can achieve a successful outcome for your clients and law firm financing solutions so you can grow your practice." (http://www.evergreenfundinggroup.com/Attorney.html)
LawFinance Group, Inc.	www.lawfinance.com	". . . our loan program . . . provides larger revolving and term loans based on the collateral value of the firm's entire portfolio of active cases, including contingency fees, cost reimbursement rights and accounts receivable." (http://www.lawfinance.com/solutions_firm.php)
Oxbridge Financial Group LLC	www.oxbridgefg.com	"Most banks will give lawyers small lines of credit. They often won't offer the amount of financing needed to work up your cases, maintain a steady income and cover your office expenses. Oxbridge Financial Group LLC can do what banks won't. We can help your firm grow." (http://oxbridgefg.com/legal_how_work.html)
Rapid Funds	www.rapidfunds.com	"When a settlement is confirmed . . . RapidFunds® can provide either the full amount, or an agreed-upon portion of the attorney's fee, the client's proceeds, or both, slightly discounted from the full value of the funds." (http://www.rapidfunds.com/about.html)
RD Legal Capital	www.legalfunding.com	"An Attorney's Line of Credit from RD Legal Funding provides the financial flexibility you need to maximize cash flow and take advantage of growth opportunities." (http://www.legalfunding.com/lineofcredit.php)
ViaLegal Funding	www.vialegalfunding.com	"ViaLegal Funding provides attorneys with loans and advances using the value of contingency cases as collateral."

^a Quotations are excerpted from the company website's homepage unless otherwise indicated.

Table 3 lists the names and websites of six ALF companies that seem to have been investing or were apparently willing to invest in commercial lawsuits in the United States during the first few months of 2010. These companies were identified partly from interviews and partly

Table 3
ALF Companies That Invest Commercial Claims in the
United States, as of Early 2010

Company Name	Website
ARCA Capital	www.arcacap.com
Burford Capital	www.burfordcapital.com
Calunius Capital	www.calunius.com
IMF (Australia)	www.imf.com.au
Juridica Investments	www.juridicainvestments.com/
Juris Capital	http://www.juriscapitalcorp.com/

from popular press and legal-trade articles, such as Demos (2009), Glater (2009), Jones (2009), and Hamerman (2010).²³

It seems that virtually all of the activity in this segment currently supports corporate plaintiffs with legal claims against other businesses. Demanders could have various reasons for wanting to exchange shares of the recoveries from their claims for financial capital. Potential motives for companies to consider ALF include the following. First, and seemingly foremost, many companies simply want to use less of their own capital to pay their outside counsel. Second, some commercial plaintiffs may seek ALF to obtain assessments of the legal merits and likely economic values of their claims to supplement those provided by their outside counsel. Third, since provision of ALF for a particular claim might send a signal to the defendant that the claim is of high quality, some companies might accept ALF (and reveal this to the other side) in hopes of strengthening their bargaining positions in settlement negotiations. Finally, in some instances, corporate legal departments may prefer using outside capital to requesting additional funds from corporate management to pursue litigation opportunities that were not identified in time to be considered in budgeting processes.²⁴

Law firms representing corporate plaintiffs might also be demanders of ALF. For example, they might want to arrange for investments in particular commercial claims on which they are working to shift some of the risk involved in contingency-fee or other alternative (to hourly) billing arrangements,²⁵ or to smooth their cash flows. Note, however, that business plaintiffs might want to shift risk to their law firms as a means of providing incentives for them

²³ Credit Suisse is often mentioned in articles about investing in commercial lawsuits in the United States. Credit Suisse is not, however, an *ALF company* as defined in this paper—and, thus, not listed in Table 3—because supplying ALF is not the principal business activity of Credit Suisse.

²⁴ The importance of this motive is unclear. Some of the people I interviewed told me that corporate general counsel are typically loathe to request budget increases, while others insisted that this is rarely the case.

²⁵ It appears that *alternative fee arrangements* (AFAs) for corporate law firms—i.e., alternatives to the billable hour—are becoming considerably more common (e.g., Jeffrey, 2009), although they are far from representing a large proportion of revenues for large corporate law firms (Loomis, 2009), and they appear to be more common for transactions than litigation work. AFAs take various forms, such as contingency-fee, partial contingency-fee, fixed-fee, discounted hourly rates with the possibility of multipliers or bonuses based on case outcomes, and so on. Ribstein (2010, pp. 18–20) views “the decline of hourly billing” as a major pressure on the business models of large corporate law firms and discusses forces tending to undermine the viability of hourly billing. Some major corporations—such as DuPont (Sager, 2006; Goehl, no date) and Pfizer, Cisco Systems, Clorox Company, FMC Technologies, Sun Microsystems, and United Technologies—appear to strongly

to economize on legal costs; in such instances, the corporate plaintiff might prefer that its law firm bears this risk rather than shift it to an ALF company.

The only three ALF companies listed in Table 3 about which substantial information is available are Juridica and Burford—because they are public companies and, as a result, are obligated to publicly report substantial information for investors—and ARCA—because they have publicly released brochures describing their business (ARCA Capital Partners LLC, no date[a], no date[b]).²⁶ In addition, top managers of these companies have provided useful information to various journalists, many of whose articles are cited in this paper.

Juridica and Burford appear to be focusing on investing in claims owned by major corporations that are represented by major law firms.²⁷ ARCA appears to be targeting smaller businesses, namely, “lower and middle market business enterprises” (ARCA Capital Partners LLC no date[a], p. 2).

It appears that investments in this segment are typically a few to several million dollars. For example, the average for Juridica as of June 2009 was about \$7.5 million, and Juris Capital “typically invests \$500,000 to \$3 million in a case” (Glater, 2009). In addition, Burford reports “The Company expects its average investment commitment to exceed \$3 million, and in many cases to be in the \$5–\$15 million range” (Burford Capital, no date). Finally ARCA indicated a “funding capacity per claim” of \$1 to 20 million (ARCA Capital Partners LLC, no date[b], p. 2), but, as of early 2010, it apparently had not committed any of its investment capital of \$110 million (Lindeman, 2010, p. 3).

While sources of funds for ALF companies are typically not revealed publicly, both Burford and Juridica are public companies, and they report their major shareholders. For both companies, the lion’s shares of the stock are held by investment companies (Burford Capital, 2009a; Juridica Investments Limited, 2009b).

prefer alternatives to hourly billing for defense-side litigation, plaintiff-side litigation, or both (Loomis, 2009; Miller, 2010). Goehl (no date) and Miller (2010) name several prominent law firms that have worked on litigation matters under AFAs.

²⁶ These brochures were downloaded from the ARCA website (aracap.com) on October 14, 2009. During a subsequent visit to that website in late February 2010, it appeared that these brochures were no longer available for download.

²⁷ According to Juridica Investments Limited (no date) “Juridica’s customers are Fortune 1000 companies, FT Global 500 companies, inventors, major universities, and the leading law firms that represent them.”

Different Meanings of *Ethics* and Implications for ALF Activity

The behavior of lawyers is regulated in various ways in various states, including common law, statutes, and rules of professional conduct. In this section, I discuss potential implications for ALF of laws and professional rules applicable to lawyers, as well as other perspectives on ethics. Some arguments that have been made against ALF or activities that might accompany or result from ALF boil down to “this is just plain wrong and, therefore, we should not allow ALF in the United States.” Such arguments are often couched in terms of ALF being “unethical.” But the term *unethical* has various meanings.

The key distinction is between (1) *unethical* as the term is understood by lawyers when they are thinking in terms of laws governing lawyers or rules of professional responsibility—i.e., unethical from the perspective of legal ethics—and (2) *unethical* as the term is understood in moral philosophy or intuitively by many people. Guidelines for legal ethics are exemplified by the American Bar Association (ABA) (2009), which does not apply directly to any lawyers because lawyers are not regulated by the ABA. Earlier versions of the ABA’s model rules have, however, been adopted or adapted and implemented in almost all states. Professional rules are important to lawyers because they take legal ethics seriously as a matter of professionalism and because lawyers who violate the legal-ethics rules can be disciplined and sanctioned.

In writings about ALF and the associated public-policy debate, the distinction between legal ethics and morality seems underappreciated or is blurred for advocacy purposes. This lack of clarity tends to undermine the quality of the policy debate. In this section, I discuss various perspectives on the ethics of ALF while explicitly distinguishing between issues that pertain to legal ethics and issues that pertain to social morality. The next two subsections focus on issues related to legal ethics, and they emphasize the distinction between laws and rules that might proscribe ALF and laws and rules that might limit activities that might accompany ALF. The section concludes with a discussion of moral principles that might be relevant to public policy regarding ALF.

Laws and Professional Rules That Could Proscribe ALF

Historically, champerty and maintenance have been proscribed by common law, statutes, rules of professional conduct for lawyers, or some combination of these.¹ Stated simply, “Maintenance is the provision of support for a lawsuit to which one is not a party[,] and champerty, a

¹ Hananel and Staubitz (2004), Martin (2004), and Richmond (2005) provide extensive discussions of how laws and professional rules might pertain to consumer legal funding.

form of maintenance, involves acquiring an interest in the recovery from the lawsuit.” (Molot, 2009b, p. 25, fn. 88).² The current laws and rules vary across jurisdictions. More specifically, Sebok (2010, pp. 44–45) writes, “Twenty-eight of fifty-one United States jurisdictions (including the District of Columbia) explicitly permit champerty, albeit with varying limitations.” Sebok (2010, p. 54) also writes, “Of the twenty-eight states that permit maintenance in some form, sixteen explicitly permit maintenance for profit. The remaining states probably permit champerty—it is just that they do not explicitly cite the investment by contract into a stranger’s suit as a permissible form of maintenance” (footnotes omitted). Bond (2002, appendix) provides an overview of case law pertaining to champerty in the 50 states and the District of Columbia.³

In jurisdictions where champerty and maintenance are proscribed, some forms of ALF may run afoul of the law, professional rules, or both. In fact, as described by Molot (2009b), the forms of ALF that are currently available and how contracts are designed may reflect to a considerable degree concerns about violating laws or professional rules.⁴

Laws and Professional Rules That Could Limit Activities That Might Accompany ALF

Opponents of ALF also sometimes argue that ALF should be proscribed because if ALF is allowed, then other laws or professional rules will be violated.

For example, some have raised concerns that ALF will lead ALF suppliers to influence decisions by claimants and their lawyers in inappropriate ways. A fairly common term for inappropriate influence or control by an entity that is not party to a lawsuit or a lawyer working on the lawsuit is *intermeddling*. Sebok (2010) helpfully distinguishes between *whether* and *how* lawsuits may be “maintained for profit”: “The most common way states control the ‘how’ question in champerty is by limiting how much *control* the investor has over the conduct of the litigation into which she has put her money” (p. 55) and “Intermeddling profit maintenance can take many forms, and there is no common test to determine whether the maintainer has crossed the line into intermeddling” (p. 60). See Sebok (pp. 55–60) for further discussion of current law related to intermeddling.

