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ARTICLES

The Shadows of Litigation Finance

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Litigation finance is quickly becoming a centerpiece of our legal system. Once a dispute arises, litigants may seek money from third-party financiers to pay their legal bills or monetize their claims, and in turn those financiers receive a portion of any case proceeds. Yet policymakers are struggling with how to evaluate and regulate litigation finance. There are two problems. The first is an awareness problem. Some commentators consider litigation finance "likely the most important development in civil justice of our time," but others have hardly heard of it. As a result, many policymakers do not quite understand what litigation finance is, how it works, and what is actually new about it. The second problem is analytical. There is no scholarly framework policymakers can rely on to evaluate whether litigation finance is actually good for the legal system and society. Moreover, the existing scholarship has overlooked important welfare effects, risking inefficient and suboptimal regulatory decisionmaking.

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This Article addresses both problems. First, it articulates what exactly litigation finance is, who uses it, why they use it, and—most importantly—what is (and is not) new about this form of financing. Second, it provides a novel framework for analyzing the welfare implications of litigation finance. Existing scholarship focuses narrowly on the effects of litigation finance on behavior after *a claim accrues and a litigant seeks funding. This Article's framework provides new insights by explaining how litigation finance also significantly affects parties' behavior* before *a legal dispute ever arises. Once these "pre-claim" effects of litigation finance are understood alongside the "post-claim" effects that scholars have previously identified, it becomes clear that policymakers should encourage rather than obstruct litigation finance.*

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INTRODUCTION

Imagine you supply innovative parts to the world's largest construction equipment maker. During a decades-long business relationship, you share your trade secrets under a confidentiality agreement. Then one day your customer, a Fortune 100 company, abruptly terminates your supply contract and starts using your proprietary information to make your parts itself. What can you do?[1]

Maybe you have millions of dollars to pay a lawyer by the hour to bring your case. But litigation is expensive.[2] You just lost your biggest contract, so money is in short supply. The cash you have, you need to rebuild your company.

Maybe you can find a lawyer willing to litigate in exchange for a contingent fee. But few top-tier attorneys have the resources or risk tolerance to finance a complex case like yours. Even if you find such a lawyer, someone still has to pay the litigation costs, including expert witness fees and travel expenses.

In the past, you might have dropped your case or settled for cheap. Today, you can seek litigation finance. A third-party investor can pay some or all of the fees and costs of your case in exchange for a share of the proceeds if you win. You can hire one of the country's best law firms and possibly win the $100 million verdict you believe you are owed.[3] Later, if your business needs cash while the defendant appeals, you can use litigation finance to monetize a portion of the judgment. If the defendant still refuses to pay, third-party financing can help pay for your enforcement and asset tracing efforts.

Litigation finance is our civil justice system's killer app. Unheard of yesterday, it is a mainstay today. Commercial litigation finance companies did not even exist in America until about 2006, the same year Twitter was founded.[4] Until a few years ago, many lawyers

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1. *See* Miller UK Ltd. v. Caterpillar, Inc., 17 F. Supp. 3d 711, 717 (N.D. Ill. 2014).

2. *See* Emery G. Lee III, *Law Without Lawyers: Access to Civil Justice and the Cost of Legal Services*, 69 U. MIA. L. REV. 499, 503 (2015) (detailing how the rising cost of legal services impedes access to justice).

3. *See* Miller UK Ltd. v. Caterpillar, Inc., No. 10-cv-03770, 2017 WL 1196963, at *1 (N.D. Ill. Mar. 31, 2017) (noting that the jury returned a verdict in favor of Miller for $90.6 million, finding that Caterpillar misappropriated trade secrets and breached its contract).

4. *A Brief History of Litigation Finance: The Cases of Australia and the United Kingdom*, 5 PRACTICE, Sept.–Oct. 2019, https://thepractice.law.harvard.edu/article/a-brief-history-of-litigation-finance [https://perma.cc/G5E4-XCV5] (identifying Credit Suisse's 2006 Litigation Risk Strategies group as the first commercial funder in the United States); *see also* Maya Steinitz, *Incorporating Legal Claims*, 90 NOTRE DAME L. REV. 1155, 1164 (2015) (discussing the launch of Juridica Investments in 2008 and Burford Capital in 2009).

had hardly heard of litigation finance.[5] Yet today one of the few scholars who studies the industry proclaims it "likely the most important development in civil justice of our time."[6] Some estimate that billions of dollars of litigation finance investments are committed each year.[7] This number will quickly grow.[8]

Whether this is a good thing has been the subject of an infant but vigorous debate. Some scholars argue that litigation finance furthers the purposes of our legal system by ensuring legal outcomes track the strength of a party's claim, not the size of its bank account.[9] Others disagree, suggesting that litigation finance will spur frivolous litigation and allow profit-seeking investors to take over our civil justice system.[10] Similar disagreements concern whether litigation finance

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5. A 2016 Burford Capital survey found that about one in three American lawyers was not even aware of the most basic litigation finance products. 2016 LITIGATION FINANCE SURVEY, BURFORD CAP. 8 (2016), https://www.burfordcapital.com/media/1263/litigation-finance-survey-2016-us.pdf [https://perma.cc/2DUV-DEFD]. Three years later, Burford found that all respondents had at least heard of litigation finance. 2019 LEGAL FINANCE REPORT, BURFORD CAP. 7 (2019), https://www.burfordcapital.com/media/1662/2019-legal-finance-report.pdf [https://perma.cc/UL8L-MS7M].

6. Maya Steinitz, *Follow the Money? A Proposed Approach for Disclosure of Litigation Finance Agreements*, 53 U.C. DAVIS L. REV. 1073, 1075 (2019).

7. WESTFLEET ADVISORS, THE WESTFLEET INSIDER: 2020 LITIGATION FINANCE MARKET REPORT 4 (2020) https://advantage.westfleetadvisors.com/the-westfleet-insider-2020-litigation-finance-market-report [https://perma.cc/B698-8YHX] (estimating that forty-six commercial litigation finance companies committed $2.47 billion in 2020). Because litigation funders frequently commit to pay for legal fees and costs as they are incurred over the life of a litigation, the committed capital is usually deployed over a multi-year period.

8. The addressable market has been estimated to be between $50 billion and $100 billion. Steinitz, *supra* note 6, at 1075; *see* Roy Strom, *Nobody Knows Litigation Finance Size, but It's Not $85 Billion*, BLOOMBERG L. (June 11, 2020), https://news.bloomberglaw.com/ip-law/nobody-knows-litigation-finance-size-but-its-not-85-billion [https://perma.cc/H698-X7XR] (noting, with skepticism, that a litigation financier estimated the addressable litigation finance market was $85 billion).

9. *See, e.g.*, Brian T. Fitzpatrick, *Can and Should the New Third-Party Litigation Financing Come to Class Actions?*, 19 THEORETICAL INQUIRIES L. 109, 122 (2018) (explaining that litigation financing's potential effects—increasing the number and length of litigated cases—increase the likelihood that cases will be resolved based on the merits, not based on the parties' resources or risk tolerances); Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 101–02 (2010) (noting that the lack of market alternatives causes risk-averse plaintiffs to settle prematurely relative to the lawsuit's merits).

