NAMIC ISSUE ANALYSIS

NAMIC ADVOCACY

CURBING A QUESTIONABLE PRACTICE:

A SURVEY OF PUBLIC POLICY MEASURES TO ADDRESS CONCERNS SURROUNDING LITIGATION FUNDING

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INTRODUCTION

Litigation funding[1] has developed into a significant public policy issue of concern for insurers and others affected by litigation over the past twenty years. The issue initially came to the attention of NAMIC when legislative action in a number of states established a regulatory framework for the practice.[2] Litigation funding typically involves a lender or litigation finance company providing funds to a plaintiff in a lawsuit in exchange for the right to collect proceeds when the plaintiff obtains a settlement or judgment in the case. This contractual obligation potentially injects a different dynamic over the traditional two-party attorney/client representation. Further, the returns to the litigation finance company when the plaintiff recovers are many times higher than is permissible in traditional lending because of exorbitant interest rates charged on the loan.

The first round of legislation in this arena afforded only meager consumer protections, such as requiring funding agreements to be in writing. These laws did not address interest rates, despite the fact litigation lenders charged rates that would be considered excessive under any state lending law. And they did not provide for disclosure of the funding agreements to the courts or other parties.

It was the litigation funding industry that pushed for limiting consumer protections with the apparent goal of avoiding meaningful regulation while establishing in state law the legitimacy of a business practice that was being increasingly questioned.[3] The resulting loose regulatory structure has led to an influx of investors, hedge funds, and other entities with high volumes of cash seeking higher returns, resulting in an estimated litigation lending market between $50 billion and $100 billion.[4]

As this litigation investment activity has expanded there has also been a concomitant rise in the number of plaintiff horror stories. In one example, a plaintiff borrowed $5,000 to support himself during litigation and then had to pay back $7,500 four months later from a recovery, an interest rate of more than 50 percent.[5] Another litigant borrowed $12,000 from a litigation lending company and was forced to pay back an additional $11,000 in fees less than a year later, nearly 100 percent interest.[6]

In NAMIC's view, litigation funding as it has developed and is currently practiced is a pernicious enterprise that distorts and possibly expands litigation while taking advantage of vulnerable consumers. Therefore, significant reforms, including interest rate limitations and requirements to disclose the existence of litigation lending to all litigants and the court, are imperative, while an outright prohibition of the practice should be considered.

Armed with a better understanding of the legal landscape, NAMIC and other organizations have worked to seek and secure meaningful public policy measures aimed at better understanding and ultimately curbing the problems associated with litigation funding. However, there is much work left to be done. The purpose of this paper is to better understand the remaining challenges and opportunities by surveying some of the recent public policy developments across the country in the litigation funding space.

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1 Litigation funding encompasses a number of terms and practices including but not limited to litigation financing agreements, litigation funding agreements, litigation lending, litigation finance, and/or third-party litigation funding. For all intents and purposes, this paper asserts for the most part the terms are interchangeable and deal mainly with third parties funding litigation concerns that basically retain a contingent interest in the outcome and use the lawsuit itself as collateral although may be non-recourse if recovery is not obtained. The differentiation in terms sometimes deals with the amount expended and whether it is for an individual plaintiff or a class action lawsuit.

2 See https://www.claimsjournal.com/news/national/2013/05/20/229242.htm.

3 Providing funds to obtain an interest in a lawsuit violates the doctrines of champerty and maintenance. Though they have archaic names these doctrines have a solid history in the common law, and modern courts in many cases, though not all, have refused to enforce contracts such as investments in litigation based on these principles. See, for example, Rancman v. Interim Settlement Funding Corp., 789 N.E.2d 217, 219-21 (Ohio 2003) and Johnson v. Wright 682 N.W.2d 671 (Minn. App. 2004).

4 See https://www.marketwatch.com/story/in-low-yield-environment-litigation-finance-booms-2018-08-17

5 See https://www.ajc.com/business/rules-lax-litigation-lending/I7UAfSoGk13yM8GCeHHIFK/.

6 https://www.nytimes.com/2005/04/04/nyregion/waiting-to-settle-a-lawsuit-beware-of-cash-advances.html.

THE CONCERNS WITH LITIGATION FUNDING ARRANGEMENTS[7]

The justifications for litigation lending/funding often involve ensuring access to the justice system for those who might be unable to afford the usually intimidating attorneys' fees associated with a potentially lengthy lawsuit. However important the principle of access may be, this justification is ultimately misleading. It leaves out the already permitted use across the country of contingency fees. Under this fee structure, rather than paying an hourly fee to an attorney for work performed, the attorney receives a percentage plus expenses for any recovery obtained. Given the unfettered access to contingency fee arrangements, any uses of litigation lending must be appropriately tailored to address a specific need.

Nor is it the case that litigation funding simply represents another equivalent method of accessing the courts; there are various costs and externalities that must be considered. As a practical matter, litigation funding through a third party creates a fundamentally different dynamic for a plaintiff seeking redress. A lawyer representing a client has certain ethical considerations that become complicated in a third-party litigation funding atmosphere. These considerations include allowing outside parties to influence litigation decisions or the independent judgment of the attorney; protecting attorney-client privileged information when potentially divulged to a third-party lender as part of the contractual arrangement including the work product of the attorney; protecting the client's interests despite third-party concerns; allowing sometimes unreasonable fee-splitting arrangements; producing unrecognized conflicts of interest; and prosecuting only meritorious claims. When litigation funding mechanisms impinge on these principles they are clearly disrupting the traditional attorney-client relationship.