Some discussions of concerns about control of lawsuits by ALF suppliers imply that ALF *creates* conflicts of interest between lawyers and their clients (e.g., Beisner, Miller, and Rubin, 2009, p. 8). I note in this regard that contingency-fee lawyers have an inherent conflict of financial interest with their clients even without ALF. For example, Miller (1987, p. 190, footnote omitted) writes, “the interests of plaintiff and attorney are never perfectly aligned. One

² Contingency-fee arrangements are excepted from rules on champerty and maintenance.

³ Sebok (2010, p. 45, fn. 150), the drafting of which was completed in February 2010, reports that his summary statements are based on his own “survey of the current state of the law” and that his assessments are consistent with those of Bond (2002, appendix).

⁴ Regarding consumer legal funding, “by charging a fixed interest rate, rather than taking a share of the plaintiffs’ recovery, cash advance firms avoid prohibitions against champerty and maintenance” (Molot, 2009b, p. 25). Regarding lending to plaintiffs’ law firms, Molot (2009b, p. 28) writes, “Lawyers are, however, permitted to borrow money.” Regarding investments in commercial lawsuits, “Champerty and maintenance restrictions typically are not interpreted to apply to commercial plaintiffs, and where they might apply, they are easily avoided by selling interests in corporate entities, rather than in lawsuits directly” (Molot, 2009b, p. 35). See Molot (2009b) for further discussion.

point of potential conflict arises in the evaluation of settlement offers The law purports to resolve this problem by giving the ultimate power of decision to the plaintiff” The more appropriate question, then, is whether ALF would *exacerbate* (rather than create) such conflicts of interest.

Another concern that has been raised about ALF pertains to professional rules prohibiting lawyers from splitting fees with nonlawyers, as described by part of ABA’s Model Rule 5.4, which is called “Professional Independence of a Lawyer,” thus suggesting the broader concern that prohibitions of fee splitting are intended to address. Prohibitions on lawyers sharing fees with nonlawyers apply in all states, but not in the District of Columbia (Molot, 2009b, p. 28).

Another concern is that the due diligence (case-evaluation) processes involved in some forms of ALF might result in inadvertent waivers of lawyer-client and work-product privileges. For example, as Beisner, Miller, and Rubin (2009, p. 8) write,

In order to evaluate a plaintiff’s claim . . . a litigation financing company generally will ask to evaluate confidential, and possibly privileged, information belonging to the plaintiff. If the plaintiff elects to provide the information to the financing company, any privilege protecting it likely would be waived.⁵

Sebok (2010, p. 87) makes a similar point but adds, “the litigant’s lawyer may not be able to give the client a clear answer [as to] whether under these circumstances she is in fact waiving privilege at all. The uncertainty surrounding this question is quite real” (footnotes omitted). Finally, Molot (2009a, pp. 391–392) discusses some legal theories that might allow due diligence by ALF companies while protecting attorney-client and work-product privileges.

In sum, the applicability of various laws and professional rules for lawyers is uneven across U.S. jurisdictions, and in many cases implications of the rules for ALF are unclear. For example, Lindeman (2010, p. 7) quotes Stephen Gillers, a legal-ethics expert, as follows: “The way established doctrines apply is quite uncertain. It is likely that judges will be quite suspicious of anything like this that is still in its infancy.”

Moral Considerations

The various laws and professional rules that make up legal ethics often seem less than compelling to those who have not been trained as lawyers. Philosophers grapple with questions such as right versus wrong and the meaning of justice in their subfield called *ethics* or *moral philosophy*. Policymakers, including those who have been trained as lawyers and indoctrinated in legal ethics, should also be interested in moral arguments concerning ALF, potential related activities, and their practical consequences.

Not surprisingly—after all, few moral principles command nearly unanimous respect—moral considerations explicitly or implicitly raised by the ALF debate can have conflicting implications for policymakers. In short—and, as illustrated presently—it appears that there is no compelling moral argument for either allowing or banning ALF or ALF-related activities.

⁵ These authors also express concern about potential waivers of privilege deterring lawyers from providing clients with “full and candid advice in writing” (Beisner, Miller, and Rubin, 2009, p. 8).

Many would view access to justice—with *justice* satisfactorily defined—as being socially desirable on the basis of moral considerations. Public-policy implications related to ALF of accepting this view, however, can sharply conflict, with some believing that proscribing or regulating plaintiff-side ALF would (more often than not) promote access to justice, and others believing the opposite. More specifically, among those who believe that plaintiffs are much more often disadvantaged in civil litigation than defendants and that additional litigation attributable to ALF will be predominantly legally meritorious, ALF is likely to be viewed as desirable from a moral perspective. In contrast, ALF is likely to be viewed as morally suspect or indefensible by those who believe that defendants are most often disadvantaged in civil litigation, for example, because they are often forced to defend themselves against and pay damages on legally unmeritorious claims. In sum, additional access to the *courts* does not necessarily involve improved access to *justice*.

Another moral principle that appears to be a double-edged sword in the ALF debate is respect for property rights. Some who support this principle would likely interpret a legal claim as the property of a claimholder and view as immoral restrictions on selling part or all of a legal claim or borrowing with a legal claim as collateral. Others who support respect for property are likely to focus on the property rights of defendants or their shareholders, argue that civil litigation often compels defendants to spend money defending and paying damages on civil claims that lack legal merit, and conclude that respect for property rights would be well served by banning or regulating plaintiff-side ALF.

In sum, it seems very unlikely that disagreements about the social desirability of ALF can be largely resolved on the basis of moral considerations. Presumably, most practicing lawyers obey the laws and professional rules that make up the legal ethics that apply in their jurisdictions and will continue to do so. As discussed earlier in this section, these laws and rules limit ALF or ALF-related activity in some jurisdictions but not in others. As a practical consequence, existing laws and rules in some jurisdictions might lead to a complete lack of availability of some types of ALF, substantial restrictions on some ALF-related activities, and higher costs of supplying ALF due to financial risks posed to ALF suppliers by lack of clarity about what is and is not permissible.

Microeconomic Perspectives on the Current and Near-Term Effects of ALF on Litigation

Much of the policy debate about ALF has focused on the effects of ALF on litigation and its outcomes. Many of the issues raised in this debate are, in principle, subject to empirical analysis. Empirical analysis, however, cannot get us very far at the present time because little or no systematic empirical information is available.

The current paucity of empirical information useful for predicting the effects of ALF in the United States reflects several factors. First, ALF is fairly new in the United States, and it has not attracted the attention of empirically oriented researchers until quite recently. Second, much of the information that would be necessary or helpful for empirical study is proprietary. Third, the histories of U.S. ALF activity in some segments are too short to enable identification of trends that can be reliably extrapolated into the future. Fourth, extrapolating from recent histories would be especially unreliable because activities in the three segments emphasized in this paper during the past few years reflect to large degrees unusual and (hopefully) temporary circumstances—such as the credit crisis, which affects both the demand for and supply of capital for ALF, and litigation opportunities associated with the recession and its precipitators such as subprime mortgage lending^{1,2}

It will be at least several years before there is a substantial empirical basis for U.S. policy analysis and design. What can be done in the meantime is to subject potential effects of ALF to logical scrutiny. The most promising basis for doing so is applying principles of microeconomics pertaining to decisionmaking by individuals and businesses and the functioning and evolution of markets. Microeconomic logic is instructive because the litigation outcomes considered here are determined primarily by market interactions among individuals, law firms, and businesses as they seek to further their private financial (economic) interests through their litigation-related activities. Analyzing the self-interested behavior of individuals and businesses and their market-mediated effects are core issues in microeconomics.

¹ Moreover, there is very little systematic information bearing on the effects of litigation financing in other countries, and, in any case, observing or estimating effects in other countries may be unreliable guides for predicting effects in the United States. This is because of differences between the United States and other countries in civil justice rules, such as whether contingency fees are allowed and who pays the legal costs of the winning party.

² Fenn and Rickman (2009) review the empirical literature addressing the effects of how litigation is financed (not including ALF) on various litigation outcomes in the United Kingdom and the United States. They use a formal theoretical model to suggest the litigation outcomes that are likely to depend on how the litigation is financed and to guide their survey of empirical studies. Most relevant to the present discussion, Fenn and Rickman review approaches to and difficulties involved in developing useful data, and, in concluding, they refer to third-party funding as a recent development and suggest that the empirical analysis of effects of third-party funding would be an important topic for future studies.

In this and the following section, I consider potential effects of the three major types of U.S. ALF on several aspects of litigation of substantial social importance: (1) the quantity of civil litigation in the United States; (2) its average quality (degree of legal merit), which has implications for access to justice for plaintiffs and defendants; (3) the likelihood and timing of settlements; (4) the fairness of settlements; and (5) transaction costs of disputing.³ After those discussions, I briefly address issues specific to class-action litigation and patent-infringement claims brought by so-called “non-practicing entities.”

As we go along, I discuss various claims about the socially undesirable effects of ALF and cite sources of such claims. Articles written by ALF industry insiders emphasizing the social advantages of ALF include Chodes (2007), regarding consumer legal funding, and Petrus (2010) and Scrantom (no date), both of which focus on investments in commercial claims.

Apparently, at least some people are concerned primarily about *future* effects as ALF markets evolve. Specifically, John Beisner, the lead author of Beisner, Miller, and Rubin (2009), reportedly has said that “the concern of many opponents is more about what third-party funding could lead to, rather than the current practices of the major third-party funders” (Lindeman 2010, p. 6).⁴ In this section, I consider the current and near-term effects of ALF, and, in the following section, I consider how markets for the three types of ALF might evolve and the potential implications for longer-term effects and for policy. To provide background for those discussions, I next consider decisionmaking by participants in ALF markets.

The goals of this and the following section are threefold. The first is to illustrate and reinforce a major theme of this paper, namely, that the effects of ALF are likely to differ greatly across ALF industry segments. The second goal is to help policymakers, policy analysts, and researchers appreciate that the effects of ALF on various aspects of litigation are often far from obvious and to alert them to be wary of assertions to the contrary. The third goal is to encourage other researchers to join the effort to help policymakers make wise choices.

Decisionmaking by ALF Suppliers and Demanders

The economic and other social effects of ALF are determined to a large degree by decisions of ALF suppliers and demanders.⁵ To analyze these decisions, I first consider fundamental perspectives on decisionmaking by individuals and organizations and their application to ALF.

Decision Problems of ALF Demanders

ALF demanders hope to enter into contracts with ALF suppliers that will help demanders achieve their goals or objectives. As described in Section 3, ALF demanders differ fundamentally across the three industry segments.