10. *See, e.g.*, Jeremy Kidd, *To Fund or Not to Fund: The Need for Second-Best Solutions to the Litigation Finance Dilemma*, 8 J.L. ECON. & POL'Y 613, 627–29 (2012) (arguing that litigation financing will increase the number of high-value frivolous claims and lawyers' rent-seeking behavior to manipulate the common law toward favorable rules); Paul H. Rubin, *Third-Party Financing of Litigation*, 38 N. KY. L. REV. 673, 675 (2011) (contending that litigation finance will increase the cost and amount of litigation, as well as move substantive law in inefficient directions).

threatens the legal profession, interferes with counsel's professional independence, and impairs the principle of party control.[11]

This debate is kindling outside the academy too. "Third-party investments in litigation represent a clear and present danger to the impartial and efficient administration of civil justice in the United States," warns the United States Chamber of Commerce's Institute for Legal Reform.[12] Most early court decisions have been more sanguine. Litigation finance "allow[s] plaintiffs who would otherwise be priced out of the justice system to assert their rights,"[13] the Minnesota Supreme Court recently concluded, echoing a New York trial court's earlier pronouncement that funding permits "lawsuits to be decided on their merits, and not based on which party has deeper pockets or stronger appetite for protracted litigation."[14]

These disagreements are fast bearing down on a three-front battle over the regulation of litigation finance. First, in Congress and statehouses across the nation, legislators are evaluating proposals to regulate litigation finance by, among other measures, mandating disclosure of funding agreements, capping funders' returns, and even prohibiting entire categories of funding transactions.[15] Second, bar associations and legal ethics committees are deciding whether litigation finance interferes with an attorney's professional responsibilities, including whether litigation finance agreements between funders and law firms violate the prohibition against "fee-sharing" between lawyers and nonlawyers.[16] Third, courts are increasingly asked to adjudicate a

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11. For discussions of the ethical issues presented by litigation finance, see Susan Lorde Martin, *Litigation Financing: Another Subprime Industry That Has a Place in the United States Market*, 53 VILL. L. REV. 83 (2008) (arguing that litigation finance has the potential to be predatory and should therefore be regulated); Julia H. McLaughlin, *Litigation Funding: Charting a Legal and Ethical Course*, 31 VT. L. REV. 615 (2007) (detailing the ethical concerns raised by litigation loan agreements); Anthony J. Sebok, *Should the Law Preserve Party Control? Litigation Investment, Insurance Law, and Double Standards*, 56 WM. & MARY L. REV. 833 (2015) (suggesting that contracts selling litigation control should not be invalidated on public policy grounds, and arguing that litigation funding does not interfere with the lawyer-client relationship); W. Bradley Wendel, *Paying the Piper but Not Calling the Tune: Litigation Financing and Professional Independence*, 52 AKRON L. REV. 1 (2018) (explaining that, although financiers may participate in litigation for a variety of reasons including political, ideological, or personal, the funding market furthers public values and poses little risk to the professional responsibility obligations of lawyers).

12. John H. Beisner & Gary A. Rubin, *Stopping the Sale on Lawsuits: A Proposal to Regulate Third-Party Investments in Litigation*, U.S. CHAMBER INST. FOR LEGAL REFORM 1 (Oct. 2012), https://instituteforlegalreform.com/research/stopping-the-sale-on-lawsuits-a-proposal-to-regulate-third-party-investments-in-litigation/ [https://perma.cc/D5G8-K5BE].

13. Maslowski v. Prospect Funding Partners LLC, 944 N.W.2d 235, 241 (Minn. 2020).

14. Lawsuit Funding, LLC v. Lessoff, No. 650757/2012, 2013 WL 6409971, at *6 (N.Y. Sup. Ct. Dec. 4, 2013).

15. For a summary of recent federal and state efforts to regulate litigation finance, see Steinitz, *supra* note 6, at 1076–81.

16. *See infra* notes 199–200 and accompanying text.

host of disputes related to funding, including whether litigation finance violates common law prohibitions against maintenance and champerty,[17] whether litigation finance contracts are subject to usury laws,[18] and whether funding documents and communications should be disclosed to opposing parties.[19]

Because the world does not wait for the law reviews, these regulatory and judicial decisionmaking processes are threatening to outrun the infant scholarly debate about litigation finance. There are two major problems. The first is an awareness problem. Litigation finance remains in the shadows, poorly understood. Basic questions linger: What exactly is litigation finance? How does it work, and why do claimholders and law firms seek funding? Unfamiliarity breeds suspicion, and the suggestion that litigation finance is a new and undomesticated creature stalking our civil justice system underpins many demands for new regulations, new disclosure obligations, and new applications of the ethics rules.[20] But how "new" is litigation finance? How exactly does it differ from the many ways third parties have long been allowed to pay a litigant's legal fees, such as through contingent fee or pro bono litigation? Regulators and judges are ill-equipped to decide whether litigation finance is a fearsome new Sasquatch or a minor adaptation of the fauna that have long populated our legal landscape.

The second problem is an analytical one. Regulatory decisions must be informed by a view about whether funding is good or bad. Legislators, judges, and ethicists thus need a full accounting of litigation finance's welfare effects. The literature does not yet provide this accounting. Existing scholarship contains a number of highly insightful analyses of litigation finance. But this literature surveys only half the field. The scholarship is almost exclusively forward-looking: it primarily studies litigation finance's effects *after* a legal claim accrues and a party seeks funding—after, for example, our construction equipment manufacturer misappropriates its supplier's trade secrets

17. *Compare, e.g.*, *Maslowski*, 944 N.W.2d at 241 (abolishing Minnesota's champerty doctrine), *with* Boling v. Prospect Funding Holdings, LLC, 771 F. App'x 562, 582 (6th Cir. 2019) (holding that a litigation finance transaction violated Kentucky's champerty law).

18. *Compare, e.g.*, Ruth v. Cherokee Funding, LLC, 820 S.E.2d 704, 710 (Ga. 2018) (holding that litigation finance transactions are not subject to usury law because repayment to funder was contingent on successful outcome of funded case), *with* Oasis Legal Fin. Grp., LLC v. Coffman, 2015 CO 63, ¶ 59 (holding that funding agreements are loans notwithstanding the lack of an absolute duty to repay).

19. *Compare, e.g.*, Benitez v. Lopez, 17-CV-3827, 2019 WL 1578167, at *1–2 (E.D.N.Y. Mar. 14, 2019) (denying discovery into litigation finance documents), *with* Cont'l Cirs., LLC v. Intel Corp., 435 F. Supp. 3d 1014, 1024 (D. Ariz. 2020) (granting in part and denying in part a request for discovery into litigation finance documents).

20. *See* infra notes 73–78 and accompanying text.

and the supplier sues. For example, scholars have asked how, once funding is brought to bear in litigation, it influences which claims are brought, alters settlement incentives, and affects attorney-client privilege.[21] These questions are important, but they tell only half the story. To fully appreciate litigation finance's effects, we must look backwards as well as forwards. We must ask how funding affects parties' behaviors *before* a litigant ever calls a funder, and indeed long before a legal dispute even arises in the first place. Until now, regulators and scholars have mostly ignored that litigation finance casts a long shadow behind as well as in front, affecting when and how people interact, contract, and negotiate in the real world.

This Article addresses both problems. First, we attempt to solve the awareness problem by describing the most common litigation finance transactions, identifying why litigants and law firms seek funding, and situating modern litigation finance among the broad array of third-party funding arrangements that our civil justice system has long permitted and even encouraged. We argue, contrary to much of the scholarship and political rhetoric, that modern litigation finance is not different in kind from these other forms of third-party financing, such as contingency fee and pro bono litigation. Advocates of new regulations specific to the modern litigation finance industry need a theory about how litigation finance differs from these long-standing methods of third-party financing.

Second, we fill the analytical void by exploring the broad shadow litigation finance casts on parties' behaviors before a legal dispute arises. Focusing on corporate contracts, the leading subject of commercial litigation finance, we argue that litigation finance has at least three pre-dispute effects that scholars have overlooked: funding will make parties more likely to contract with each other; it will affect parties' bargaining and contract design; and it will decrease inefficient breaches while still encouraging efficient breaches. Each of these impacts results from parties bargaining in the shadow of litigation finance, changing their behaviors because they know funding makes it

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21. Some of the leading articles, all of which focus on funding's effects after a cause of action accrues, include Ronen Avraham & Abraham Wickelgren, *Third-Party Litigation Funding — A Signaling Model*, 63 DEPAUL L. REV. 233, 244 (2014); Fitzpatrick, *supra* note 9; Keith N. Hylton, *The Economics of Third-Party Financed Litigation*, 8 J.L. ECON. & POL'Y 701, 709–10 (2012); Molot, *supra* note 9; Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367 (2009); Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61 (2011) [hereinafter Sebok, *The Inauthentic Claim*]; Anthony J. Sebok, *Selling Attorneys' Fees*, 2018 U. ILL. L. REV. 1207 (2018) [hereinafter Sebok, *Selling Attorneys' Fees*]; Joanna M. Shepherd & Judd E. Stone II, *Economic Conundrums in Search of a Solution: The Functions of Third-Party Litigation Finance*, 47 ARIZ. ST. L.J. 919 (2015); Steinitz, *supra* note 6; Maya Steinitz, *Whose Claim Is This Anyway? Third Party Litigation Funding*, 95 MINN. L. REV. 1268 (2011); and Wendel, *supra* note 11.

more likely that cash-strapped or risk-averse parties will be able to enforce at least some violations of their rights.[22]

We pair these insights with the stuff of existing scholarship—an analysis of litigation finance's effects on parties and the legal system after a legal claim accrues—to develop a unified framework for evaluating litigation finance's total welfare impact. We hope this unified framework provides an important intervention in the policy debate about litigation finance. That debate, mirroring the scholarly discourse, focuses only on funding's "post-claim" effects: its impact on society and the law *after* a claim accrues and funding is sought. If we continue to ignore the substantial "pre-claim" effects of financing, then the cost-benefit analyses conducted in statehouses, courthouses, ethics committees, and law reviews will overlook huge swaths of financing's impact and reach suboptimal policy conclusions.