With large caches of capital and murky parameters for underwriting the litigation endeavors of plaintiffs, one can see the exponential explosion of meritless litigation. There has long been concern with nuisance suits where litigants file merely trying to get a de minimus settlement out of a defendant opting to avoid the costs of litigation. These funding mechanisms can easily create cottage industries abusing frivolous lawsuits for quick payouts, but the additional costs to the system are real and borne by the public at large. Excessive litigation serves only to bog down the judicial system and prevent courts from expeditiously hearing and deciding serious and substantive cases on their dockets.

At the most basic level this third-party, loan-based funding scheme undermines several long-established legal principles that, for good reason, have been a part of the Western legal canon for hundreds of years. Despite tortured interpretations to the contrary[8], litigation funding undermines the traditional common law ban on abuses of the legal system such as champerty, maintenance, barratry, and usury. Champerty deals with maintaining a suit in return for a financial interest in the outcome. Maintenance is the intermingling in litigation for the express purpose of intensifying litigation and for other encouragements. Barratry involves the continuing practice of maintenance or champerty. Finally, usury is charging inappropriate interest rates that exceed moral or statutory parameters for a given product or service. While courts sometimes struggle with how to handle these historical concepts in a modern society, it is clear that the litigation lending industry runs afoul of all of them, which should raise serious questions about the practice.

These are only a few of the concerns that arise out of the litigation loan funding scheme, and yet they highlight how the potential for abuse can add costs and raise questions about who is actually gaining access to the tort system and for what purpose.

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[7] NAMIC first published an exploratory review of the public policy concerns related to litigation lending and financing titled "Third-Party Litigation Funding: Tipping the Scales of Justice for Profit" in May 2011. See Appendix I.

[8] See e.g. Litigation Funding: Charting A Legal And Ethical Course, McLaughlin, Vermont Law Review, Vol. 31:615, 628 (2007), "The case is significant, not so much because of the legal issues it addresses, but because of the legal issues the court fails to reach in considering the legality and ethics of LLAs [litigation lending agreements]."

Ultimately, it seems clear that the costs far outweigh the benefits and the best public policy course of action is to end or severely curtail litigation lending. For a full discussion of the potential issues and costs created by litigation funding, see Appendix I.

Unfortunately, lawsuit lending is far from harmless. It hurts consumers while undermining the integrity of the justice system.

The practice hurts consumers by eating into their recoveries in litigation. The New York Law Journal reported on the case of a Brooklyn man who borrowed $27,000 from a lawsuit lender for a slip-and-fall lawsuit. His case was settled five years later, but the lender demanded $100,000 – two-thirds of the total settlement and more than three times the amount of the original loan. To add insult to injury, the plaintiff's lawyers pocketed an additional one-third of the settlement – leaving the plaintiff with just $111 out of a $150,000 settlement. In another case reported by the New York Times, a plaintiff actually lost money. After winning nearly $170,000 at trial, the plaintiff's lender claimed it was owed $221,000 – an amount 30 percent larger than the total recovery.[9]

STATE LAWS THAT FORMALIZED LITIGATION FUNDING

Three states – Maine, Nebraska, and Ohio – enacted laws between 2007 and 2010 that purported to establish a regulatory framework for litigation lending, but in fact merely codified the practice and removed significant questions about its legal propriety.

In addition to these statutes, in 2005, New York Attorney General Eliot Spitzer entered into agreements with nine lawsuit lending companies that had the same effect as the legislation in that they essentially authorized litigation lending.[10] While Spitzer said at the time that the agreements would "fundamentally change the manner in which these personal injury litigation cash advances are offered and negotiated," in reality they merely gave the industry a blessing to continue with existing practices.

MAINE

Maine's statute, Maine Rev. Stat. Ann. tit. 9-A, § 12-101, effective Jan. 1, 2008[11], defines legal funding as "a transaction in which a company makes a cash payment to a consumer in exchange for the right to receive an amount out of the potential proceeds of any realized settlement, judgment, award or verdict the consumer may receive in a civil claim or action" and notes that the consumer is not required to pay the company if no proceeds are received in the civil action.

The law requires that legal funding contracts be written in "a clear and coherent manner" using "words with common, everyday meanings" and have a "meaningful arrangement" in terms of divisions and captions. The contracts must provide that the consumer can cancel within five business days of receiving funds. The contracts must further advise consumers that legal funding providers are required to register with the state and include the state website where consumers can contact funders or obtain comparative rate quotes. They must contain language advising the consumer to obtain advice from an attorney before signing and stipulating that the funding provider cannot and will not make decisions with respect to the underlying civil action. The law limits the assessment of fees to 42 months and provides they cannot be compounded more than semiannually. The law also includes registration requirements for litigation funders, including a finding by the state credit administrator that "the business will be operated honestly and fairly."

[9] U.S. Chamber of Commerce Institute for Legal Reform web page – https://www.instituteforlegalreform.com/issues/lawsuit-lending.
[10] https://ag.ny.gov/press-release/personal-injury-cash-advance-firms-agree-reforms.
[11] Available at https://legislature.maine.gov/statutes/9-A/title9-A.pdf.