³ Presser (2009, p. 1) argues that there are two ideological positions in the United States about litigation: the “traditional” view that “litigation is something pernicious that ought to be discouraged” and the view that “litigation is a noble tool that can lead to transformative social change.” I agree with Presser’s conclusion that “What one thinks about third-party financing of litigation may turn simply on the choice of which model or ideology seems more appealing.” A fundamental premise of this paper, however, is that policymakers should not approach ALF as a matter of ideology; instead, they should assess and weigh societal-level effects of ALF on outcomes of social importance.

⁴ It is not clear whether Beisner’s statement refers only to investments in commercial litigation—the focus of Lindeman (2010)—or also to other types of ALF.

⁵ Makers of legal policy also influence these effects.

Demanders of consumer legal funding. Individuals with pending legal claims attempt to promote their personal well-being (*utility*, in economists' jargon) in deciding whether to apply and contract for non-recourse loans. These decisions are likely to be financially motivated in most instances, and focusing on financial issues seems appropriate in early-stage theorizing (such as the effort here). To predict or interpret the behavior of cash-advance demanders, it also seems to be important to recognize that (1) they have pending lawsuits whose outcomes are uncertain; (2) they are very unlikely to be "repeat players" in the cash-advance market, so they are unlikely to know how or where to find the best offers available from cash-advance companies;⁶ (3) many of them may be unable to understand the financial implications of contracts used by at least some funders; and (4) many of them are likely to be under considerable stress as they try to meet high-priority financial obligations, such as medical bills or rent or mortgage payments.

Demanders of loans to plaintiffs' law firms. Plaintiffs' lawyers pursuing personal-injury claims typically work on a contingency-fee basis, may have insufficient hourly work to provide steady streams of revenue, and incur out-of-pocket expenses to pursue their clients' claims. Thus, they often experience uneven and unpredictable cash flows. Firms that consider ALF are likely to be motivated by a desire to remain solvent, smooth their cash flows, invest more resources into pending cases, have the financial wherewithal to take on additional cases, or compete for business with law firms that have more capital than they have. All of these motives suggest that financial considerations predominate in their decisions about seeking and accepting ALF. Plaintiffs' lawyers make these decisions in the context of substantial uncertainty about the outcomes of their cases, including when they will be resolved.

Demanders of investments in commercial claims. It is likely that businesses with opportunities to bring promising lawsuits for money damages against other businesses are typically motivated by financial considerations—both in deciding to bring lawsuits and in considering ALF—as are the law firms representing them. Some businesses with pending plaintiff-side legal claims might not have the capital to pursue these claims and would require ALF to enable them to proceed. Inability to finance claims is likely to be fairly rare among the large companies that Juridica and Burford seek as clients, less rare for smaller businesses that ARCA seeks as clients, and perhaps fairly common for very small and start-up companies.⁷ No matter what its size or ability to finance litigation without ALF, a company will be willing to accept an investment in a legal claim if the share of the recovery that it must cede to an ALF company is small enough in relation to the amounts of capital that ALF suppliers are willing to provide in return.

Goals of ALF Suppliers

ALF suppliers offer capital to ALF demanders in hopes of making money—business profits in the cases of ALF companies and investment income in the cases of other ALF suppliers. And,

⁶ Demanders of non-recourse loans are also unlikely to know someone who has recently extensively explored opportunities for cash-advance demanders. Lawyers representing some cash-advance demanders are likely to be familiar with some providers of consumer legal funding and may have opinions about which of those offer the best terms. Few plaintiffs' lawyers, however, are likely to be well informed about the terms currently available from several companies.

⁷ A scenario that is often suggested by ALF proponents involves a very small company that has a valid legal claim—often a patent-infringement claim—but literally does not have the capital to pursue the claim if they must pay their lawyers on an hourly basis.

it seems, ALF suppliers such as investment funds are willing to accept substantial risks associated with particular investments in exchange for opportunities to achieve unusually high rates of return on their capital. ALF companies seek to profit in an environment in which they wish to please their investors. Another high priority for these companies is limiting the likelihood that they will run out of money, in which case they are likely to have great difficulty raising additional capital.⁸

Costs and Risks of ALF Companies

ALF companies will participate in ALF markets only if they expect to be able to cover their costs, including their costs of capital. The main costs of ALF suppliers associated with a particular deal⁹ are costs associated with evaluating prospects for repayment (i.e., *due diligence* costs) and opportunity costs of capital (i.e., costs associated with having money tied up). Financial risk is appropriately addressed as a feature of the portfolio of an ALF company, not on a deal-by-deal basis. The nature of risks associated with ALF companies' portfolios, due diligence costs per potential deal, and the degrees of effectiveness of due diligence in reducing risk appear to differ substantially across the three segments of the ALF industry.

A fundamental challenge for all ALF suppliers is that ALF demanders will tend to be more willing to accept ALF, other things equal, the less optimistic they are about the financial prospects of their legal claims. Such opportunistic exploitation of information that ALF demanders have and ALF suppliers don't have exemplifies the well-known general problem called *adverse selection*, the precise nature of which differs across segments. Moreover, ALF demanders may exploit their informational advantages relative to ALF suppliers by taking such actions as misrepresenting the strength of their legal claims in efforts to benefit financially. Such opportunistic actions, which may not be detectable by ALF suppliers, are examples of the well-known general problem called *moral hazard*.¹⁰

ALF suppliers of all types can take actions to reduce their costs associated with adverse selection and moral hazard. They will do so, however, only to the extent that the costs of these actions make financial sense for them in terms of the resulting financial benefits. Since it is likely to be extremely expensive—and perhaps literally impossible—to eliminate all such costs, due diligence processes will typically only reduce, rather than eliminate, ALF suppliers' costs associated with adverse selection and moral hazard.

Consumer legal funding. The potential adverse-selection problem in this industry segment is that consumers with pending lawsuits perceive lower costs to promising to pay out of their proceeds if they think that they are more likely to obtain no recovery or a recovery not much in excess of the sizes of their non-recourse loans. As reported in Section 3, it appears that individual transactions in this segment are fairly small, perhaps in the range of \$1,750

⁸ HNWI and investment funds that supply capital to ALF companies may be able to largely diversify their investment risks using other investments. If so, they may be largely unconcerned about risks associated with the portfolios of the ALF companies in which they invest. Nonetheless, the ALF companies themselves may be concerned about—and take actions to reduce—the riskiness of their portfolios because of the potential for their companies to fail. In any event, if those who supply capital to ALF companies are well diversified, this will tend to reduce ALF companies' costs of capital.

⁹ In economists' jargon, these are *marginal* costs of a deal.

¹⁰ A more specific potential moral-hazard problem pertains to providers of consumer legal funding. It is that consumers who have little or no prospects of having substantial money left after paying their ALF suppliers will have little, if any, incentive to cooperate with their lawyers in pursuing their claims. See Molot (2009b, p. 36), who discusses this possibility in the context of consumers who might sell their "entire claims."

to \$4,500. There are two important implications of this observation. First, the amount that an ALF supplier in this industry segment would be willing to spend on due diligence for any application is fairly small.¹¹ Second, for suppliers of consumer legal funding that are well-enough capitalized to have many (e.g., 50 or more) non-recourse loans outstanding concurrently, portfolio risk—that is, variation in the returns on the portfolio—can be fairly small because of risk pooling across deals.¹² Applying “laws of large numbers” or, more colloquially, “laws of averages,” risk pooling can reduce portfolio risk to almost zero if a portfolio includes a sufficient number of deals whose risks are sufficiently unrelated. Regarding “unrelated risks,” for a given number of outstanding non-recourse loans of a specific size, risk pooling will be more effective if the factors determining whether the various non-recourse loans are repaid have fewer common underlying elements (i.e., if the risks are less correlated across deals). Consumer legal funders can act to limit the degree to which the deals in their portfolios contain related risks, such as limiting the proportions of their transactions to (1) claimants in the same mass tort, because some mass torts fail from the plaintiffs’ perspective, in which case few, if any, cash advances to claimants in the mass tort will be repaid; (2) clients of the same lawyers or law firms, because a lawyer or firm might underperform on many cases if, for example, a key attorney dies or becomes disabled; and (3) claimants in the same type of case, such as pharmaceutical product liability¹³ or medical negligence in a single state,¹⁴ because a public-policy change could greatly decrease the values of all claims of such types.¹⁵

Loans to plaintiffs’ law firms. The nature of the potential adverse-selection problem in this segment is that plaintiffs’ firms nearer to financial collapse are more likely to seek loans because they have little to lose. The average size of a loan in this segment is almost surely larger than the average size of non-recourse loans provided by consumer legal funders. Thus, financially sensible levels of due diligence costs are likely to be higher as well. It is unclear how many loans ALF suppliers in this segment can afford to have outstanding at any time; thus, the degree of potential risk pooling across loans cannot be assessed. Nonetheless, ALF suppliers could reduce the risks associated with their portfolios by not concentrating their loans on a small number of law firms or firms with, for example, portfolios of cases substantially dependent on the same mass torts. ALF suppliers in this segment may also reduce their risk by lending to (cash-constrained) law firms whose portfolios of cases are well diversified.

Investments in commercial litigation. The potential adverse-selection problem in this segment is that owners of commercial claims will be more willing, other things equal, to share

¹¹ The fact that lawyers have accepted the cases on a contingency-fee basis would likely be viewed by funders as a positive signal about the quality of the underlying lawsuits—but this will not help them discriminate among the many applicants for which this is true. This factor will discriminate among applicants, however, to the extent that a funder also has information about how well the relevant lawyers or firms screen cases for legal merit and economic value.

¹² In this context, *risk* refers to the amount of variation in the ALF company’s return on its portfolio. If, however, the underlying deals have on average small (or even negative) expected returns, this would mean that there is little variation around a financially unattractive (or even negative) rate of return.

¹³ The potential for many claims of the same broad type to fail is illustrated by *Wyeth v Levine*, a case decided by the U.S. Supreme Court in March 2009. If that case had been decided differently, pharmaceutical failure-to-warn cases (which account for almost all pharmaceutical product-liability claims) would have been pre-empted nationally.

¹⁴ Because of the possibility, for example, that a state will institute a damage cap in medical negligence cases, which would tend to reduce each claimant’s recovery.