This Article proceeds in three parts. Part I discusses the background of litigation finance and attempts to solve the awareness problem. Part II lays out our unified framework, which considers both the pre-claim and post-claim effects of litigation finance. This Part also applies that framework in the contract setting and through a law and economics lens, and it concludes that litigation finance likely improves welfare and promotes efficiency in the marketplace. Part III shows how our unified framework can be applied in various normative ways to other kinds of legal disputes for which litigation finance is frequently sought.

I. WHAT IS LITIGATION FINANCE?

We describe the modern litigation finance industry by answering three questions. First, what do litigation finance transactions look like? Second, why do litigants and law firms seek litigation finance? Third, what (if anything) is new about litigation finance?

A. What Do Litigation Finance Transactions Look Like?

Litigation finance is the practice where a third party provides capital to a litigant or law firm in connection with a legal claim. Litigation finance is *usually* provided to plaintiffs seeking money

22. *See* Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 968–69 (1979) (arguing that default legal rules in the divorce context affect negotiations and bargaining that occurs outside of the courtroom); *see also* Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980) (arguing that known default damage awards make parties behave differently in the contracting negotiation phase).

damages.[23] Defense financing is theoretically available, though in practice rarely provided.[24] And litigation finance is *usually* provided by a funder with a profit motive. But it is sometimes offered to advance ideological rather than financial objectives, as in the well-known example of billionaire Peter Thiel financing Hulk Hogan's invasion of privacy lawsuit against Gawker.[25]

Our definition of litigation finance is broader than the narrower, more colloquial understanding of litigation finance as simply the practice where a third party pays some or all of the fees and costs of litigation on behalf of a claimholder in exchange for a share of case proceeds.[26] This type of financing—we call it "fees and costs funding"—is only one type of funding available, just like a wrench is one of many tools.

The for-profit litigation finance industry starts from the premise that a legal claim is an asset, the same way a person's home or a company's inventory is an asset.[27] Litigation finance allows claimholders, or law firms with contingent fee interests in claims, to secure financing against those assets, just as the owner of a home, factory, or account receivable may use those assets as collateral for financing.

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23. *See* Steinitz, *supra* note 21, at 1276–77. Suits seeking purely injunctive relief are not normally candidates for funding from for-profit litigation funders, though there are exceptions. For example, funding is sometimes sought for section 337 investigations before the International Trade Commission ("ITC"). Although the ITC can only issue injunctive relief (usually in the form of an exclusion order) against the importation of foreign goods, parties before the ITC frequently settle claims for financial consideration. *See* Michael Kallus, *Litigation Funding in ITC Investigations*, WOODSFORD LITIG. FUNDING, https://woodsfordlitigationfunding.com/us/white-paper-llitigation-finance-in-itc-investigations/ (last visited Feb. 1, 2021) [https://perma.cc/5X43-T9DK].

24. For discussions of what defense-side litigation finance might look like, see Molot, *supra* note 21, at 378–79; and Emily Samra, Comment, *The Business of Defense: Defense-Side Litigation Financing*, 83 U. CHI. L. REV. 2299, 2326 (2016).

25. For a discussion of the Gawker suit, see Wendel, *supra* note 11, at 4–5. *See also* Lee Drucker, *Don't Judge Lawsuit Funders by Peter Thiel*, WALL ST. J. (June 17, 2016, 10:42 AM), https://on.wsj.com/2C6e5sE [https://perma.cc/79GG-6UE2] (contrasting Thiel's litigation funding with the more common for-profit litigation finance).

26. *See, e.g.*, Marco de Morpurgo, *A Comparative Legal and Economic Approach to Third-Party Litigation Funding*, 19 CARDOZO J. INT'L & COMPAR. L. 343, 350–51 (2011) (focusing on the "narrow" definition of funding as fees and costs funding); Michael K. Velchik & Jeffrey Y. Zhang, *Islands of Litigation Finance*, 24 STAN. J.L. BUS. & FIN. 1, 36 (2019) (focusing on litigation finance investments where a funder "provides the party with the resources to hire a law firm's lawyers to pursue the case or to maintain a law firm that is already on the case").

27. *See* Geoffrey P. Miller, Commentary, *On the Costs of Civil Justice*, 80 TEX. L. REV. 2115, 2115 (2002) ("A lawsuit is essentially a sale. The defendant buys a valuable asset from the plaintiff, in the form of a release of claims if the case is settled, or a verdict with res judicata effect if the case goes to a verdict."); Molot, *supra* note 9, at 72 (characterizing a lawsuit as "an asset for the plaintiff and a liability for the defendant"); Anthony J. Sebok & W. Bradley Wendel, *Duty in the Litigation-Investment Agreement: The Choice Between Tort and Contract Norms When the Deal Breaks Down*, 66 VAND. L. REV. 1831, 1842 (2013) ("A cause of action is an asset whose value can be affected by the actions of the claimant and the claimant's lawyer.").

For plaintiffs, a legal claim's value depends on the claimholder's ability to convert that claim into an enforceable final judgment against a solvent defendant.[28] To accomplish this task requires money—and often a lot of it—to pay for legal services.[29] But no matter their economic condition, litigants have at least one asset for collateral: the legal claim itself.[30] Litigation finance is most commonly used as project finance for legal claims, giving claimholders the capital they need to pay the legal fees and costs associated with bringing a case. This is very similar to using your new home as collateral for the mortgage you need to buy that home.

What do funding transactions look like? With "fees and costs" funding, the funder usually pays some or all of the attorneys' fees and costs of the litigation, in exchange for a share of case proceeds. In one common arrangement, the funder pays half of the attorneys' fees, with the law firm forgoing payment on the remaining fifty percent of its fees in exchange for a share of case proceeds if the plaintiff wins.[31] The funder may also pay half the "costs" of litigation, including expert fees, travel costs, and court filing fees, with the claimholder covering the balance.[32] This arrangement ensures the claimholder and law firm each have "skin in the game," or money at risk in the litigation.

Because legal claims are assets, they can be monetized for purposes other than obtaining the fees and costs necessary to bring litigation. Instead of or in addition to providing capital to pay legal fees,

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28. Shepherd & Stone, *supra* note 21, at 927 ("Prosecuting litigation necessarily requires an immediate substantial capital investment for a remote future reward.").

29. One study found that the median cost of litigation in the U.S. was $15,000 for plaintiffs and $20,000 for defendants, with the costs at the 95th percentile rising to $280,000 for plaintiffs and $300,000 for defendants. EMERY G. LEE III & THOMAS E. WILLGING, FED. JUD. CTR., PRELIMINARY REPORT TO THE JUDICIAL CONFERENCE ADVISORY COMMITTEE ON CIVIL RULES 2 (Oct. 2009), https://bit.ly/38ctzpY [https://perma.cc/UPN5-GUP2]. These numbers have led some to question whether concern about the mounting costs of litigation is overblown. *See, e.g.*, Danya Shocair Reda, *The Cost-and-Delay Narrative in Civil Justice Reform: Its Fallacies and Functions*, 90 OR. L. REV. 1085, 1090 (2012). But even $15,000 of litigation costs are outside the reach of many plaintiffs, while the complex commercial litigations that are usually the subject of commercial litigation funders typically have multimillion-dollar budgets. Lee, *supra* note 2, at 508–11. From a comparative perspective, one study found the United States ranks 99th out of 126 countries for affordability and accessibility of its civil justice system. William C. Silverman & Madison Marko, *The Right to Counsel in Civil Proceedings: An International Perspective*, PROSKAUER ROSE LLP: PROSKAUER FOR GOOD (Apr. 11, 2019), https://bit.ly/2Qf1ZQD [https://perma.cc/GNG7-A5T3].