NEBRASKA

Nebraska's statute, Neb. Rev. Stat. § 25-3301(et. seq.) effective April 13, 2010[12], requires that "nonrecourse civil litigation funding" contracts must meet certain formatting standards, state the total dollar amount to be funded, any fees, the annual percentage rate, and the frequency of compounding. It requires that the contract include notice of the consumer's right to cancel within five business days of receiving funds and stipulates that the civil litigation funding company has no right to make decisions regarding the underlying claim or settlement. The statute requires that contracts contain language recommending the consumer consult an attorney as well as potentially a tax or financial professional. The statute requires that the contract contain a written acknowledgement by the consumer's attorney that:

> The attorney is being paid on a contingency fee basis;
>
> All proceeds of the civil litigation will be disbursed from the attorney's trust account;
>
> The attorney is following the written instructions of the consumer with regard to the non-recourse civil litigation funding;
>
> The attorney representing the consumer in the legal claim shall not be paid or offered to be paid commissions or referral fees; and
>
> Whether the attorney representing the consumer in the legal claim does or does not have a financial interest in the civil litigation funding company.

The Nebraska statute lists certain prohibited acts for civil litigation funding companies and requires the companies to register with the secretary of state who must make a determination that the business "will be operated honestly or fairly."

OHIO

Ohio's statute, Ohio Rev. Code § 1349.55(A)(1) effective Aug. 27, 2008[13], was enacted presumably in response to the state's Supreme Court decision finding litigation lending is against public policy. The law requires that contracts for "non-recourse civil litigation advance" include the total amount to be advanced to the consumer, an itemization of one-time fees, the total dollar amount to be repaid, and the annual percentage rate. It provides for cancellation within five business days of receiving funds, and prominent notice of the same, and requires certain representations by the attorney representing the consumer. The Ohio law does not contain a licensure or registration requirement.

STATE LAWS THAT IMPOSED MEANINGFUL LIMITS ON LAWSUIT FUNDING

Following enactment of the Maine, Nebraska, and Ohio statutes, the insurance industry and broader business community started to oppose legislation that did little more than legitimize the litigation lending industry and began to explore ways in which legislation could curb the practice and address its most problematic aspects.

[12] Available at https://www.nebraskalegislature.gov/laws/browse-chapters.php?chapter=25.
[13] Available at http://codes.ohio.gov/orc/1349.55.

TENNESSEE

The first success came about in Tennessee, where the Legislature enacted the Tennessee Litigation Financing Consumer Protection Act, Tenn. Code Ann. § 47-16-101 et seq. effective July 1, 2014.[14] The law contained many of the same provisions as previously passed laws but included a significant provision that limited the interest rate and fees that lawsuit lenders could charge. "All consumers entering into litigation financing transactions shall pay the litigation financier an annual fee of not more than ten percent (10%) of the original amount of money provided to the consumer for the litigation financing transaction," the statute states. It also limits the length of litigation financing transactions to three years and limits maximum yearly fees to $360 annually for each one thousand dollars ($1,000) of the unpaid principal amount of the funds advanced to the consumer up to a maximum of three (3) years in addition to the annual fee as mentioned above.

In addition to the interest and fee limitations, the Tennessee statute requires litigation financers to register with the secretary of state, though it does not require any finding that the firm will be operated to any particular standard of conduct.

Like the statutes of other states, the Tennessee law requires that litigation financing contracts indicate the consumer can cancel the contract within five days of receiving funds and provides for certain disclosures to the consumer, such as recommending consulting an attorney.

Violations of the Tennessee statute render the contract unenforceable under the statute and also constitute unfair or deceptive practices that could trigger potential recovery for attorneys' fees and costs and enforcement by the attorney general.

Enactment of the Tennessee law had the immediate effect of prompting a leading litigation lending firm, Oasis Legal Finance, to announce that it would no longer do business in the Volunteer State. [15]

OKLAHOMA

Oklahoma took a different approach than Tennessee in 2013 when it enacted the Consumer Litigation Funding Act, putting oversight of the practice under the state Department of Consumer Credit.[16] The statute, Okla. Stat. § 14A-3-801(6), is part of the state's Consumer Credit Code.

First, the law requires litigation funders to obtain a license from the state's Department of Consumer Credit prior to engaging in the business. The Oklahoma statute defines "consumer litigation funder" as a person who enters into a "consumer litigation funding agreement," which is defined as an agreement "under which money is provided to or on behalf of a consumer by a consumer litigation funder for a purpose other than prosecuting the consumer's legal claim" and "the repayment of the money is in accordance with a litigation funding transaction, the terms of which are included as part of the consumer litigation funding agreement."

Other than establishing that the practice fits within the broader scope of consumer credit regulatory oversight, the Oklahoma statute is similar in many respects to the other laws that preceded it. It provides the consumer with the right to cancel within five days of receiving funds and specifies what must be in the litigation funding agreement.

[14] Available at https://law.justia.com/codes/tennessee/2017/title-47/chapter-16/.

[15] "Litigation Financing Firm Exits Tennessee as New Law Goes Into Effect," Andrew G. Simpson, Insurance Journal, July 3, 2014, available at https://www.insurancejournal.com/news/southeast/2014/07/03/333772.htm.

[16] See https://www.ok.gov/okdocc/documents/Consumer%20Litigation%20Funder%20license%20announcement.pdf.