¹⁵ In contrast, it is very unlikely that the prospects of different auto-injury or slip-and-fall claims are related to each other or to other types of claims.

the financial upside of their claims the less optimistic they are about the legal viability and likely damages associated with these claims. For example, a company with several (plaintiff-side) commercial claims may seek investments in those claims that it thinks are relatively weak and not seek investments on those that it believes to be relatively strong. As reported in Section 3, the amounts of capital supplied in individual deals in this segment are often in the range of a few to several million dollars. Moreover, many of the commercial cases for which investments are considered are likely to be considerably more complex than the typical cases relevant to the other two segments. Thus, the levels of due diligence costs per deal that make financial sense are likely to be much higher in this segment than in the other two. Some empirical hints consistent with this prediction are available. For example, Juridica Investments Limited (no date) describes its process as follows

A carefully selected network of outside legal experts evaluates the merits, legal theories involved, and prospects for recovery. . . . For each investment, a thorough ethics review and ethics advisory opinion is generated.

Regarding the time and costs involved, Juridica's CEO has been quoted as follows: "It's a very detailed and expensive process, averaging about 60 to 90 days' . . . and 'Juridica spends an average of \$75,000–\$100,000 for each screening.'" (Lindeman, 2010, p. 4).¹⁶

Some of the ALF companies in this segment may not be sufficiently capitalized currently to have enough cases for their portfolio risk to be negligible through the operation of a law of large numbers. For example, Juridica—which may have the most assets under management available for investments in U.S. litigation among ALF companies in this segment—reports that, as of February 1, 2010, its investment portfolio included 15 investments in a total of 23 cases comprising a total commitment of \$121.3 million (Juridica Investments Limited, 2010). Burford, which had been in operation for only a few months at the time that this paper was written, had raised \$130 million (*The Sunday Times*, 2009) and expects its average investment commitment to exceed \$3 million (Burford Capital, no date), suggesting a capacity to fund roughly 40 investments initially. As of mid-January 2010, Burford had made five investments, only two of which involve U.S. litigation (Burford Capital, 2009b, 2010).¹⁷ Currently, then, the best strategy for limiting risk in this segment may be to concentrate investments in claims that have very high probabilities of a recovery. For example, Juridica reportedly rejects "claims that raise novel legal questions or that will probably end up before a jury" (Glater, 2009).

ALF Companies' Preferences over Potential Deals

A fundamental insight from microeconomics is that market transactions are voluntary for both buyers and sellers, and thus a transaction will occur only if both parties believe that the deal is better for them than their best alternatives are. Thus, an ALF supplier cannot make a deal unless the ALF demander believes that the deal is preferable to its best available alternative and vice versa.

¹⁶ Lindeman (2010, p. 4) also describes due diligence processes at Burford and ARCA, both of which rely on outside experts to considerable degrees.

¹⁷ According to Lindeman (2010, p. 3), as of early 2010, ARCA had roughly \$110 million in capital but had not made any investments.

Microeconomic models of business decisions in the presence of risk or uncertainty often assume that decisions are made to maximize expected profits and that potential transactions are evaluated in terms of expected profits. This hypothesis has several implications of interest for present purposes. Contrary to the hypothesis or assumption of maximizing expected profits, however, some ALF suppliers apparently do care about risk. For risk-averse ALF companies that cannot largely diversify risks through portfolio construction, risk may affect their other decisions. My discussion in this subsection emphasizes the implications of maximization of expected profits by ALF companies, and in some instances I comment on implications of risk for decisionmaking.

Many ALF companies suggest that they are interested in financing only claims with high probabilities of generating a return. This makes good sense for consumer legal funding companies and companies offering loans to plaintiffs' law firms because of the structures of their deals. More specifically, the returns to ALF suppliers on consumer legal funding and loans to plaintiffs' law firms are limited by contract to financing fees and interest payments. In particular, ALF suppliers in these segments do not have claims on shares of the recoveries in the underlying lawsuits. In contrast, the upside potential of investments in commercial claims can, at least in principle, be very large because the returns to the ALF suppliers are based on percentages of the recoveries in these claims. To appreciate the importance of this distinction, consider the following.

For an ALF supplier, the expected profit on a single deal can be expressed as

$$\text{Expected profit} = (\text{Probability of any repayment}) \times (\text{Expected size of the repayment if there is a repayment}) - (\text{Supplier's cost of the deal}).$$

That is, the expected profit on a deal equals the product of the probability of *any* return and the expected size of the return *if* there is any return, minus the supplier's (marginal) costs of the deal.

This formula implies that the expected profit on an ALF investment could be high even if the probability of any return is fairly low if the potential recovery in the case and the ALF supplier's share of the recovery are sufficiently high. This does not imply, however, that investors in commercial claims do, in fact, invest in claims with fairly low probabilities of generating returns. For example, as discussed above, concentrating investments in cases with high probabilities of returns may be part of the best risk-reduction strategy. Moreover, in the current environment, in which the demand for ALF investments may greatly exceed supply of capital for such investments,¹⁸ ALF companies might be able to succeed financially without considering weak cases with unusually high potential damages.

The Effects of ALF on Litigation

In this subsection, I consider the plausibility of various predictions or assertions about the effects of ALF on civil litigation in the United States, implicitly suggest many research ques-

¹⁸ For example, according to Juridica Investments Limited (2009a), through June 30, 2009, "340 investment opportunities have been considered of which 23 have been selected."

tions, and offer thoughts about what currently appear to me to be crucial considerations for analyses of these questions.

The analysis in this section is organized along similar lines to the ALF debate to date—namely, in terms of potential effects of ALF on various aspects of or issues in U.S. civil litigation, such as the quantity and quality of litigation, settlement behavior, and transaction costs. To provide context for this discussion and to implore readers not to infer any summary assessment on my part concerning the social desirability of ALF,¹⁹ I offer the following comments.

First, as I have emphasized and detailed in earlier writings, I have no doubt that some lawsuits are socially beneficial and some lawsuits are socially detrimental.²⁰ Accordingly, policymakers might best think in terms of allowing or enabling lawsuits of the former type and limiting those of the latter type rather than focusing on the volume of litigation per se (Garber, 1993, 1998). These views pertain to both of the widely accepted social objectives of liability law, namely, compensation and deterrence.

Second, fairness of compensation seems most appropriately judged in relation to applicable legal doctrine. More specifically, in my view—which is applied in the remainder of this paper—fairness in compensation requires compensation when and only when legal doctrine calls for compensation or, synonymously, when legal claims have merit. Moreover, when compensation is appropriate, the amount of compensation should be consistent with legal doctrine.²¹

Third, the term *deterrence* refers (in the litigation context) to how exposure to lawsuits affects the behavior of people whose actions can harm others (physically or financially). As elaborated in Garber (1998, pp. 251–257), it seems clear that some deterrence effects of litigation are socially desirable and others are socially undesirable. Whether, on balance, deterrence effects of U.S. litigation are socially beneficial or socially detrimental is unknown—and, perhaps, unknowable—and controversial. It seems to me, however, that deterrence effects would almost surely be improved by policies that would increase the incidence of meritorious lawsuits, decrease the incidence of unmeritorious ones, or both.

Effects of ALF on the Quantity of U.S. Civil Litigation

As detailed presently, some have argued that availability of ALF will increase the number of lawsuits filed or, synonymously, increase the “quantity” or “volume” of litigation. Some of those people also argue that an increase in the quantity of litigation should suffice for policymakers to conclude that ALF should not be allowed or that ALF should be heavily regulated. The suggestion that any resulting increase in the quantity of litigation suffices to make ALF socially undesirable is suspect because, in the views of many, including me, some civil lawsuits are socially desirable and others are socially undesirable. For example, Dana and Schanzenbach (2009, p. 11) write: “Of course, the volume of litigation itself is a poor indicator of the social costs of litigation.”

¹⁹ I have performed no such summary assessment, and, in fact, I detail below various reasons that I believe that it would be inappropriate for anyone to attempt to do so at this time.

²⁰ The relative numbers of U.S. lawsuits that are socially advantageous versus disadvantageous is unknown, and controversial.

²¹ The latter criterion is of little practical significance in the case of noneconomic (or general) damages, however, because legal doctrine provides little guidance on how to quantify in dollars compensable harms such as pain and suffering.

Some who have predicted that ALF will increase the quantity of litigation implicitly suggest that this prediction applies to all types of ALF. For example, Rubin (2009) presents arguments leading him to conclude (p. 6) that “the obvious effect of increased third party financing would be increased litigation.”²² For another example, Beisner, Miller, and Rubin (2009, p. 5) write that as “a matter of simple economics: by increasing the amount of money available to pay attorneys to litigate claims, third-party funding necessarily increases the volume of claims litigated.” Moreover, to support the prediction that ALF will increase the volume of litigation, both Rubin (2009) and Beisner, Miller, and Rubin (2009) refer to Abrams and Chen (no date), who analyze data from Australia and conclude that, in Australia, ALF has increased the volume of litigation.²³

An increase in litigation volume as a result of ALF seems considerably more plausible than no effect or a decrease. The claim that such an increase is “a matter of simple economics” does not stand up to scrutiny, however. First, the intuition that more capital means more lawsuits implicitly assumes that a major factor limiting the volume of litigation is lack of capital available to plaintiffs and their attorneys. Another plausible explanation for why more lawsuits aren’t filed in the United States is the lack of additional potential claims that make economic sense to contingency-fee plaintiffs’ attorneys.²⁴ Second, if ALF enables many individuals or organizations to strengthen their claims or to bring claims that they otherwise would not bring, this could increase the costs to potential defendants of activities that lead to claims and, as a result, decrease behavior that causes or allegedly causes compensable harms. Stated simply, if ALF increases deterrence of behavior that tends to lead to lawsuits, this effect will tend to reduce, not increase, the volume of litigation.²⁵ Third, as I now discuss, the considerations relevant to the effects of ALF on litigation volume differ considerably across types of ALF.

Consumer legal funding. It seems implausible that the availability of non-recourse loans would have a major effect on the quantity of litigation. To argue otherwise would seem to require that either (1) ALF suppliers would often be willing to advance sufficient capital to allow plaintiffs who cannot or prefer not to engage their lawyers on a contingency-fee basis to hire their lawyers on an hourly basis, or (2) substantial numbers of recipients of non-recourse

²² This is a positive or descriptive claim about the effects of ALF on the volume of litigation. As a normative or prescriptive matter, Rubin (2009) also discusses some reasons that litigation can undermine economic efficiency and concludes (p. 15) that “allowing increased sale of lawsuits would create incentives for inefficient lawsuits and inefficient precedents. The common law was right in forbidding champerty and its variants.”

²³ In contrast, I am skeptical that the Abrams and Chen (no date) analysis provides evidence that ALF will increase litigation volume in the United States. First, the demand for litigation financing in Australia is undoubtedly higher, other things equal, than in the United States because contingency-fee financing—a close substitute for ALF in the eyes of demanders—is not allowed in Australia. Second, willingness to self-finance “representative actions” (which are similar to class actions in the United States) is discouraged by the “loser pays” rule in Australia. Third, the evidence presented by Abrams and Chen is far from convincing even with regard to effects in Australia; for example, their statistical analyses rely on sample sizes of five to seven observations.