30. *See* David R. Glickman, *Embracing Third-Party Litigation Finance*, 43 FLA. ST. U. L. REV. 1043, 1046 (2016) (the "most valuable asset" that claimholders own is frequently "their contingent claim to a future award of damages" in the case that needs financing).

31. David J. Kerstein & Wendie Childress, *Mechanics of Litigation Finance*, BLOOMBERG L. 2 (Nov. 2019), https://bit.ly/31JEi90 [https://perma.cc/HSQ5-YTVE]; *Understanding How Litigation Funding Enhances Attorney Effort*, OMNI BRIDGEWAY: BLOG (July 8, 2016), https://bit.ly/2SBppkS [https://perma.cc/56UJ-BCDV].

32. Kerstein & Childress, *supra* note 31, at 2 (noting that litigation funders will often commit to paying a portion of case costs, with the claimholder responsible for the balance of costs).

litigation funders may give claimholders "working capital," or funds paid directly to the claimholder for general personal or corporate purposes, such as to cover medical expenses or to help grow the claimholder's business.[33] For example, a litigation finance company could provide $1 million in working capital that a company can use to pay its employees or grow its business, with the funder's investment repaid only from case proceeds if the company prevails in its litigation.

Claimholders can seek funding at all stages of a case, from before a complaint is filed to after final judgment is entered. Most commonly, funding happens before the complaint is filed, with the claimholder and law firm needing funding to proceed with the litigation. Other times, the claimholder and law firm may have launched litigation without funding, but their financial situation changed mid-litigation, causing them to seek additional capital to finance discovery or trial. During the COVID-19 pandemic and accompanying economic crisis, many litigants in financial distress sought funding for cases that were already underway.[34] Or a plaintiff whose favorable trial court judgment is on appeal may contract with a litigation funder to partially monetize the judgment, with the funder receiving a return if the judgment withstands appeal.[35] After final judgment is entered, financiers sometimes provide resources to hire an asset-tracing or judgment-enforcement firm, or the funder might simply monetize a portion of the plaintiff's judgment, with the funder's return coming from any amounts ultimately recovered from the defendant.[36]

While most litigation finance transactions were initially single-case, fee-and-cost funding agreements between a litigation funder and

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33. Lee Drucker, *Transaction Structures in Litigation Finance*, LAKE WHILLANS, https://bit.ly/37lDyZ3 (last visited Dec. 23, 2020) [https://perma.cc/SK62-QQ4W] ("Most frequently, funds are used to pay for litigation fees and expenses, but it is also quite common for claimholders to take additional capital to use toward operating costs such as R&D, payroll, or manufacturing.").

34. *See* Alaina Lancaster, *Law Firms Flock to Litigation Funders Amid COVID-19 Outbreak*, LAW.COM (Apr. 9, 2020), https://bit.ly/2BmiaYY [https://perma.cc/SFC3-CAPK]; Paige Long, *Litigation Funding Demand Rises as Pandemic Suits Percolate*, LAW360.COM (Nov. 6, 2020), https://www.law360.com/articles/1326533/litigation-funding-demand-rises-as-pandemic-suits-percolate [https://perma.cc/4JG3-TED6]; Annie Pavia, *Litigation Finance Ready for Post-Covid Challenges*, BLOOMBERG L. (May 18, 2020), https://bit.ly/3fFU4aR [https://perma.cc/ATV4-7CMU] (noting how litigation funders are well positioned for economic downturns)*; see also* Steinitz, *supra* note 21, at 1283 (arguing that economic recessions "produce more claimants who possess less funding for, or at least less appetite to bear, litigation costs").

35. *See* Courtney R. Barksdale, *All That Glitters Isn't Gold: Analyzing the Costs and Benefits of Litigation Finance*, 26 REV. LITIG. 707, 711 (2007) (discussing appeals funding); *Strategies*, LAW FIN. GRP., https://www.lawfinance.com/strategies (last visited Feb. 1, 2021) [https://perma.cc/4PSN-H7AW] (listing appeal financing as one of four strategies the firm pursues).

36. Barksdale, *supra* note 35, at 712–13 (discussing funding for post-judgment situations); *Legal Finance for Asset Recovery*, VALIDITY FIN. (Sept. 5, 2019), https://bit.ly/2SDbta3 [https://perma.cc/W5TN-ZBHR] (explaining that funders can monetize a portion of a judgment pending the completion of asset enforcement efforts).

a *claimholder*, an increasing number are agreements between a funder and a *law firm*.[37] The funder's investment is backed by the law firm's contingent fee interest in litigation matters.[38] Law firm funding is usually provided on a "portfolio" basis, with the funder's investment secured by a basket of three or more matters.[39] With portfolio funding, the funder frequently provides capital to the firm at fixed intervals, such as on a quarterly or monthly basis. These arrangements typically allow the law firm to use that capital to pay the costs associated with litigating those contingency fee cases or for general firm purposes, such as hiring new employees or investing in new practice areas.

Virtually all litigation finance transactions are "nonrecourse," meaning the funder's return is secured only by proceeds from the funded case(s).[40] If the case fails, the funder recovers nothing.[41] The nonrecourse nature of litigation finance frequently makes it more attractive than taking out traditional debt, which imposes an absolute duty to repay the loan at set time intervals and usually requires collateral other than litigation proceeds.[42] This feature of litigation finance can also make it more attractive than issuing equity (e.g., selling an ownership interest in a company to raise money to pursue litigation), since equity holders are usually entitled to returns from all of a business's efforts and may have voting and control rights too.[43]

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37. *See* WESTFLEET ADVISORS, *supra* note 7, at 6 (reporting that fifty-six percent of litigation finance capital was committed to law firm portfolios in 2020).

38. Molot, *supra* note 9, at 98–100.

39. *See* Victoria Shannon Sahani, *Reshaping Third-Party Funding*, 91 TUL. L. REV. 405, 417 (2017) (discussing portfolio funding).

40. Avraham & Wickelgren, *supra* note 21, at 244 ("Third-party financing, such as the consumer legal funding discussed in our signaling model, generally is in the form of nonrecourse loans and therefore does not require repayment to the funding company if the party recovers nothing."). There are some exceptions to this rule, indicating the wide variety of transactions that may fall within the definition of "litigation finance." For example, Burford's "complex strategies" business line acquires assets whose value may increase due to litigation, but where "[i]n most cases, there is underlying asset value to support the position, in addition to potential value from legal or regulatory proceedings." BURFORD CAPITAL, ANNUAL REPORT 2019, at 20 (2020), https://www.burfordcapital.com/media/1734/fy-2019-report.pdf [https://perma.cc/NC3V-9HXW].

41. Mariel Rodak, *It's About Time: A Systems Thinking Analysis of the Litigation Finance Industry and Its Effect on Settlement*, 155 U. PA. L. REV. 503, 506–07 (2006) ("[L]itigation financiers offer nonrecourse funding—if the plaintiff ultimately loses her case at trial she has no obligation to repay the amount advanced, and the company thus forfeits its entire investment.").

42. *See* J.B. Heaton, *Litigation Funding: An Economic Analysis*, 42 AM. J. TRIAL ADVOC. 307, 309–10 (2019) ("The non-recourse nature of most litigation-funding allows the litigant to protect the downside of a loss by trading to the funder more of the gains from a win.").