ARKANSAS

Arkansas enacted its consumer litigation lending statute, Ark. Code § 4-57-109, in 2015. The law explicitly applies the 17 percent maximum rate of interest set by statute and the state constitution to "a consumer lawsuit lending transaction."[17]

It defines that term in similar fashion as other states, as "providing money to a consumer to use for any purpose other than prosecuting the consumer's dispute, the repayment of which is conditioned upon and sourced from the consumer's proceeds from the outcome of the dispute by judgment, settlement, or otherwise" and "Purchasing from a consumer a contingent right to receive a share of the proceeds of the consumer's dispute by judgment, settlement, or otherwise."[18]

INDIANA

In March 2016, Indiana enacted a statute, Ind. Code 24-4.5-3-110, that uses a different term, "civil proceeding advance payment transaction," or "CPAP transaction," defined as "a nonrecourse transaction in which a CPAP provider provides a funded amount to a consumer claimant to use for any purpose other than prosecuting the consumer claimant's civil proceeding, if the repayment of the funded amount is" ... "required only if the consumer claimant prevails in the civil proceeding" and "sourced from the proceeds of the civil proceeding, whether the proceeds result from a judgment, a settlement, or some other resolution."[19]

The Indiana law specified that such transactions are not a loan, a provision that prompted approval from lenders.[20] On the other hand, they did not approve of the law's establishment of a 36 percent cap on interest rates.[21]

VERMONT

Vermont's Legislature took a purposively deliberative approach to addressing litigation financing. House Bill 84[22] passed in 2015 and codified as 8 V.S.A. § 2251 et. seq.[23], established definitions and reporting requirements for litigation lenders, and called for the commissioner of Financial Regulation and the attorney general to "submit a recommendation or draft legislation to the General Assembly that reflects a balance between providing consumers with access to funds for personal expenses while the consumer is a party to a civil action or legal claim and protecting the consumer from predatory practices by a person who provides consumer litigation funding."[24]

In January 2017, the commissioner of financial regulation and attorney general issued a brief report required by statute noting the operation of only a single lender in the state and offering the following conclusion: "There is insufficient data at this time to make any other recommendations, including any recommendation on limiting the charges imposed under a consumer litigation funding contract. The Commissioner and the Attorney General will continue to monitor litigation funding contracts for future analysis and recommendations."

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[17] https://codes.findlaw.com/ar/title-4-business-and-commercial-law/ar-code-sect-4-57-109.html.
[18] Ibid.
[19] https://www.lawserver.com/law/state/indiana/in-code/indiana_code_24-4-5-3-110.
[20] "Indiana and Vermont regulate consumer litigation funding," Victor Li, July 7, 2016, available at http://www.abajournal.com/news/article/indiana_and_vermont_regulate_consumer_litigation_funding.
[21] Ibid.
[22] https://legislature.vermont.gov/assets/Documents/2016/Docs/ACTS/ACT128/ACT128%20As%20Enacted.pdf.
[23] https://legislature.vermont.gov/statutes/section/08/074/02251.
[24] http://www.dfr.vermont.gov/sites/default/files/2015%20Act%2055%20Consumer%20Litigation%20Funding%20Report%20.pdf.

WISCONSIN

In 2018, Wisconsin became the latest state to enact a law directed at litigation funding by requiring disclosure of funding agreements.[25] Wisconsin Act 235 requires in part that parties to a civil action, "without awaiting a discovery request, provide to the other parties any agreement under which any person, other than an attorney permitted to charge a contingent fee representing a party, has a right to receive compensation that is contingent on and sourced from any proceeds of the civil action, by settlement, judgment, or otherwise."[26]

Enactment of the law, as part of a package of other civil-justice-related matters, was met with swift approbation by the business community and just as swift condemnation from lenders. "Wisconsin's law brings litigation funding out of the shadows, so that funders in the state can't anonymously 'pull the strings' of a lawsuit without other parties' knowledge," Lisa A. Rickard, president of the U.S. Chamber of Commerce's Institute for Legal Reform, said in a press release.[27]

NEW YORK

Since 2005 there have been several developments in New York in response to the growing litigation lending industry in the state. First, legislation to meaningfully curb litigation funding has been pursued for several years in succession by business groups, including the Lawsuit Reform Alliance of New York.[28] Additionally, New York's highest state court issued a ruling in 2016 that put the fate of at least small-scale litigation lending in New York in doubt.[29] The decision in Trust for Certificate Holders v. Love Funding clarified the general applicability of the doctrine of champerty that prohibits investments in litigation but also affirmed the applicability of a safe harbor for deals involving sophisticated investors.

Finally, in July 2018, the Professional Ethics Committee of the New York City Bar Association issued an opinion questioning lawyers' involvement with litigation funding arrangements.[30]

NCOIL DEBATE

The propriety of litigation funding and related public policy issues were debated in earnest before the National Conference of Insurance Legislators for several years as the organization of state lawmakers attempted to develop a model law to regulate the practice.[31]

The issue was first raised at the National Council of Insurance Legislators by Indiana Rep. Matt Lehman in his role as chairman of the organization's Property-Casualty Committee. Lehman's original proposal included a cap on interest rates and

25 "Wisconsin law requires all litigation funding arrangements to be disclosed," Jamie Hwang, April 10, 2018. Available at http://www.abajournal.com/news/article/wisconsin_law_requires_all_litigation_funding_arrangements_to_be_disclosed.

26 https://docs.legis.wisconsin.gov/2017/related/acts/235.