²⁴ See Kritzer (1997) on the roles that plaintiffs’ attorneys play in limiting filing of some lawsuits in their capacity as “gatekeepers in the civil justice system” and for Kritzer’s argument that gatekeeping by plaintiffs’ attorneys is “in large part an exercise of economic self interest.” Garber et al. (2009) provide empirical evidence that plaintiffs’ attorneys tend to be less willing to take cases that offer lower expected fees per hour of lawyer time.

²⁵ For example, Dana and Schanzenbach (2009, p. 9) write, “Much of the limited literature on third-party financing assumes that the availability of funds to pursue litigation will generally increase the volume of litigation. Some have pointed out that this will increase deterrence, particularly in the tort context, and therefore will not unambiguously increase litigation.”

loans file lawsuits only because they know that they may be able to monetize portions of their legal claims if they do so. The former possibility is logically cogent, but I have seen no hints that this form of ALF is used by consumers to pay their lawyers. The type of behavior involved in the latter possibility would be more plausible the larger are the proportions of the expected values of the underlying legal claims that ALF suppliers are willing to advance. As reported in Section 3, non-recourse loans may typically be less than 10 percent of the estimated recoveries in the underlying lawsuits, in which case consumers could monetize only fairly small proportions of the full values of their legal claims by taking non-recourse loans. I note, in addition, that, considering how quickly financing fees can accrue—at least on some non-recourse loans—it seems unlikely that a consumer legal funding company would be willing to provide a large (e.g., 30 percent of more) proportion of the expected value of a consumer’s claim unless it is anticipated that the claim will be resolved quite soon. This expectation seems plausible only for claims for which settlements have been reached or the ALF supplier believes that settlement is imminent. In sum, the availability of consumer legal funding could increase the volume of personal-injury litigation, but major increases seem somewhat implausible.

Loans to plaintiffs’ law firms. Whether and how much the availability of this type of ALF will increase the volume of litigation depends on how the recipient law firms use their outside capital. To the degree that these funds are used to take on more clients than they otherwise would, this will tend to increase the volume of litigation. Other uses of loans from ALF suppliers imply, however, no effect on the number of lawsuits filed. There would be no effect if, for example, recipient law firms use extra capital merely to smooth cash flow or to work more intensively the cases they have already taken. In sum, this type of ALF is likely to increase the volume of litigation, but the likely size of such an effect cannot be assessed with currently available information.

Investments in commercial claims. As with the two types of ALF just discussed, there are plausible scenarios under which the availability of outside capital in this segment increases the number of claims. One such scenario involves a plaintiff company that has filed a lawsuit but (1) is unable or unwilling to use internal capital to pay legal expenses on an hourly basis, (2) is unable to find a suitable law firm to represent it on a contingency-fee basis, *and* (3) the economics of the claim look favorable to an ALF company. Consider each of these conditions in turn.

Regarding the first condition, small companies—including start-ups—are more likely to be capital-constrained than the kinds of companies that Juridica and Burford are apparently targeting. The capacity and willingness of ARCA, which is targeting smaller companies, to make ALF available to companies that are truly capital-constrained is unclear. Finally, very small companies, including many start-ups, may be unable to afford to pursue their claims paying for legal services on an hourly basis.

Regarding the second condition, many corporate law firms, including some of the most respected ones in the country, do at least some litigation work on a contingency-fee basis for plaintiffs in commercial litigation. A major unknown here is the level of demand for such legal services relative to their supply. If demand greatly exceeds supply, this would leave considerable demand for ALF in this segment because ALF can be a close substitute for legal fees financed by law firms on a contingency-fee basis.

The third condition may also be satisfied fairly often. However, to the extent that the inability of some commercial plaintiffs to retain high-quality legal representation on a contingency-fee basis is due to unattractive economics of their claims to lawyers, ALF companies are also

likely to be unwilling to invest in those claims unless they can contract for a higher share of the eventual recovery than what law firms usually receive under contingency-fee arrangements.

Effects of ALF on the Quality of U.S. Litigation

Some commentators, including Beisner, Miller, and Rubin (2009), have predicted that there will be more “frivolous” litigation with ALF than without ALF. In the ALF context (as with broader debates about civil-justice policy) the term *frivolous* is used informally to characterize lawsuits that have no or only dubious legal merit, not in a strict legal sense as, for example, the term is defined by Rule 11 of the *Federal Rules of Civil Procedure*.

The implicit reasoning of some who predict that ALF will tend to increase frivolous litigation may be that plaintiffs and their lawyers will be more prone to bringing unmeritorious lawsuits if someone else is available to finance such cases. This is an expression of the adverse-selection problem faced by ALF suppliers—a problem that many, and perhaps almost all, of them seem to understand quite well.

To analyze “frivolous” litigation logically, one needs a specific definition of that term. As discussed by Abramowicz (2009, pp. 6–11), it is controversial how best to define *frivolous litigation* for analytic purposes. One such definition—and the one used by Abramowicz—is that the probability of winning at trial is low.²⁶ Following Abramowicz, for present analytic purposes, I will focus on lawsuits that have low probabilities of judgments for the plaintiffs if they were to go to trial, and refer to such suits as *low-probability* rather than *frivolous* or *unmeritorious*. In this regard, I offer two caveats. First, a lawsuit might have considerable legal merit but nonetheless have only a small probability of a plaintiff win at trial. This could be the case, for example, if the defense lawyers are more skilled than the plaintiffs’ lawyers, the key plaintiffs’ witnesses are less articulate or charming than those of the defense, or the defense expends much more effort than is possible or sensible for the plaintiffs, perhaps because the defendant wishes to build a reputation for a “scorched-earth” litigation style in hopes of deterring others from bringing claims. Second, a lawsuit lacking legal merit can have a high probability of recovery if the costs of defending it are high enough, or the risks of going to trial are so large that defendants would be willing to settle it. This is a description of what are often called “nuisance suits.”²⁷ In short, *frivolous* does not imply *low-probability*, and *low-probability* does not imply *frivolous*.

Consumer legal funding. The business models of the cash-advance companies do not allow for major costs of due diligence because their typical deals are fairly small. As discussed in the previous subsection, however, it is implausible that the availability of non-recourse loans would have major effects on what lawsuits are filed. A corollary of non-recourse loans not influencing filings in major ways is that they cannot affect in major ways the proportion of lawsuits that might have low probabilities of winning at trial or, more generally, objectively characterized as frivolous.

²⁶ Abramowicz (2009) discusses and analyzes a conceptually interesting and constructive response to concerns about ALF leading to increases in filings of low-probability lawsuits. His basic idea is that it may be possible to design and implement rules limiting payoffs to ALF suppliers that make ALF for low-probability lawsuits financially unattractive to ALF suppliers. The practical potential of this approach to designing regulations is unclear.

²⁷ I have no doubt that nuisance suits exist and almost no doubt that, in the aggregate, they substantially undermine the performance of the litigation system in promoting social goals.

Loans to plaintiff's law firms. For the availability of this type of ALF to increase the number or proportion of low-probability lawsuits, the ALF recipients would have to use their outside capital to invest more resources in low-probability claims or to take on additional clients with low-probability claims. Since ALF suppliers in this segment do not share in the upside potential of low-probability claims, they would tend (other things equal) not to want to lend to firms with substantial numbers of low-probability claims in their portfolios. The degrees to which their due diligence processes can and do enable them to avoid making such loans is unclear.

Investments in commercial claims. As described above, a low-probability lawsuit can, in principle, have high expected profits in this segment because ALF suppliers share in the recovery. There are reasons to doubt that, currently or in the near future, ALF suppliers would knowingly choose to invest in such cases, however. First, it appears that ALF companies are able to find ample profitable investment opportunities in claims with fairly high probabilities of resulting in recoveries. Second, building their portfolios with high-probability claims may be part of their best risk-management strategies.

Effects on the Likelihood and Timing of Settlements

Effects of ALF on settlements are potentially important in weighing the social benefits and costs of ALF because large proportions of civil cases are resolved through settlements. Some have argued that the availability of ALF will promote settlements, and others have argued the opposite.

For a given set of pending lawsuits, there are some social advantages to increasing the rate of settlement and, for cases that will eventually settle, decreasing the time from claiming to settlement. Regarding increasing the rate of settlement (i.e., the proportion of cases that settle rather than go to trial), social advantages include avoiding transaction costs involved in trials, including the transaction costs borne by private parties in the process of disputing as well as burdens on the courts.²⁸ Regarding reducing times to settlement of cases that would settle eventually, social advantages include reduced transaction costs associated with additional disputing and—for settlements that are reasonably viewed as just—decreased delays in achieving justice.

In contemplating the effects of ALF on settlement, standard microeconomic principles and a large theoretical literature on settlements suggest that we view litigants and their lawyers as trying to achieve the case dispositions that best serve their interests. For simplicity of discussion here, unless stated otherwise, I will implicitly assume that settlements are driven by the preferences of plaintiffs and defendants or, equivalently, that the lawyers faithfully pursue the objectives of their clients.

A general issue that I do not consider segment-by-segment below is the potential effects on settlements of disclosure by ALF recipients that they have received ALF. For example, a defendant who knows that the plaintiff has ALF might perceive a consequent decrease in the defendant's bargaining power (e.g., by reducing the credibility of some threats in negotiations), and as a result be more prone to settling. This possibility seems potentially relevant to all ALF segments. It has also been suggested to me that an ALF company's willingness to provide ALF

²⁸ The long-standing view that settlements are preferred to trials has been tempered recently because of the phenomenon of the so-called "vanishing trial." There is a large and growing recent literature on the existence and implications of this phenomenon. See, for example, the November 2004 special issue of the *Journal of Empirical Legal Studies*.

could be viewed as a seal of approval on the quality and economic prospects of a plaintiff's claim and, if so, affect the settlement negotiations and outcomes. In this scenario, a defendant who knows that the plaintiff has ALF may infer from the existence of ALF that the legal claim has legal merit or high economic value (or at least assign a higher subjective probability to that possibility), in which case this change in beliefs by the defendant will affect the negotiation and its outcome. This scenario, however, seems plausible only in the context of investments in commercial claims. This is because it is only in this segment that due diligence processes of ALF suppliers related to particular lawsuits are plausibly sufficiently rigorous for the defendant to infer much about the quality of the claim from the existence of ALF.²⁹

Consumer legal funding. Economic reasoning suggests that the existence of a non-recourse loan to a plaintiff could impede settlements both early and late in the life of the underlying lawsuit, but promote settlements during a period of time in between. More specifically, early in the life of the dispute, receipt of a non-recourse loan might often prevent plaintiffs from settling quickly by enabling those who are desperate for cash to pay their bills in the interim. But once non-recourse loans are received, the fairly rapid rate at which a plaintiff's debt to the ALF company can increase tends to make plaintiffs desire a rapid settlement if settlement offers are high enough for the plaintiff to repay the cash-advance company and have a substantial amount of money remaining.^{30,31} As time goes by, however, the amount owed to the ALF company can eventually exceed what the defendant will be willing to offer in settlement, in which case the plaintiff has nothing to lose in going to trial in hopes of obtaining a recovery that leaves that person with money after repaying his or her ALF supplier. Finally, it seems unlikely that consumer legal funding associated with mass-tort claims can affect settlements much, if at all. This is because mass tort cases are rarely settled one or a few claims at a time, and when settlement negotiations involve large numbers of claims,³² the preferences of individual claimants have almost no scope for influencing settlements.