43. *See* Samuel Issacharoff, *Litigation Funding and the Problem of Agency Cost in Representative Actions*, 63 DEPAUL L. REV. 561, 563 (2014) (discussing why litigation finance may be a more attractive means of financing litigation than other, more traditional, forms of financing). *See generally* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 413 (2006) (providing a taxonomy of shareholder rights). For the argument that litigation

The nonrecourse nature of litigation funding usually means funding is a riskier investment than many debt or equity transactions. So litigation finance as an asset class typically demands higher returns. The funder's return is frequently expressed as a percentage of case proceeds, a multiple of the funder's investment, or an accruing interest on the funding amount, with the return typically escalating over time.[44] Terms from publicly released commercial litigation finance contracts indicate that funders frequently seek a return of roughly two to six times their investment.[45] In its 2019 annual report, Burford Capital, a publicly traded litigation finance company, reported an internal rate of return of about thirty percent over the past five years for its core business, with a net return on invested capital ranging between sixty and ninety-three percent.[46] Of course, the return that funders seek varies depending on the matter's risk profile. For example, appeals funding (cases funded only after a judgment has been entered in the district court and the defendant appeals) usually commands a lower return than funding presuit, because appeals present less merits risk (the claimant already won at trial) and less timing risk (the case is likely to resolve within two years).

The for-profit litigation finance market consists of two mostly distinct segments: the *commercial* funding market and the *consumer* funding market.[47] The commercial funding market typically involves larger transactions involving disputes between corporations, while consumer funders usually fund relatively small claims by individuals, especially for personal injury and medical malpractice claims.[48]

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finance transactions may be conceived of as equity investments with a limited right to a divided only from case proceeds, see Steinitz, *supra* note 4, at 1175.

44. *See* Ronen Avraham & Anthony Sebok, *An Empirical Investigation of Third Party Consumer-Litigant Funding*, 104 CORNELL L. REV. 1133, 1134–35 (2019) (explaining that litigation funders' returns are expressed "variously as a portion of the amount recovered, a multiple of the amount advanced, or a very high fixed interest rate on the amount advanced").

45. *See* Purchase and Sale Agreement, List Interactive v. Knights of Columbus, No. 17-cv-00210-RBJ (D. Colo. Dec. 31, 2019), ECF No. 267–2 (litigation funding agreement of LexShares, Inc.); Litigation Funding Agreement Between Legalist Fund II, L.P. & DiaMedica Therapeutics Inc. § 1.0 (Exhibit to Form 8-K, DiaMedica Therapeutics, Inc.) (Dec. 27, 2019), https://bit.ly/2ZwmPAc [https://perma.cc/Y4EW-7BEZ] (defining the "Funder Recovery Amount" in a litigation finance agreement of Legalist, Inc.); *see also* W. Bradley Wendell, *Are There Ethical Pitfalls in the Use of Third-Party Litigation Financing?*, 80 ADVOC. (TEX.), Fall 2017, at 51, 52 (stating that litigation finance returns often vary from two to five times the invested amount, with the return typically escalating the longer the litigation remains ongoing).

46. BURFORD CAPITAL, *supra* note 40, at 3.

47. *See* Sebok, *supra* note 11, at 842 (distinguishing between the commercial and consumer funding markets); Sebok & Wendel, *supra* note 27, at 1833 n.2 (discussing the bifurcated market and suggesting that funding to law firms may comprise a third segment).

48. Anthony J. Sebok, *Litigation Investment and Legal Ethics: What Are the Real Issues?*, 55 CAN. BUS. L.J. 111, 113–14 (2014):

Commercial financiers include companies focused solely on litigation finance (including Burford, Lake Whillans, Omni Bridgeway, and Validity Finance) plus hedge funds and other strategic investors (e.g., the D.E. Shaw Group and Fortress Investment Group). One recent survey reported that, in 2020, there were forty-six commercial litigation funders active in the U.S. market, with a combined $11.3 billion of assets under management.[49] Consumer funders include groups like LawCash, Mustang Funding, Oasis Financial, and U.S. Claims.

The distinction between the commercial and consumer segments is important because some proposed and enacted regulatory schemes primarily regulate the consumer funding market, usually because such schemes apply only to transactions with natural persons, not corporations.[50] This distinction mirrors the champerty and usury laws in some jurisdictions, which in many instances exempt from their scope the higher-dollar transactions typically found in the commercial funding market.[51] This different treatment presumes that corporations are more likely to be sophisticated entities that do not need the benefit of consumer protection laws and that corporations are better off having access to high-cost financing than no financing at all.[52]

We have focused here on the for-profit litigation finance industry. Scholars have also noted the existence of third-party financiers who fund lawsuits for an ideological or public-interest motive.[53] One leading example is Peter Thiel's financing of Hulk Hogan's suit against Gawker in retaliation for Gawker "outing" Thiel.[54] The frequency of such third-party financing is difficult to track but

> In the consumer market an investor purchases a portion of a future recovery of a relatively small personal injury claim. . . . [In the commercial market] [t]he claim is not a small-value personal injury claim but a high-value commercial claim arising from a variety of causes of action, including fraud, contract, intellectual property rights, antitrust, and even *qui tam*.

49. WESTFLEET ADVISORS, *supra* note 7, at 4.

50. *See, e.g.*, NEB. REV. STAT. § 25-3302(2) (2010); IND. CODE § 24-12-1-1(7) (2019); VT. STAT. ANN. tit. 8, § 2251(2) (2019) (defining, in each state source, that consumers are persons or individuals for purposes of consumer litigation funding laws).

51. For example, New York's champerty statute does not apply to transactions of at least $500,000. N.Y. JUD. LAW § 489(2) (LexisNexis 2020); Justinian Capital SPC v. WestLB AG, 65 N.E.3d 1253, 1254 (N.Y. 2016). Meanwhile the state's civil and criminal usury laws do not apply to transactions of at least $250,000 and $2,500,000, respectively. N.Y. GEN. OBLIG. LAW § 5-501(6) (LexisNexis 2020). Usury laws typically do not apply to litigation finance transactions for the additional reason that those laws generally do not restrict nonrecourse transactions like litigation funding agreements. *See supra* sources cited in note 18.

52. *See* Marvin F. Milich, *Incorporation to Circumvent Usury Laws: Associated Tax Problems and Law*, 14 J. CORP. L. 527, 528–30 (1989) (explaining that most state usury laws do not apply to corporations).

53. *See, e.g.*, Steinitz, *supra* note 6, at 1088–89; Wendel, *supra* note 11, at 4–5.

54. *See* Wendel, *supra* note 11, at 4–5, 17–19.

likely overstated—subject to the important qualification (discussed further below) that it is difficult to distinguish this form of third-party financing from ordinary pro bono litigation.[55]

B. Why Do Litigants and Law Firms Seek Litigation Finance?

It may seem novel for someone to obtain third-party financing to pay *for litigation*. But third-party financing *in general* is anything but new. Every day, companies and individuals use third-party financing to grow their businesses and pay for things they want or need. Mom-and-pop bakeries take out lines of credit from their local bank; Silicon Valley startups raise venture capital; growth-stage companies obtain mezzanine debt or IPO; multinational corporations sell shares or issue low-yield debt. Individuals call on third parties to help finance the purchase of a new home, an education, or anything you can get with the swipe of a credit card.

Why do companies and people use third-party financing? Usually because they need liquidity or want to share risk.[56] Examples of people with liquidity problems include an entrepreneur toiling in her garage and needing money to build her brilliant widget, a chef needing cash to start his dream restaurant, or an individual needing credit to buy a new car. Others may wish to share some risk: companies or individuals may have the money to buy what they want, but they may prefer for someone else to share the downside financial risk in exchange for some upside if the venture succeeds.[57] The capital markets—from retail banks to the New York Stock Exchange—help efficiently allocate capital from investors to liquidity- and risk-constrained doers and consumers, and they are a cornerstone of our economy.[58]

Companies and people seek third-party litigation finance for the same reasons they seek third-party financing for anything else.

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55. *See infra* notes 83–85 and accompanying text.

56. *See* Cary Martin, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, 37 DEL. J. CORP. L. 49, 59 (2012) (briefly summarizing why companies and individuals may raise capital from third parties).

57. *Id.*

58. *See id.*:

> The public capital markets are the backbone of our current economic structure for several reasons. First, enterprises frequently rely on these markets to raise money to support their operations. . . . Second, capital markets provide investors with the tools for risk management, such as security diversification and strategic hedging. Third, individual investors rely on the markets to finance retirement funds, supplement personal savings, fund higher education costs, and for other personal uses.