27 See https://www.instituteforlegalreform.com/resource/wisconsin-forward-state-enacts-groundbreaking-litigation-funding-transparency-law.

28 "Protect consumers from cash advance companies, too," Thurbert Baker and Tom Stebbins, March 23, 2017. Available at https://www.timesunion.com/tuplus-opinion/article/Protect-consumers-from-cash-advance-companies-too-11023763.php?utm_medium=Email&utm_source=ExactTarget&utm_campaign=&utm_content. See also https://lrany.org/2017/07/21/nylj-tort-reform-group-champions-bill-to-regulate-certain-litigation-funders/.

29 "New York's top court clamps down on shoestring litigation funders," Allison Frankel, October 28, 2016, available at https://www.reuters.com/article/us-frankel-litigation-idUSKCN12S2M3.

30 "Litigation Funders React to NYC Bar's Opinion on Fee Sharing," September 7, 2018. Available at https://litigationfinancejournal.com/litigation-funders-react-nyc-bars-opinion-fee-sharing/. See also https://www.jdsupra.com/legalnews/financing-arrangements-between-a-lawyer-38146/.

31 See "Indiana lawmakers can expect lawsuit lending debate in 2015," Amanda Robert, December 15, 2014. Available at https://legalnewsline.com/stories/510628247-indiana-lawmakers-can-expect-lawsuit-lending-debate-in-2015.

was generally viewed as a positive proposal by the insurance industry. However, another NCOIL leader, Sen. Neil Breslin of New York, was apparently moved by arguments advanced by litigation lenders to propose an alternative version without a rate cap, similar to those bills that simply authorized the practice and removed legal uncertainties.[32]

That development led to a standoff ultimately resulting in NCOIL dropping the idea of adopting a model law in this area, a result that was met with approval by litigation lenders.[33]

The progression of the issue at NCOIL highlighted the division of opinions regarding the propriety of litigation funding in which its defenders assert arguments appealing to notions of free enterprise and access to justice while its critics cite concerns regarding distortion and expansion of litigation along with protection of vulnerable consumers. As the litigation funding industry continues to grow and its impact on the litigation environment is increasingly understood, there may be new opportunities to engage NCOIL on this issue in a constructive manner.

RULES OF CIVIL PROCEDURE

In addition to attempts in the legislative and judicial arenas, there have been efforts to address third-party litigation funding through the administrative court process. NAMIC and a host of other organizations have been advocating for a change in the Federal Rules of Civil Procedure to add a requirement to disclose third-party litigation funding, or TPLF, arrangements in any civil actions filed in federal court.

"Absent robust disclosure requirements, TPLF will continue to operate in the shadows, concealing from the court and other parties in each case the identity of what is effectively a real party in interest that may be steering a plaintiff's litigation strategy and settlement decisions," the organizations wrote in a June 1, 2017, letter to the secretary of the Committee on Rules of Practice and Procedure of the Administrative Office of the United States Courts.[34]

To address this concern, the organizations have proposed on two occasions the addition of a requirement to the existing rule regarding initial disclosures in litigation that "a party must, without awaiting a discovery request, provide to the other parties ... for inspection and copying ... any agreement under which any person, other than an attorney permitted to charge a contingent fee representing a party, has a right to receive compensation that is contingent on, and sourced from, any proceeds of the civil action, by settlement, judgment or otherwise."

A change along these lines to the Federal Rules of Civil Procedure would be significant, as it would broadly result in disclosure of lawsuit funding and lending in federal court litigation. Moreover, it would likely promote disclosure in litigation in state courts as well, as states frequently look to and replicate the federal rules in their separate rules of civil procedure.

The proposal has resulted in the formation of a subcommittee of the Advisory Committee on Civil Rules, which has conducted a listening tour to gather information about TPLF. There have been indications that some members of the subcommittee have moved from being uncertain as to whether courts should concern themselves with legal funding to potentially embracing the idea that courts should be aware of its existence.

[32] Ibid.
[33] See http://arclegalfunding.org/insurance-legislators-take-best-course-of-action-to-preserve-consumer-access-to-legal-funding/.
[34] Available at http://www.uscourts.gov/sites/default/files/17-cv-o-suggestion_ilr_et_al_0.pdf.

Meanwhile, some federal courts have adopted rules requiring disclosure of funding arrangements. In January 2017, the U.S. District Court for the Northern District of California announced a change to a standing regarding the contents of joint case management statements so that it requires the disclosure of "any person or entity that is funding the prosecution of any claim or counterclaim" in any proposed class, collective, or representative action. While helpful, it is worth noting that the adopted rule did not go as far as an earlier proposal that would have applied to initial disclosures for all matters before the court and would have included language specifically referring to "litigation funders."[35]

In addition, some courts have adopted rules for disclosure of financial interest in litigation for the purposes of assessing potential conflict of interest for recusal purposes. The U.S. District Court for the Northern District of Georgia requires parties to file "A complete list of other persons, associations, firms, partnerships, or corporations having either a financial interest in or other interest which could be substantially affected by the outcome of this particular case."[36] Presumably, such a broad requirement would include litigation lenders and funders.