Loans to plaintiffs' law firms. Under the assumption that client preferences determine whether settlements are accepted, it seems likely that outstanding, fairly high-interest loans to

²⁹ Moreover, if knowledge by a defendant that the plaintiff has ALF would affect settlement behavior, then this knowledge could affect all outcomes of litigation, because the parties can anticipate effects on settlements even when, for example, they decide whether to bring the claim at all. Analyzing such possibilities suggests a challenging agenda for applied game theorists and empiricists. For example, under what circumstances would an ALF recipient think it beneficial to reveal the existence of ALF to the other side? How would the effects of revelation depend on whether revelation is mandatory or voluntary? How would a revelation of either type affect settlements and other litigation outcomes? Would policies requiring revelation (or, for example, allowing parties to learn about the presence of ALF within the discovery process) affect the social desirability of the litigation outcomes?

³⁰ Regarding this time period during the life of a dispute, Molot (2009b, p. 24) writes, "A plaintiff whose net recovery declines the longer he or she goes without settling will have strong incentives to settle quickly and have a much harder time rejecting low settlement offers and holding out for more."

³¹ In a private email communication on April 2, 2010, John H. Beisner and Gary A. Rubin of Skadden Arps suggested to me that pressure on the consumer to settle because of mounting financing fees will often not facilitate settlement, because settlement offers from defendants tend to start low and increase over time. The quantitative significance of this argument depends how often settlement offers are large enough for consumers with non-recourse loans to pay off their ALF suppliers and have a substantial amount left over. This, of course, depends on numerous factors, such as the stage of the settlement negotiations at the time that the consumer receives funding and the proportion of likely settlement offers that the ALF supplier provides in funding.

³² For example, when *global* or *inventory* settlements are negotiated. (Inventory settlements involve settlement of most, and often all, cases brought by a single law firm.)

the clients' lawyers would have no effect on settlements. This is because the clients are unlikely to factor into their settlement preferences and decisions the fact that their lawyers are particularly anxious for cash to repay their loans or to avoid further use of their lines of credit. To the extent that lawyers influence their clients' expectations of the sizes of settlement offers they can reasonably expect, however, lawyers hoping to keep their ALF suppliers happy may be able to influence settlements in the directions preferred by the ALF suppliers.

Investments in commercial litigation. In this segment, the deal involves a corporate plaintiff that has promised a share of the recovery to an ALF supplier. Whether an ALF contract of this form would more often increase or decrease the offer required by the plaintiff to be willing to settle is far from clear and may depend on the structure or the details of the ALF contract. The plaintiff's incentive to settle is likely to depend on the proportion of the recovery that the plaintiff has retained and the proportion of incremental legal fees that the plaintiff is paying. Further analysis of this issue requires additional conceptual and empirical knowledge.

Effects on the Accuracy or Fairness of Settlements

Another issue of substantial social concern is the degree to which plaintiffs are compensated appropriately given the laws that apply to their cases. (In some circumstances, no compensation is appropriate because the legal claims lack merit.) Molot (2009b) considers this issue in detail, treating *accuracy* as synonymous with *fairness*.³³ Regarding the meaning of *accuracy*, Molot (p. 2) writes,

A principal goal of civil procedure—indeed, *the* principal goal—is the accurate application of law to fact. . . . If we want to promote the accurate application of law to fact, we need to ensure not only that adjudicated cases are resolved accurately, but also that settlements are based on trial expectations.

A fundamental point made by Molot is that when a litigant is at a bargaining disadvantage relative to the litigant on the other side—because of greater risks, less tolerance for risk, fewer resources available for disputing and negotiating, or some combination—then providing ALF to the disadvantaged party could avert settlements that reflect primarily bargaining power rather than legal merit. Molot focuses on plaintiff-side ALF in his analysis but reminds readers that defense-side ALF would tend to promote accuracy if it is the defendant who is at a bargaining disadvantage for reasons other than legal merit. The basic point is that if ALF levels the playing field between plaintiffs and defendants, this will tend to improve the accuracy or fairness of settlements. Of course, providing ALF to the party that already has a bargaining advantage—whether that party is the plaintiff or the defendant—will tend to work *against* accurate and fair settlements.

Effects on the Transaction Costs of Disputes

A major economic downside of litigation generally is the high resource costs involved in resolving disputes. These costs, which are known as *transaction costs* of litigation, include such resources as the time of lawyers, litigants, witnesses, and court personnel. The transaction costs of litigation can be shockingly high. For example, in an early and extensive empirical study of

³³ For example, Molot (2009b) writes, “promote fair, accurate settlements” (p. 5) and “Part I explores conventional efforts to promote fair settlements” (p. 7).

this issue, Kakalik and Pace (1986) estimated that for U.S. tort suits terminated in 1985, aggregate transaction costs were roughly the same as the amount that plaintiffs' received in compensation.³⁴ More recent studies have reached similar conclusions. For example, Tillinghast-Towers Perrin (2004, p. 17) estimates that total transaction costs of the tort system in 2003 (comprising administrative costs, defense costs, and attorneys fees of claimants) were about 17 percent higher than the total amount of (net) compensation received by claimants.

A major driver of aggregate, nationwide transaction costs of litigation is the volume of litigation; more precisely, holding constant transaction cost per lawsuit, additional lawsuits increase aggregate transaction costs. The potential effects of ALF on litigation volume have been discussed above. An important driver of transaction costs per case is whether and at what stages cases are resolved. The potential effects of ALF on the timing of settlements have also been discussed above. In this subsection, I consider other potential effects of ALF on transaction costs per case.

The most obvious potential routes by which ALF could affect transaction costs per case are through (1) ALF suppliers influencing how cases are pursued, (2) ALF suppliers providing information to lawyers that helps them avoid uses of time and money that aren't sufficiently productive in advancing the interests of their clients, and (3) ALF demanders reducing their transaction costs in hopes of increasing their chances of obtaining ALF. My only comment regarding the third potential route is that it seems somewhat implausible that this could have substantial effects on transaction costs per case.

Regarding the other two routes, it is unknown whether, how often, and how ALF suppliers influence how cases are pursued or ALF suppliers provide information to ALF demanders that might influence how cases are pursued. If they do attempt to do so, their incentives to do so differ across the three segments. Below, I consider what kinds of changes in transaction costs would promote the interests of the three different kinds of ALF companies, which are relevant to the (unknown) extents that ALF influences the behavior of attorneys.

Providers of consumer legal funding would want to increase the chances that the claimant receives a recovery—because if there is no recovery, the company receives no repayment at all—and extra transactions could increase the likelihood of a recovery. However, when the lawyer's expenses are reimbursed out of the plaintiff's share of the gross recovery, increased expenses tend to reduce a claimant's net recovery, which reduces the amount that the claimant can repay. Whether these two forces would, on balance, more often increase or decrease transaction costs per case is unclear.

Lenders to plaintiffs' law firms would want transaction costs to be at the level that maximizes the chances that the loans are repaid. Extra expenses devoted to any case will tend to increase the chances of a recovery and its amount but will reduce the law firm's profits if there is no recovery, in which case the expenses will not be recovered. It is not clear whether the net effect of these two forces would more often be an increase or decrease in transaction costs per case. The former seems more likely, however. This is because a cash-constrained plaintiffs' firm will tend to invest less in out-of-pocket expenses (such as expert consultants and witnesses) than is optimal from its point of view (as a result of being cash-constrained). When this is the case, receipt of loans or lines of credit would tend to loosen the cash constraint and, thus, is likely to result in additional out-of-pocket expenses and transaction costs per case.

³⁴ Net of their lawyers' fees and any case expenses that are paid out of the plaintiffs' shares of the gross recoveries.

Investors in commercial litigation seek to maximize their expected rates of return on their investments. Implications for the level of transaction costs that would best promote this goal seem to depend on the precise nature of the deal. Key issues are the share of the recovery to which the ALF supplier is entitled and the share of incremental legal costs for which the ALF company is responsible. In cases, however, where ALF is sought to enable more money to be invested in prosecution of a commercial claim—the frequency of which is unknown—receipt of ALF seems likely to increase transaction costs.

Considerations Specific to Class Action and Patent-Infringement Claims

Some advocates of restraining ALF have put special emphasis on class-action litigation or patent-infringement litigation.

Class Actions

Beisner, Miller, and Rubin (2009) warn that ALF for class actions (and other kinds of aggregate litigation, such as mass actions) is especially troublesome. They argue that ALF will contribute to further litigation “abuses” associated with aggregate litigation, including claims lacking legal merit, interference with and delays in settlements, and effectively forcing defendants to settle unmeritorious claims because the risks of trial are unacceptable.³⁵ All of these possibilities have been discussed above.

The primary concern expressed in Beisner, Miller, and Rubin (2009)³⁶ may be viewed as a cautionary tale for policymakers in the United States. The cautionary scenario is based on experience in Australia, particularly the *Fostif* case,³⁷ which may have no analog in the United States. In that case, a litigation financing company not only invested in the plaintiffs’ representative (essentially, class) action for a share of the eventual recovery, the financing company also apparently initiated and tightly controlled the litigation. These arrangements were found by the Australian High Court not to conflict with law or public policy because New South Wales (as well as two other Australian states) had repealed its laws treating champerty and maintenance as crimes and torts. Allowing litigation funders to initiate and control litigation does not appear to be imminent in the United States; this cautionary tale, however, seems worthy of U.S. policymakers’ attention. To my mind, the main lesson is that allowing ALF suppliers to initiate litigation in areas in which many lawsuits lack legal merit—and I believe this to be true of class actions of some types—is likely to be socially undesirable.

My other comments about class actions are specific to the three currently active segments of the ALF industry that are the focus of this paper. First, class actions seem to be largely irrelevant in the context of consumer legal funding. This is because rarely, if ever, would a consumer’s potential recovery from a class action be large enough to support an application for a non-

³⁵ It is unclear whether these authors believe that all or almost all class actions are socially detrimental. My view is that many, but not nearly all, class actions are socially beneficial.