Claimholders and law firms usually want to solve either "liquidity constraints" or "risk constraints."[59]

Liquidity constraints typically take one of two forms. First, some claimholders cannot afford the expense of litigation. They do not have the thousands or millions of dollars it takes to litigate a complex civil case.[60] The illiquid includes the destitute: poor individuals, bankrupt corporations, and so on. But others have liquidity constraints too. A claimholder may not be poor, but her money may be tied up elsewhere: say, paying off a mortgage or manufacturing widgets.[61] And liquidity constraints are often a matter of degree, not kind. Litigants may be able to purchase the services of an average lawyer, but not first-rate counsel.[62] Litigation finance helps address these liquidity constraints too.

Second, claimholders might be liquidity constrained in that, wholly apart from (and often in addition to) lacking the resources to bring litigation, they need capital to meet their individual or corporate responsibilities. Someone might have medical bills she needs to pay—bills often incurred because of the defendant's alleged wrongdoing. Or a corporation might need capital to weather financial distress—once again, distress that might exist because of the defendant's alleged wrongdoing.[63] For claimholders who seek redress in the legal system, there is a time lag, often lasting years, between when the wrong is

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59. For earlier discussions of liquidity and risk constraints in the context of litigation finance transactions, see Avraham & Wickelgren, *supra* note 21, at 235; Heaton, *supra* note 42, at 309; Shepherd & Stone, *supra* note 21, at 923–30.

60. Velchik & Zhang, *supra* note 26, at 19–20 ("[L]iquidity constraints would often prevent individuals with meritorious claims from litigation, because they could not afford to pay for litigation costs today and await for judgments for months, if not years."). Individuals may litigate *pro se*, but successfully litigating a case *pro se* is beyond the ken of most individuals. Corporations generally are wholly prohibited from litigating *pro se*, even when the corporation has only a single shareholder. *See* Suneal Bedi, *The Corporate Pro Se Litigant*, 82 OHIO ST. L.J. (forthcoming 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3550886 [https://perma.cc/63PM-RJDT].

61. *See* Shepherd & Stone, *supra* note 21, at 927 ("Most companies . . . have lucrative substitutes for the capital required to prosecute a complex commercial case, including developing new product lines, recruiting scarce or expensive talent, or expanding current manufacturing or distribution channels."); Heaton, *supra* note 42, at 309 ("[Litigation funding] may allow a plaintiff that is not budget-constrained to finance the litigation without tapping other available cash, using that case for other purposes.").

62. *See* Jonathan T. Molot, *The Feasibility of Litigation Markets*, 89 IND. L.J. 171, 173–74 (2014) ("Litigation finance enables the top-flight lawyer at an hourly fee firm to represent a small plaintiff with a meritorious claim even if the client cannot afford his or her hourly bills and his or her firm refuses to agree to contingent fee arrangements."). Law firms are especially likely to face liquidity constraints in light of restraints that the legal ethics rules place on the ownership and capitalization of law firms. *See infra* note 79 and accompanying text.

63. *See* Wendel, *supra* note 11, at 14 (noting that a large competitor might feel emboldened to misappropriate a smaller competitor's trade secrets "kn[owing] that, even if it eventually lost the trade secrets lawsuit, protracted litigation would force the small company to pay out of pocket, tying up a significant amount of its current working capital in payments to lawyers").

committed and when (if ever) the defendant pays damages.[64] But many claimholders are most in need of capital when the wrong happens, not many years later when the defendant pays damages. They may immediately need operating capital to pay their bills, retain their employees, and keep their businesses running. The litigation claim may be their best (and perhaps their only) asset against which they can secure operating capital.[65]

As for risk constraints: litigation is risky. Its ultimate outcome depends on a host of factors beyond anyone's control or foresight.[66] Will the key witness wilt on the stand? Will the plaintiff draw a sympathetic judge or jury? Will discovery reveal a smoking gun—or shoot the plaintiff in the foot? Will the defendants have enough resources at the end of litigation to pay an adverse judgment? Even the strongest legal claims are not sure bets, and even if they were, they would still bring uncertainties around how long the litigation will last and how much money the plaintiff will have to spend litigating the case.

Risk constraints affect many litigation decisions. Most obviously, they affect a claimholder's decision whether to litigate at all. Risk constraints might also affect how the litigation is conducted: whether a top-tier law firm is hired, or whether the litigant prefers to conserve her resources and instead litigate "on the cheap," without the best attorneys or the necessary expert witnesses. Risk constraints also affect settlement decisions. Risk-averse claimholders may accept settlement offers well below the expected value of their claim in order to avoid putting further legal fees at risk in pursuit of an uncertain verdict.[67]

Thus, many risk-averse litigants may possess valuable legal claims, but they may be unwilling to devote their finite resources to

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64. *See* George Steven Swan, *The Economics of Usury and the Litigation Funding Industry:* Rancman v. Interim Settlement Funding Corp., 28 OKLA. CITY U. L. REV. 753, 758 (2003) ("Nearly without exception, time favors a defendant. . . . Most plaintiffs settle because they are unable to wait the nearly two years elapsing before the average case comes to trial."). The notion that "justice delayed is justice denied" is nothing new. *See, e.g.*, Carrie E. Johnson, *Rocket Dockets: Reducing Delay in Federal Civil Litigation*, 85 CALIF. L. REV. 225, 230 (1997).

65. *See supra* note 30 and accompanying text.

66. *See* J.B. Heaton, *The Siren Song of Litigation Funding*, 9 MICH. BUS. & ENTREPRENEURIAL L. REV. 139, 148–49 (2019) (identifying the many ways to lose in litigation, and arguing that for a single-count claim with four elements, there are fifteen ways to survive a motion to dismiss and sixty-five ways to lose); Molot, *supra* note 9, at 69–70 (discussing the range of outcomes that a sample personal-injury plaintiff may face during litigation).

67. Molot, *supra* note 9, at 69–70 (explaining that risk-averse plaintiffs in personal-injury lawsuits may settle for less than the expected value of their claim to avoid the risk of a very low recovery).

purchase legal services to pursue those claims.[68] Litigation finance allows these claimholders to share two types of risk. First, the litigant may share the financial risk associated with paying lawyers to bring a case. This form of risk-sharing minimizes the claimant's out-of-pocket cost in bringing the case. Second, the litigant may share some of the case's upside in exchange for a partial payment or monetization today. As noted, the litigant may accept immediate working capital in exchange for giving the funder a larger portion of case proceeds should the matter prevail.[69]

Further complicating our picture, a litigant's liquidity and risk profile may change over the course of litigation. A claimholder may have sufficient liquidity to self-finance during the early stages of the case but may not be able to do so later on, perhaps because of ballooning litigation costs or a change in her financial resources. Similarly, claimholders who are otherwise willing and able to pay counsel an hourly fee to litigate their case at the outset may nevertheless want to hedge against possible changes in their liquidity or risk profiles at later stages of the case.

Distinguishing between liquidity and risk constraints provides a useful lens for evaluating the rhetoric used about litigation finance in the public square. Proponents of litigation finance frequently emphasize financing's role in assisting the liquidity constrained, classically expressed as helping David battle Goliath.[70] Few people publicly oppose the use of litigation finance to help claimholders who have strong legal claims that they would pursue but for their ability to afford legal services.

Opponents of litigation finance, like the Chamber of Commerce's Institute for Legal Reform, emphasize instead funding's effect on the risk-constrained. They argue, for example, that litigation finance promotes frivolous litigation because there may be circumstances where a claimholder is unwilling to risk her own capital to self-finance a case,

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68. *See* Wendel, *supra* note 11, at 14:

> During the time the lawsuit was pending, the small company would not be using its capital to innovate and compete more effectively against the large manufacturer. Litigation financing thus offers litigants the opportunity to make more productive use of their working capital, rather than dissipating it on the expenses of litigation;

Shepherd & Stone, *supra* note 21, at 927 ("Companies with outside investors are also hesitant to incur voluntary expenses with uncertain prospective payoffs because they must justify these expenses both directly to investors and through publicly available reports and metrics.").

69. *See* Fitzpatrick, *supra* note 9, at 115 ("The virtue of the new, claim-investing financing is that it mitigates the problem of risk imbalance. Now, the risk-averse plaintiff can simply sell some or all of its claim to a third-party financier who is risk-neutral.").