IN THE COURTS AND ADMINISTRATIVE AGENCIES

As discussed, the legislative activity regarding litigation funding that has gone on for the past dozen or so years was, in some ways, responsive to the question of whether courts would enforce lending agreements or refuse to do so based on the doctrines of champerty and maintenance. Separate from that issue, courts have been asked to determine whether lawsuit lending would fall under state lending laws, including those that limit interest. The fundamental question to be addressed is whether the practice is a "loan" as defined by existing law or some other kind of transaction distinguished by the fact that they are "non-recourse" in nature because plaintiffs who receive funds do not have to pay them back if they do not recover in a judgment or settlement.

Different courts have taken different approaches. In Pennsylvania, a state court determined that maintenance, champerty, or barratry doctrines prohibit such agreements and render them unenforceable.[37]

In Colorado, Attorney General John Suthers issued an order finding that lawsuit loans are in fact loans subject to Colorado's consumer protection laws, including the Colorado Uniform Consumer Credit Code, regardless of their non-recourse nature. His determination was affirmed by a Denver district court judge and the Colorado Supreme Court.[38]

On the other hand, in Cherokee Funding v. Ruth, the Georgia Court of Appeals refused to extend the definition of a loan to litigation funding contracts, instead insisting that the Legislature is the proper arena to expand two state laws intended to regulate payday lenders and other allegedly abusive lenders.[39] That holding was affirmed on appeal by the Georgia Supreme Court.[40]

[35] See "Transparency Watch: Federal District Court Mandates Automatic Disclosure of Third-Party Funding Arrangements for Class Actions," April 10, 2017. Available at https://www.carltonfields.com/insights/expect-focus/2017/transparency-watch-federal-district-court-mandates.

[36] See http://www.gand.uscourts.gov/sites/default/files/NDGARulesCV.pdf.

[37] See, e.g., WFIC, LLC v. LaBarre, 148 A.3d 812, 818–19 (Pa. Super. Ct. 2016) (finding champertous litigation finance agreement unenforceable).

[38] https://www.forbes.com/sites/danielfisher/2015/11/16/lawsuit-finance-contracts-are-loans-colorado-supreme-court-rules/#6fa95f7182a8. See also https://www.chamberlitigation.com/cases/oasis-legal-finance-group-llc-v-coffman-ii. The full decision is available at https://www.courts.state.co.us/userfiles/file/Court_Probation/Supreme_Court/Opinions/2013/13SC497.pdf.

[39] https://litigationfinancejournal.com/investment-loan-litigation-fundings-ongoing-debate/.

[40] See https://www.bizjournals.com/prnewswire/press_releases/2018/10/26/UN51480.

The question of whether litigation lending and funding constitutes lending has also been addressed by administrative agencies on a number of occasions. In South Carolina, the Department of Consumer Affairs ruled in 2014 that entities that fund litigation in exchange for a piece of the recovery are providing loans that must comply with state laws governing lending. “The broad concept of a ‘loan’ under the [Uniform Consumer Credit Code] certainly encompasses those circumstances where the consumer does not have an unconditional obligation to repay,” Department Administrator Carri Grube Lybarker wrote.[41] The Kansas Office of the State Bank Commissioner made a similar ruling in 2009.[42]

CONGRESSIONAL INTEREST

While most public policy developments regarding litigation lending/funding have taken place in the states, Congress has also shown some interest in the subject. In March 2017 the U.S. House of Representatives approved the Fairness in Class Action Litigation Act, which, among other provisions, would require the disclosure of third-party litigation funding.[43]

In May 2018, Senate Judiciary Committee Chairman Chuck Grassley, R-Iowa, and Sens. Thom Tillis, R-N.C., and John Cornyn, R-Texas, introduced legislation requiring disclosure of third-party litigation financing agreements in civil lawsuits.[44] The Litigation Funding Transparency Act of 2018 would require the written disclosure of the identity of any commercial enterprise that has a right to receive payment that is contingent on the receipt of monetary relief in any class or multidistrict litigation case filed in U.S. district courts.

“For too long, obscure litigation funding agreements have secretly funneled money into our civil justice system, all for the purpose of profiting off someone else’s case,” Grassley stated as the bill was introduced. “The courts and opposing parties should know whether there are undue pressures and secret agreements at play that could unnecessarily drag out litigation or harm the interest of the claimants themselves.” While not seeking to prohibit litigation funding, Grassley said the bill would provide transparency “needed to ensure that these profiteers aren’t distorting our civil justice system.”

Unsurprisingly, the bill has been criticized by one the of the leading litigation funding firms, Burford Capital, as “the wrong way to handle disclosure,” suggesting that “mandating broad disclosure to the defendant” would be “misused to create expensive and time-wasting frolics and detours in litigation and as a tactical device by defendants.” Due to lack of support from the Minority in the Senate, the bill did not pass the chamber prior to the 115th Congress ending.

[41] “South Carolina agency rules lawsuit loans are traditional loans subject to state law,” John O’Brien, November 17, 2014. Available at https://legalnewsline.com/stories/510628059-south-carolina-agency-rules-lawsuit-loans-are-traditional-loans-subject-to-state-law.

[42] Ibid.

[43] “Goodlatte Praises House Passage of Fairness in Class Action Litigation Act,” March 9, 2017, available at https://goodlatte.house.gov/news/documentsingle.aspx?DocumentID=831. See also https://www.instituteforlegalreform.com/resource/the-ficala-fix-for-litigation-abuse.

[44] “Grassley, Tillis, Cornyn Introduce Bill to Shine Light on Third Party Litigation Financing Agreements,” May 10, 2018, available at https://www.grassley.senate.gov/news/news-releases/grassley-tillis-cornyn-introduce-bill-shine-light-third-party-litigation.