³⁶ As elaborated in a private email on April 2, 2010, from John H. Beisner and Gary A. Rubin of Skadden Arps (two of the authors of Beisner, Miller, and Rubin, 2009).

³⁷ My description of the *Fostif* case is based on Beisner, Miller, and Rubin (2009, pp. 9–11) and Cornwall Stodart (no date).

recourse loan.³⁸ Second, class actions may be indirectly supported through loans to plaintiffs' law firms. A major unknown here is whether class actions in a plaintiffs' firm's portfolio would make loans to such firms more or less attractive to ALF suppliers. It seems that the answer to this question is specific to the class action, the plaintiffs' firm's status in the class action, and its stage at the time that a loan is considered. Third, it is unclear how often investments in commercial class-action claims would be economically attractive to ALF suppliers.³⁹

Patent-Infringement Claims

In discussions of the social desirability of ALF, it is not uncommon for concerns to be voiced about increases in the volume of patent-infringement claims brought by so-called patent "trolls" or, less pejoratively, "nonpracticing entities" (NPEs).⁴⁰ PricewaterhouseCoopers (2009, p. 2) defines NPEs as "organizations . . . that do not design, manufacture, or distribute products." (Other definitions of NPEs are similar.) It is not entirely clear why NPEs evoke *special* hostility from those whom they sue.

One possibility is that some NPEs apparently purchase patents for the sole purpose of bringing infringement lawsuits, an activity that is their entire business, and such lawsuits are believed by many to create no social value whatever. Regarding the implication that NPEs do nothing but bring litigation, I merely note that many NPEs may be involved in socially useful activities other than designing, manufacturing, or distributing products. For example, an NPE listed in Chart 2C of PricewaterhouseCoopers (2009, p. 7) is Cornell University. Moreover, as suggested by Molot (2009b, p. 27), in some instances, NPEs may purchase patents, for example, from high-technology start-ups that don't have the financial resources to protect their patents (without ALF), and participating in such litigation could, in any event, be debilitating for small start-ups that can create more social value by focusing on developing their products, services, and so on. In this scenario, NPEs can help start-ups succeed with their primary goals by providing investment capital in exchange for their patents (i.e., by monetizing the start-ups' legal claims).

In fact, from the perspective of a patent holder, ALF can be a fairly close substitute for selling the patent to an NPE. This is because an investment in the claim by an ALF company involves partial monetizing of the associated legal claim, while selling the patent to an NPE (or any other entity) would involve full monetizing. Thus, availability of ALF could, in principle, reduce litigation activity by NPEs.

Another possible source of special hostility towards NPEs is that lawsuits brought by NPEs are or are believed to be less meritorious on average than infringement suits brought by other types of organizations. PricewaterhouseCoopers (2009) provides a hint that there is a tendency in this direction. Specifically, PricewaterhouseCoopers (p. 5) suggests that lawsuits

³⁸ One reason for this is that it is fairly rare for personal-injury class actions to be certified these days; see, for example, Muehlberger and Mizell (2006).

³⁹ Northway (2000) focuses on ALF (which she refers to as "syndication of lawsuits") in the context of class actions and argues that professional rules developed with ordinary litigation in mind make little sense in the context of class actions.

⁴⁰ Much of this discussion pertains to the existence of NPEs that buy patents for the purpose of bringing legal claims. How this activity relates to the forms of ALF emphasized in this paper is unclear. More specifically, purchasing a legal claim by purchasing a patent may or may not involve ALF as defined here, and it is unknown how often ALF suppliers invest in commercial patent claims brought by NPEs.

brought by NPEs fail at summary judgment at a somewhat higher rate than other patent-infringement lawsuits.

In sum, many defendants appear to be especially concerned about patent-infringement litigation brought by NPEs, but the policy discussion to date seems not to be well connected to standard concerns of civil-justice policymakers. If NPEs raise nonstandard concerns, it would be helpful for these concerns to be clearly articulated. Future analyses of these questions might help improve patent-litigation policies generally and ALF policies more specifically to the (unknown) extent that ALF exacerbates or ameliorates socially undesirable aspects of patent litigation.

Policy Assessment and the Effects of ALF over Time

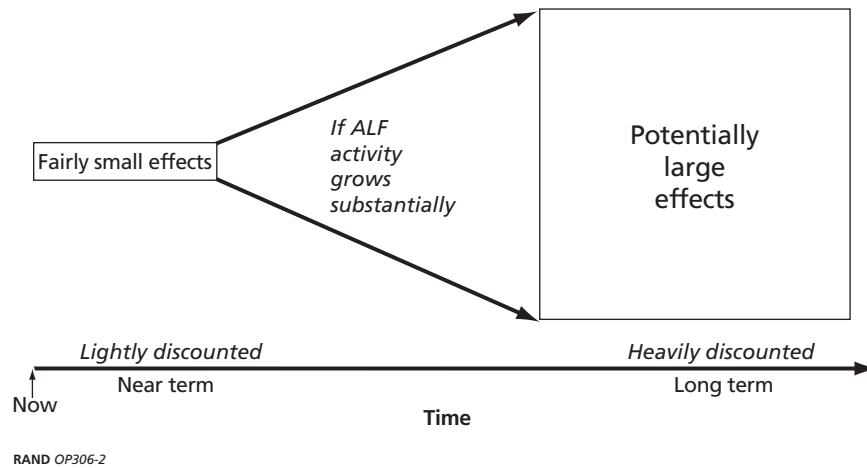
Despite some calls for major, immediate policy responses, it seems unwise currently to prohibit ALF or to implement regulations that fundamentally constrain the development of existing and potential future forms of ALF. First, there are major unknowns pertaining to the current effects of ALF in the three active segments, and we don't know nearly enough to decide which segments and which activities within these segments have been socially advantageous and which have been socially disadvantageous. Second, the current and recent effects of ALF would provide unreliable bases for predicting the future effects of ALF because recent ALF activity is likely to reflect, to a very substantial degree, special circumstances associated with the recession and credit crisis. Third, we don't know what new business models for ALF suppliers might emerge if policymakers allow markets to develop. For example, will substantial defense-side ALF emerge, and, if so, in what forms? Will new forms of plaintiff-side ALF emerge, and, if so, what will they look like? Fourth, we don't know how the sizes of and the activities in the three currently active segments will evolve.

In this section, I continue to focus on the three currently active segments of the ALF industry, consider how market forces might reshape them, and point out potential barriers to achieving close to the full potential benefits of competition. The market for consumer legal funding has been active for a decade or more and includes dozens of suppliers. It is unclear whether we should expect market forces to reshape this segment in substantial ways. In contrast, investments in commercial litigation are quite new and that market is changing rapidly. For example, Juris Capital and Juridica were apparently investing in commercial lawsuits in the United States during the first half of 2009, but the other four companies listed in Table 3—namely, ARCA, Burford, Calunius, and IMF—have entered the U.S. market since then. Thus, it seems reasonable to suggest that this segment is in its infancy.

Policy evaluation properly focuses on future social effects because we can't change the past. It seems more than plausible that the three segments will grow considerably unless policymakers prevent them from doing so. If these segments grow, their longer-term effects—10 years or more in the future, say—on outcomes of social concern may be much larger than their nearer-term effects. To combine effects that occur at different times in the future, it is standard practice, and appropriate, to put more weight on effects the sooner they will occur. In more technical terms, this is accomplished by discounting effects occurring at different times to present values.

Despite heavier discounting of effects that will occur in the more-distant future, long-term effects can dominate the present value and, thus, the policy assessment, if they are sufficiently large relative to near-term effects. This possibility is illustrated in Figure 2. If these

Figure 2
Long-Term Effects Could Dominate ALF Policy Evaluations



activities do not grow substantially, the social stakes in policies related to ALF may be too small to warrant substantial policy concern or attention.

Thus, the potential long-term effects of ALF should be considered when contemplating ALF-related policies. In this section, I focus on future effects of ALF on two social objectives: fairness and economic efficiency. I discuss these objectives separately. Adopting a standard perspective in policy evaluation, how to combine effects in these two domains requires value judgments that are best left to policymakers.

Fairness

As discussed above, fairness to both plaintiffs and defendants is a legitimate concern of policymakers, and the U.S. civil litigation system seems to administer many large doses of unfairness both to particular plaintiffs and to particular defendants. A lawsuit is unfair to a defendant when it lacks legal merit. In such instances, defendants' tangible costs—a partial measure of the costs of unfairness to them—include costs of defense and sometimes costs of settlements or paying awards. For plaintiffs, unfairness can involve an inability, for financial reasons, to bring a claim that has legal merit or a failure to obtain just compensation in such cases. In the context of ALF, key issues in these regards are the extent to which, in the future, ALF will increase or decrease the prevalence of unmeritorious lawsuits and the extent to which ALF will help to promote or undermine fair settlements by leveling or further tilting the playing fields. These issues have been addressed in Section 5 in the context of effects of ALF to date. I don't see any major reason to expect that the future evolution of ALF will fundamentally affect these outcomes. In contrast, there is considerable reason to think that the future evolution of the ALF industry will affect the extent to which ALF affects other outcomes of major policy concern.

Economic Efficiency

Economic efficiency refers to the degree to which we as a society use scarce resources to improve average standards of living currently and in the future. Our interest centers here on the efficiency implications of various potential policy actions related to ALF.

We often look to competition among suppliers to promote economic efficiency because of the Theorem of the Invisible Hand, which says that, *under ideal conditions* (i.e., conditions comprising “perfect competition”), competition leads to economically efficient use of resources. The ideal conditions underlying the theorem also provide guidance about sources of inefficiency and potential policy actions that could promote efficiency when market outcomes are inefficient. Let us consider the current state of competition in the three currently active segments of the U.S. ALF industry and efficiency implications of ways that these markets might evolve.