70. *See, e.g.*, Bruno Deffains & Claudine Desrieux, *To Litigate or Not to Litigate? The Impacts of Third-Party Financing on Litigation*, 43 INT'L REV. L. & ECON. 178, 180 (2015); Rodak, *supra* note 41, at 514–15; Wendel, *supra* note 11, at 9–10.

but a third-party funder with a different risk profile would finance the matter.[71] Proponents of litigation finance embrace funding's effect on the risk-constrained, contending that it is good for risk-averse plaintiffs to share risk with a third party and thereby avoid settling for less than the full value of their claim.[72] But note that even if the Chamber's argument is correct with respect to the risk constrained, it does not speak to litigation finance's value to the liquidity constrained.

The foregoing analysis situates third-party funding for litigation as consistent with the well-established practice of companies and people using third-party funding for nearly the entire spectrum of human pursuits, like building a business or financing the purchase of a new home. But if we are comfortable with third-party financing when it comes to just about any other purpose, why the reluctance to embrace this financing to pursue litigation? There is a widespread assumption that there is something new or different about third-party funding *to pursue litigation*. We turn to that issue now.

C. What (If Anything) Is New About Litigation Finance?

Scholars and commentators widely agree that litigation finance is new. They have described litigation finance as a "new field,"[73] a "nascent but fast-growing" industry,[74] a novel practice that "takes getting used to,"[75] and even a "new twist on legalized gambling."[76] The assumption that litigation finance is "new" underpins efforts to regulate the industry. The Chamber of Commerce's Institute for Legal Reform has warned about the "recent growth of third-party litigation financing in the United States" and has argued that financing was not popularized until 1998.[77] Senators Chuck Grassley and John Cornyn, sponsors of federal legislation to require disclosure of financing

71. *See, e.g.*, Michael Abramowicz, *Litigation Finance and the Problem of Frivolous Litigation*, 63 DEPAUL L. REV. 195, 197 (2014) (arguing that litigation finance may result in the filing of "low-probability lawsuits" that claimholders might not bring on their own); Beisner & Rubin, *supra* note 12, at 4 (arguing that litigation funders can pool risk and thus bring individual cases that would not be brought without risk pooling).

72. Molot, *supra* note 9, at 101–02.

73. Rodak, *supra* note 41, at 503.

74. Steinitz, *supra* note 6, at 1089.

75. Lincoln Caplan, *Lawyers and the Ick Factor*, NEW YORKER (July 9, 2015), https://bit.ly/3hAnZCY [https://perma.cc/X7D3-J78G].

76. Elizabeth Sniegocki, *The Advanced Litigation Funding Industry: Gambling on Justice?*, FLA. UNDERWRITER, May 2003, at 29, 29.

77. John Beisner, Jessica Miller & Gary Rubin, *Selling Lawsuits, Buying Trouble: Third-Party Litigation Funding in the United States*, U.S. CHAMBER INST. FOR LEGAL REFORM 2–3 (2009), https://bit.ly/2N4MXwe [https://perma.cc/PGF2-3GBX]. As noted earlier, however, the commercial section of the litigation finance market more accurately dates to around 2006.

agreements in certain matters, have described litigation finance as a "burgeoning industry" that has recently enjoyed "rapid expansion."[78]

To be sure, the legal market has long been regulated in a way that resists third-party financing of litigation. Lawyers are limited in their ability to obtain third-party financing by an ethics rule that prohibits lawyers from "sharing fees" with nonlawyers except in certain limited circumstances.[79] Most jurisdictions prohibit the assignment of personal injury claims, while many states prohibit the assignment of other claims such as fraud and professional malpractice.[80] Common law prohibitions on maintenance and champerty, which originated in England and were adopted in some states, prohibit "officious intermeddlers" from financing the litigation of others.[81] Each of these restrictions limits or prohibits some methods of third-party financing for legal claims.

Yet it would be odd to find that third-party funding did not already exist in the law, particularly given that, as noted, in contexts other than litigation, companies and people rely on third-party financing all the time to manage their liquidity and risk constraints.[82] Indeed, it turns out that for centuries, litigants have found ways to share the costs of litigation with third-parties, notwithstanding the formal restrictions on third-party financing of litigation.

If there is a wall against third-party financing of lawsuits, it is a wall of Swiss cheese, with many holes that permit some—but not all—types of third-party financing to pass through. It is more accurate to say that our legal system bans *some methods* of third-party financing, while allowing others. Here, we identify some permissible methods of third-party financing, and we draw out two themes that apply to each of these methods. First, whether a litigant's claim is eligible for some of these "permissible" forms of third-party financing often depends on reasons having little to do with the strength of that party's claim. Second, these accepted forms of third-party financing are not hidden or obscure. They are well-established, long-accepted features of our legal system

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78. Letter from Charles E. Grassley, Chairman, U.S. Senate Judiciary Comm., & John Cornyn, Chairman, Subcomm. on the Const., to Charlie Gollow, Managing Dir., Bentham IMF 1–2 (Aug. 27, 2015), https://bit.ly/3fAIPQV [https://perma.cc/2V3S-6VZA].

79. *See* MODEL RULES OF PRO. CONDUCT r. 5.4(a)(4) (AM. BAR ASS'N 2013). Some variant of this rule has been adopted in every state and in the District of Columbia. Sebok, *Selling Attorneys' Fees*, *supra* note 21, at 1218. For a discussion of the prohibition against fee sharing in the context of litigation finance transactions, see Steinitz, *supra* note 21, at 1291–92.

80. Sebok, *supra* note 11, at 862; Sebok, *The Inauthentic Claim*, *supra* note 21, at 62.

81. For background on the ancient prohibitions against champerty and maintenance, see Max Radin, *Maintenance by Champerty*, 24 CALIF. L. REV. 48 (1935). For a discussion of the doctrines in the context of litigation finance transactions, see Steinitz, *supra* note 21, at 1286–91.

82. *See supra* note 58 and accompanying text.

that do not generate the same controversy as the modern litigation finance industry.

The most familiar method of third-party financing is the contingency fee, which allows lawyers to finance their clients' litigation in exchange for a share of case proceeds.[83] Contingency fee agreements allow illiquid or risk-constrained litigants to permit lawyers to bear some or all of the financial costs and risks of litigation in exchange for the attorney receiving a share of the rewards if the matter succeeds.[84] Contingency fee litigation thus achieves the same end as the "fees and costs" litigation finance arrangements discussed above: the claimholder trades away a portion of the case upside in exchange for assistance meeting the financial burdens of litigation. Indeed, fees and costs funding usually pairs litigation finance with a "hybrid" contingency fee arrangement, because law firms typically discount their hourly rates in exchange for a contingent share of case proceeds upon success.

Pro bono litigation provides another example of third-party financing of litigation. Organizations like the ACLU, the NAACP Legal Defense Fund, and the Becket Fund, among many others, are third parties to litigation that raise funds from donors and then use those funds to finance litigation on behalf of claimholders.[85] "Because financing litigation—particularly Supreme Court litigation—is well outside the means of the average citizen, civil liberties require coordination among financiers to effect social change."[86] Unlike the controversies surrounding modern litigation finance, pro bono litigation is not viewed as a bug in the legal system. It is instead considered an indispensable and highly desirable feature of the legal firmament.[87]

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83. Molot, *supra* note 9, at 90 ("The principal market for litigation claims in this country is found in the contingent fee system."); Velchik & Zhang, *supra* note 26, at 15–16 (identifying the contingency fee agreement as a form of third-party financing for litigation).

84. Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 CHI.-KENT L. REV. 625, 646 (1995) (describing the contingency fee arrangement as a risk-sharing device between plaintiff and lawyer, where the lawyer is better able to diversify against the risk that any one litigation will fail); Velchik & Zhang, *supra* note 26, at 19 (with contingency fee agreements, "[t]he litigant benefits from being able to pursue his claim though he may otherwise lack the means to pay a lawyer upfront").

85. *See* Steinitz, *supra* note 21, at 1298–99 (noting the similarities between commercial litigation financing and pro bono litigation, the latter of which "eliminates litigation costs" and "therefore alters the power dynamics among attorneys, their clients, and opposing parties").