CONCLUSION

While additional laws that appear to regulate the business of litigation funding but actually serve to eliminate legal uncertainties are unlikely to be enacted without due consideration, it is also the case that the appetite for outright prohibitions on the practice seems low. Three states – Arkansas, Indiana, and Tennessee – have enacted rate caps, but there have not yet been broad indications that more states are inclined to follow suit in the near-term.

When it comes to disclosure, however, a different story is taking shape. Courts, Congress, and state legislatures appear to be more open than ever to requiring at least disclosure of funding agreements to other parties and potentially to courts as well. If nothing else, this is a favorable trend in that it will enhance awareness and transparency of litigation lending and funding and expand understanding of how they affect the process and resolution of civil actions. This in itself may be a favorable outcome, and it could in the future lead to better-informed policy discussions.

The considerable growth of the third-party litigation funding industry is still a relatively new development, but it is a trend that can only be expected to continue. The property/casualty insurance industry should continue to support strong disclosure initiatives but must also continue to seek out more avenues to eradicate or curtail the negative effects of the litigation funding/lending industry.

INTRODUCTION

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

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

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

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

TWO MODELS OF LITIGATION FUNDING

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

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

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

EFFECTS ON PLAINTIFFS AND ATTORNEYS

Litigation funders insist that they make no effort to influence the lawsuits in which they invest, but it is difficult to take these claims seriously. Since all investors inherently desire to protect and nurture their investments, it is reasonable to expect that litigation funders will naturally seek to exert control over strategic decisions that affect their litigation portfolios. This should not be particularly difficult in situations where the attorney has contracted directly with the funding company and thus has contractual duties to it that are independent of the attorney's duties to his nominal client, the plaintiff. Indeed, over time one would expect partnerships to develop between particular funders and attorneys that would operate to the mutual advantage of each party. For example, a funding company that specializes in lending to personal injury plaintiffs might provide borrowers with referrals to particular attorneys who agree to prolong cases, thereby extending the time period during which interest accrues on the funds advanced.

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

CLASS ACTIONS

Class action litigation is particularly vulnerable to the pursuit of profit through third-party funding schemes. There is no practical way to obtain permission from all the potential plaintiffs as to whether the attorneys representing the class may obtain litigation funding, or from whom they may obtain it. Nor are members of the class in a position to negotiate or approve the terms of the funding arrangement. Thus, the entire process of obtaining funding will occur without the consent, or even the knowledge, of the plaintiffs.[3]

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

EFFECTS ON DEFENDANTS

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

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

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

In addition to the direct monetary costs of defending against a lawsuit, a company that is the target of litigation will also face opportunity costs. Time, money, and effort that would otherwise be devoted to developing new products, hiring new workers (or maintaining current workers) and serving customers will instead be diverted to lawsuit defense. These costs include the time and effort devoted to searching paper files, electronic files, and e-mail records in response to document requests, as well as the time and effort involved in preparing testimony in depositions and at trial.[4]

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

Litigation-focused media campaigns of this sort can be very expensive, and ordinarily relatively few law firms will be able to afford them.[5] The advent of third-party litigation funding, however, makes it more likely that such tactics will be utilized, particularly in cases with facts that can be used to fabricate sensational or scurrilous allegations against the defendant. Again, the costs associated with reputational damage are unrecoverable, regardless of whether the defendant actually engaged in any wrongdoing.

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

EFFECTS ON THE CIVIL JUSTICE SYSTEM

Though a burgeoning third-party litigation funding industry is a relatively recent phenomenon in the U.S., it is based on a concept quite familiar to previous generations of judges and lawyers. That concept, known as "maintenance," is defined in the Oxford English Dictionary as "the action of wrongfully aiding and abetting litigation; spec. sustentation of a suit or suitor at law by a party who has no interest in the proceedings…."[6] A subspecies of maintenance, "champerty," specifically refers to the type of financial agreement that typically exists between funders and litigants. Champerty, according to Black's Law Dictionary, is "an agreement to divide litigation proceeds between the owner of the litigated claim and a party unrelated to the lawsuit who supports or helps enforce the claim."[7] The meaning of the two terms has been neatly summarized by the U.S. Supreme Court: "Put simply, maintenance is helping another prosecute a suit; champerty is maintaining a suit in return for a financial interest in the outcome."[8]

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

> Third-party funding is likely to encourage the filing of frivolous lawsuits in cases where the potential payout is very large.

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

Part of the reason that Anglo-American law has historically frowned on third-party funding arrangements is that prominent jurists regarded lawsuits in much the same way as they regarded disputes in non-judicial settings: something that disrupts and subverts the harmonious interpersonal relationships that are essential to a peaceful and prosperous social order. Although disputes of all kinds, including legal disputes, were inevitable, they were certainly not to be encouraged. Financing of lawsuits by third parties with no involvement in the dispute, it was widely believed, encouraged people who otherwise would not do so to bring lawsuits, and this was thought to be socially undesirable.