Some elements of the analysis (if phrased sufficiently generally) are common to all three segments. These include the following:

1. The extent to which the activities of ALF companies grow over time depends on the extent to which demand for ALF grows. Factors affecting the demand for services provided by ALF companies include changes in the volume and costs of litigation and the extent to which ALF suppliers other than ALF companies expand their ALF activities.
2. ALF companies will grow more, holding demand constant, if the prices of their services are lower. Two key factors determining trends in the prices of ALF services are the degree of competition—since competition tends to reduce prices of services toward the costs of providing them—and decreases in costs of producing ALF services. Decreases in costs of providing services might result, for example, from ALF suppliers learning over time how to perform tasks such as case evaluation at lower costs—comprising due diligence costs, per se, and the implicit costs of underperforming ALF deals attributable to shortcomings in case-evaluation capabilities or processes.
3. The more profitable that ALF companies are in a market (industry segment) at any time, the more entry of capital we can expect into that market. We should expect that expansion of capital available to ALF suppliers will come from a mixture of two processes—expansion of capital available to current (or incumbent) ALF suppliers and entry by new ALF suppliers. Expansion of capital availability for ALF of either type will tend to strengthen competition, reduce prices, and thus increase the values that ALF recipients obtain from ALF.
4. Entry of capital and accompanying increases in competition will tend to reduce the profits of ALF companies. Entry will tend to continue as long as entrants expect to be able to achieve higher rates of return on their capital as ALF suppliers than that capital can earn elsewhere in comparably risky uses.
5. Once the entry and competitive processes reach an (approximate) equilibrium in an ALF industry segment, the ALF suppliers that have cost or demand advantages over their competitors will be more profitable than those competitors. Cost advantages might reflect better case-evaluation capabilities, and demand advantages might stem from superior reputations among demanders resulting from providing services of higher value given their prices or investments in building relationships with demanders.

Let us move on to considerations that are specific to the three segments of the ALF industry.

The market for consumer legal funding. One ideal condition for markets to achieve economic efficiency is that sellers (in our context, ALF suppliers) do not have the ability to increase prices beyond the levels necessary to cover their costs. It is often thought that having sufficient numbers of sellers competing in a market—and there are several dozen cash-advance companies—is sufficient to achieve this lack of “market power.” However, another ideal condition is that buyers and sellers have “perfect information”—meaning they have all of the relevant information for making their decisions, without incurring any costs of acquiring or developing information. It seems to me that two major impediments to enhancing efficiency in the market for consumer legal funding are two information problems faced by consumers.

First, it is likely to be very costly for some applicants for consumer legal funding to understand the contracts provided by at least some cash-advance companies. If so, this can undermine efficiency through unnecessarily high costs to demanders of understanding the contracts. For cash-advance demanders who don’t understand the contracts they sign, there may be substantial efficiency costs from decisions that demanders think promote their well-being but actually don’t. Perhaps market forces will help mitigate this difficulty. For example, some providers of consumer legal funding may decide that a promising competitive strategy is to use contracts that are easier to understand than those of their competitors and highlight that fact on their websites and in other forms of promotion of their services.

Second, it appears that cash-advance demanders have poor information about what deals are available from different cash-advance companies—for example, what financing fees the companies would charge demanders in their circumstances. It seems that the costs of acquiring such information are currently quite high. For example, in many instances, information acquisition may require demanders to fill out applications for several providers of consumer legal funding, which would involve considerable time costs, as well as financial costs in the cases of companies that require application fees.¹ As a result, these companies may be able to charge financing fees that substantially exceed the companies’ costs—including costs associated with risks of nonpayment—because of lack of information by consumers.

Since the value to demanders of this kind of information for consumers could be very high, future market developments might help solve this problem. For example, brokers might invest in information, build relationships with cash-advance companies, and connect consumers with the suppliers who will offer them the best terms.² Less optimistically, if this information problem is substantial and is not largely ameliorated, then inefficient search costs for consumers would persist in the long term. Moreover, if this information problem persists, another type of inefficiency might also persist. In particular, providers of consumer legal funding might be able, even in the long term, to charge fees in excess of the minimum possible costs of supplying non-recourse loans and thereby enable market survival by funders that fail to attain

¹ No systematic information exists concerning which or how many providers of consumer legal funding require application fees or the sizes of such fees. I have been told, however, that some companies do not require any application fees, some others charge between \$150 and \$250, and that the ALFA members that use application fees charge them only on completed transactions and that these fees are paid only when the consumer repays the ALF company. (Private email from Harvey Hirschfeld, Chairman of ALFA, April 11, 2010.)

² An analogy to insurance brokers seems instructive. Specifically, it would be much more difficult for consumers to find the best offers for homeowners, auto, and other personal insurance lines without the aid of independent insurance brokers.

minimum possible cost levels (i.e., some funders may operate inefficiently but survive in the long term).

These considerations suggest that if policymakers are inclined to intervene in cash-advance markets, they might best focus on how to lower information costs for demanders of consumer legal funding.

The market for loans to plaintiffs' law firms. The number of ALF suppliers competing with each other in this market may be too few to be confident about the current market offering loans at rates close to the costs of ALF suppliers. If the incumbent suppliers appear to be earning rates of return on investment exceeding those available in other areas with comparable risks, entry by additional suppliers might lower borrowing costs if they are, in fact, currently above competitive levels. It is unknown how costly it is for plaintiffs' law firms that can't access lower-cost sources of capital to learn about and compare offers potentially available from different ALF suppliers. Perhaps brokers will emerge and play roles analogous to those just discussed in the context of the cash-advance market.

The market for investments in commercial claims. As part of their efforts to reduce their legal costs, during the past two or three years, many corporations have been pushing their outside counsel to enter into alternative (to hourly billing) fee agreements, and there appears to be significant movement towards use of AFAs. The extent to which this trend will increase demand for services of ALF companies depends of several factors. First, how rapidly will corporate plaintiffs expand their willingness to exchange shares of their recoveries for lower litigation costs? Second, to what extent will this translate into acceptance of AFAs by corporations' outside counsel? The latter question is important because law firms working under AFAs are likely to be viewed as fairly close substitutes, in the eyes of corporate claim holders, for at least some of the services available from ALF suppliers. Third, many corporate law firms appear to be entering into AFAs not because they prefer to work under such arrangements but because there is competitive pressure to accept AFAs. To the extent that corporate law firms are working under AFAs but would prefer to bear less risk, these law firms are themselves potential demanders of the services of ALF companies.

How might the costs of ALF suppliers change over time in this segment of the ALF industry? The three most important components of cost seem to be (1) costs of capital to ALF suppliers, (2) costs of case evaluation, and (3) costs associated with the risks of investing in cases that don't return any or much money to ALF suppliers. I have nothing worth saying about future levels of costs of capital. There seems to be considerable potential for decreasing (inflation-adjusted or constant-dollar) costs of case evaluation and risks of making investments that don't pay off, as ALF suppliers learn from experience. As also discussed presently, however, as the market grows, costs associated with adverse selection may increase.

There is substantial reason to think that competition will continue to increase in this market segment over the next several years. One of the reasons is that the publicity that this activity has received lately, along with suggestions that ALF suppliers are achieving unusually high rates of return, should be expected to attract a continued flow of new capital into this market. Some of this entry may even be by banks and insurance companies.³

Perhaps the greatest threat to promoting economic efficiency in this segment is entry by ALF suppliers who won't have the skills or networks of legal consultants necessary to evalu-

³ For example, Molot (2009b, p. 32) writes, "large, reputable capital providers such as banks and insurance companies . . . thus far have stayed away in part because of the legal uncertainty and stigma that surrounds litigation finance."

ate complex cases effectively.⁴ If this type of entry occurs to a substantial degree, such ALF suppliers may be prone to investing in cases for which the economics are not favorable or in cases that lack legal merit but have favorable economics (i.e., nuisance suits). Investing in cases with unfavorable economics will tend to lead to losses, and such ALF suppliers will tend to disappear because of these losses. More optimistically, in the course of the development of this industry segment, the state of the art in evaluation of commercial cases is likely to continue to improve, and more and more people and organizations are likely to develop strong capabilities in the area.⁵ Thus the prospects for future entrants to avoid financially unattractive investments might improve considerably. Investing in nuisance suits, however, may be a viable business model that the market will not be effective in eliminating.

⁴ In principle, adverse-selection and moral-hazard concerns may also be mitigated by pricing or contractual arrangements. For example, ALF suppliers may successfully negotiate for contract terms penalizing ALF recipients for withholding adverse information that subsequently comes to light.

⁵ Recall that, according to Lindeman (2010, p. 4), ARCA, Burford, and Juridica all seem to rely somewhat heavily on assessments of claims by outside experts.

Concluding Comments

I have offered many somewhat detailed and specific ideas and suggestions. For current purposes of policymakers, however, details and specifics should not be important. This is because (1) almost all of the details and specifics offered here are preliminary and tentative, and many of them are likely to be useful only to policy researchers and analysts, and (2) even if all of the details and specifics are accurate, they would still not provide policymakers with enough information to design effective policies because, for example, ALF and ALF markets are in states of flux.

In my view, the key lessons for U.S. policymakers offered in this paper are as follows:

- Policymakers would be well advised not to accept uncritically claims about ALF or ALF activities being “unethical.” Any valid claims of this variety are likely to pertain to legal ethics but not to social morality.
- The economics of the three segments of the ALF industry on which I have focused differ considerably. As a consequence, the issues for policymakers also differ considerably. Analogous observations are likely to apply to forms of ALF that have yet to emerge, whether they finance plaintiffs or defendants.
- Policymakers would be wise to be skeptical of broad claims about “effects of ALF” that don’t distinguish among segments of the ALF industry, including segments or types of ALF that may emerge in the future.
- Policymakers should also be skeptical about the relevance for the United States of the effects of ALF in other countries, such as Australia and the United Kingdom, that have very different legal rules pertaining to litigation, such as not allowing lawyers to work under contingency-fee agreements and requiring the losing side to pay the winning side’s legal expenses. The effects of ALF—and, indeed, the forms and details of ALF—in other countries are likely to be greatly affected by such fundamental features of their litigation systems.
- It is also wise to be skeptical of one-size-fits-all policy responses because, in light of major differences in the economics of different types of ALF, it seems implausible that widely applicable policies will be widely effective in promoting social objectives.
- The massive uncertainties about how ALF markets operate and where they are heading suggest that, in the near term, policymakers might best limit themselves to searching for “robust” policies—that is, policies whose outcomes are likely to be satisfactory, or at least not very unsatisfactory, no matter what the truth may be about key unknowns.

I end by elaborating on robust policies.

It seems to me that, in the context of ALF, there are two key characteristics of robust policies for the short term. The first might be called *light-handedness*, by which I mean avoiding policies that could fundamentally impede the development of effective competition in ALF and related markets. The second characteristic might be called *precision*, by which I mean avoiding policies that apply more broadly than necessary to alleviate conditions that are viewed as unacceptable in the short term.

Limiting policy responses to robust policies is likely, however, to require patience from policymakers. There are at least three reasons that patience is likely to be a virtue in this context. First, the current effects of ALF are likely to be small relative to potential future effects, particularly if ALF activities grow considerably. Moreover, if ALF activities do not grow considerably, the effects of ALF might not be substantial enough to warrant much attention from policymakers. Second, major, socially undesirable effects of ALF do not appear to be imminent; thus, the costs of watchful waiting are unlikely to be uncomfortably large. Third, the degree to which ALF markets promote economic efficiency is likely to increase over time with growing competition and, perhaps, the emergence of market-based responses to the information problems highlighted in Section 6.

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