Today, however, the view has taken hold among many legal elites, if not the population as a whole, that lawsuits are the primary means by which ordinary citizens may obtain "access to justice." From the perspective of those who equate "more lawsuits" with "more justice," financing arrangements that facilitate more lawsuits are unobjectionable and even desirable.[10] It is presumably this view that has prompted many jurisdictions in the U.S. to abandon the doctrines of maintenance and champerty; indeed, courts in as many as two-fifths of the states have overruled defenses based on the doctrines.[11]

One such state is Massachusetts, whose supreme court nullified the doctrines in a case specifically involving a third-party funding arrangement. The court's opinion contained several observations that are reflective of the pro-litigation mindset. For example, the court justified its abolition of champerty by noting that "we have long abandoned the view that litigation is suspect, and have recognized that agreements to purchase an interest in an action may actually foster resolution for a dispute." The court further declared that society no longer views litigation as a "social ill, which, like other disputes and quarrels should be minimized," adding that "it is now seen as a socially useful way to resolve disputes."[12]

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

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FRIVOLOUS LAWSUITS

We have already discussed some of the ways in which third-party funding, by increasing the volume of litigation, will impose additional economic costs and inefficiencies on defendants regardless of their guilt or innocence. And we have made the point that these concerns merit careful consideration by policymakers, notwithstanding the dubious axiom that more lawsuits equal more justice. The question more commonly raised in the public policy debate today, however, is whether third-party funding is likely to increase the number of frivolous lawsuits.

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

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

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

When it comes to investing in lawsuits, some investors, especially if they are well-capitalized funding companies, will rationally invest in lawsuits with a low probability of success if the suit seeks a large enough damages figure. Consider, for example, that from an investment standpoint, a suit seeking $100 million in damages with only a 10 percent chance of success has a net present value of $10 million. A funding company can pursue a strategy of taking on the greater risk of investing in a less-meritorious suit by spreading the risk across its portfolio, which may consists of dozens or even hundreds of lawsuits. In sum, claims that third-party litigation funding will not increase the number of frivolous lawsuits do not comport with conventional theories of strategic investment or with the observed behavior of actual investors, and should therefore be viewed with much skepticism.

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STRATEGIC LAWSUITS

Because it is a product of the common law of the states, the American tort liability system is continuously altered and shaped by the development of new case law. This occurs despite the tradition of stare decisis, which ostensibly obliges judges to follow the precedents established by prior cases. As the fate of the maintenance and champerty doctrines illustrates, judges sometimes alter precedents or abandon them altogether. The malleability of the tort system makes it susceptible to strategic litigation, where the goal is not simply to prevail in a particular case, but to alter tort law by pursuing cases that have the potential to generate new precedents that are favorable to one's long-term interests. Plaintiff attorneys have been known to engage in strategic litigation of this kind, and well-capitalized third-party funders would seem to have especially strong incentives to do so.

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

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

EFFECTS ON INSURERS AND THEIR POLICYHOLDERS

A large share of litigation defense costs is paid by insurers under liability insurance policies. Interestingly, this has led some proponents of third-party litigation funding to suggest that insurance companies act as de facto litigation funders on the defense side. By providing plaintiffs with a source of external financing, litigation funding companies serve to "level the playing field" and thus provide a valuable public service, according to this view.

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

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

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

CONCLUSION AND RECOMMENDATIONS

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

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

Third-party funding should not be allowed in class action settings or to finance mass tort litigation.

Interest rates on funds advanced under third-party financing arrangements must be limited to a "reasonable" amount.

Third-party funding must be restricted to actions by individual plaintiffs for torts involving personal injury.

The amount that can be taken as loan repayment from the net recovery should be limited to a percentage of the net recovery.

Litigation funding companies should not be allowed to make referrals to attorneys on behalf of a potential plaintiff, nor accept advertising from attorneys on their websites or in their marketing materials.

Attorneys should not be allowed to have a financial interest in a litigation funding company.

Litigation funding companies should not be allowed to exert influence over the plaintiff's decision to settle or to otherwise direct the course of the litigation.

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

Legislative proposals seemingly aimed at protecting consumers from predatory third-party funding practices will do nothing to shield defendants, insurers, and taxpayers from the harmful systemic effects of third-party litigation funding. Indeed, toothless legislation that does little more than create the illusion that litigation funding is a regulated industry may be worse than no regulation at all, in that it will mainly serve to codify the legitimacy of a practice that poses a direct threat to the integrity of the civil justice system.

ENDNOTES

[1] See, e.g., Binyamin Appelbaum, "Investors Put Money on Lawsuits to Get Payouts," New York Times (November 14, 2010).

[2] Jason Lyon, "Revolution in Progress: Third-Party Funding of American Litigation," 58 UCLA Law Review 571, at 578 (2010).

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

[4] Paul H. Rubin, "On the Efficiency of Increasing Litigation," available at http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf.

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

[6] Oxford English Dictionary, p. 226 (2nd ed. 1989).

[7] Black's Law Dictionary, p. 262 (9th ed. 2009).

[8] In re Primus, 436 U.S. 412, 424-25, n. 15 (1978).

[9] William Blackstone, Commentaries on the Laws of England, Vol. IV, pp. 135-136 (1769).

[10] In the words of one litigation-funding entrepreneur, "If there's less money [available to finance lawsuits], you'd have less litigation. But then you'd also have less justice." Quoted in Appelbaum, op. cit.

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

[12] Saladini v. Righellis, 687 N.E. 2d at 1226 (Mass 1997).

[13] Anglo-Dutch Petroleum Intern., Inc. v. Haskell, 193 S.W. 3rd 87, 104-105 (Tex. App. 1st Dist. 2006).

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