86. Velchik & Zhang, *supra* note 26, at 17 (footnote omitted).

87. It is especially hard to distinguish traditional pro bono litigation from third-party financing of litigation like Peter Thiel's funding of Hulk Hogan's lawsuit against Gawker. In each instance, a third party finances the lawsuit of a claimholder to vindicate the claimholder's claimed rights. As a result, it is difficult to draft a regulation that would ban third-party funding like Thiel's but would allow traditional forms of pro bono litigation involving constitutional or statutory rights, like challenges to bail laws or restrictions on abortion or religious liberty. Indeed, pro bono

There are other common methods of third-party financing of litigation. Family members, friends, and employers sometimes pay litigation expenses on behalf of loved ones or employees. The classic example is a parent who pays her adult child's divorce fees, or a wealthy benefactor who helps a friend injured in a car accident bring a civil claim against the reckless driver. Companies frequently pay the defense costs of (and money judgments against) directors or officers sued for breach of fiduciary duty. Similarly, state and federal governments typically pay the legal defense costs of (and, again, judgments against) officers sued for violations of constitutional rights. The legal ethics rules expressly permit these types of third-party financing.[88]

There are other examples too, each of which, like several of the examples just mentioned, involves a third-party funder with a profit motive. Consider insurance subrogation: an insurer pays a claimholder (say, the victim of a botched medical procedure or car accident) and then sues the wrongdoer hoping to recover the money it paid the claimholder.[89] Or think about bankruptcy claims trading, where creditors may freely sell their claims to third parties willing to undergo the time and expense of litigating those claims.[90] Parties may assign their contract rights, and creditors may sell their debt to third parties.[91] Each of these instances involves a claimholder sharing with a third party some or all of the financial risks of litigation.

Another analogue to modern litigation finance has gone relatively unnoticed in the literature: claimholders that need financing to bring legal claims can simply raise traditional equity or debt financing to do so. A company can seek out new equity investors or creditors who provide capital the company needs to litigate its claims. But a company's ability to bring on equity or debt investors to finance

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litigation, like contingency fee litigation and modern third-party funding, has previously been attacked as violating champerty laws. *See* Susan Lorde Martin, *Syndicated Lawsuits: Illegal Champerty or New Business Opportunity?*, 30 AM. BUS. L.J. 485, 491 (1992). One might argue that pro bono litigation is usually brought against government entities better able to bear litigation defense costs, but some targets of "cause" litigation—which is often brought on a pro bono basis—are private entities. *See, e.g.*, Zarda v. Altitude Express, Inc., 883 F.3d 100 (2d Cir. 2018), *aff'd sub nom.* Bostock v. Clayton Cty., 140 S.Ct. 1731 (2020) (addressing whether Title VII of the Civil Rights Act of 1964 prohibits discrimination based on sexual orientation in the context of lawsuits against private employers); Students for Fair Admissions, Inc. v. President & Fellows of Harvard Coll., 397 F. Supp. 3d 126 (D. Mass. 2019) (addressing whether Title VII prohibits the affirmative action program of Harvard College).

88. *See* MODEL RULES OF PRO. CONDUCT r. 5.4(c) (AM. BAR ASS'N 2020) (acknowledging that a third-party may "pay[ ] the lawyer to render legal services for another," but prohibiting that third party from "direct[ing] or regulat[ing] the lawyer's professional judgment in rendering such legal services").

89. Velchik & Zhang, *supra* note 26, at 26.

90. *Id.* at 28–29.

91. Steinitz, *supra* note 21, at 1296–97.

litigation will often vary for reasons having nothing to do with the strength of the party's legal claim. Some very strong companies may be able to raise such financing: their core businesses may be sufficiently robust and attractive to investors that they can easily raise new rounds of capital to finance litigation or pursue other corporate objectives. Very weak companies may also be able to raise such financing, particularly where the company is so infirm that it is no longer an operating entity and is worth only the value of the litigation claim. In that circumstance, the company (which might have been put out of business by the defendant's allegedly wrongful acts) can sell equity shares in exchange for the capital necessary to pursue litigation.[92] This phenomenon is often observed in patent litigation, where the asset that is the subject of litigation—the patents—are readily alienable and may be easily transferred from one owner to another.[93] But many companies are less capable of raising equity and debt financing specifically for litigation purposes—perhaps because the company does not have a strong enough core business to attract investors, yet the company is worth more than the value of the litigation claim.

The possibility of companies raising equity and debt financing to fund litigation raises at least two problems relevant to the regulation of litigation finance. First, as discussed, a company's ability to raise third-party funding is often uncorrelated with the strength of that party's claim. It follows that from an efficiency perspective, any ban or limitation on modern litigation finance will be underinclusive, almost arbitrarily prohibiting some claimholders with meritorious claims from obtaining financing while allowing others to obtain the funding they desire.

Second, the ability to raise equity or debt financing suggests that any prohibition on commercial litigation finance may be difficult to police. For example, corporate claimholders could structure third-party litigation finance transactions as equity investments, with the investor's return coming from a special class of stock whose worth is tied solely to the outcome of one or more litigations. Indeed, there are already some documented instances where litigation finance transactions have taken the form of investments in special classes of stock or special purpose vehicles, allowing the investor's return to come

92. *See* Steinitz, *supra* note 4, at 1192 (describing the Crystallex litigation).

93. The Patent Act provides that patents "shall have the attributes of personal property" and that patents are assignable. 35 U.S.C. § 261. *See generally* Erik Hovenkamp, *Competition, Inalienability, and the Economic Analysis of Patent Law*, 21 STAN. TECH. L. REV. 33, 47–48 (2018) (discussing the alienability of patent rights).

only from litigation proceeds.[94] This way of structuring third-party litigation finance would be consistent with long-standing methods of third-party financing that have always been permitted, and it is difficult to see why one form rather than the other should make a difference for regulatory purposes.

More broadly, the prevalence of the methods of third-party financing we have just discussed presents challenging theoretical and practical problems for regulators. Assuming regulators will not rid the legal system of these long-standing forms of third-party financing—contingency fee litigation, pro bono litigation, bankruptcy claims trading, equity and debt financing, and so on—a theory is needed for why modern commercial litigation finance ought to be regulated differently than these other forms of financing. As noted, the ethical rules do not outlaw these forms of third-party financing, nor do statutes or court rules generally require mandatory disclosure of most of these forms of third-party financing. And if regulations apply to only modern litigation finance, these regulations may be circumvented, especially by structuring the investment so that financiers stand as shareholders of a company. Regulators could presumably go even further and actually prohibit entire categories of corporate shareholder interests and governance rights, but this would demand far-reaching intrusion into long-accepted private corporate structures that will likely meet significant resistance.

It follows that litigation finance is not different or new *in kind*. Third-party financing has long been a mainstay of our legal system. But the modern litigation finance industry is different *in degree* from prior methods of third-party financing. The rise of litigation finance as an asset class has made available billions more dollars specifically dedicated to addressing claimholders' liquidity and risk constraints. Claimholders who previously have been unable to obtain the various other forms of third-party funding may now obtain modern litigation funding. And even claimholders who could obtain the other forms of third-party funding may find that litigation finance provides a more efficient way to finance litigation.

Consider the contingency fee. There are restrictions on the contingency fee market that make it inefficient and inadequate to the needs of many litigants. First, only lawyers may practice law, giving attorneys as a class a monopoly on legal fees.[95] While there should exist

94. For a discussion of specific instances where litigation finance transactions have taken the form of investments in special classes of stock or spin-off special purpose vehicles, see Steinitz, *supra* note 4, at 1175–97.

95. Painter, *supra* note 84, at 655–56.

price competition among lawyers, some scholars have argued that lawyers charge higher contingency fee rates, in the form of larger percentages of case proceeds, than they could in a fully competitive market where nonlawyers could compete to provide third-party financing.[96]

Second, many of the largest, best-financed law firms are reluctant to litigate cases on contingency fee, limiting the supply of high-quality providers of contingency fee litigation.[97] There are many reasons why. One culprit is the ethical rule against fee sharing, which generally prohibits lawyers from sharing fees with nonlawyers.[98] The rule limits lawyers' ability to avail themselves of third-party capital to share business risk (including the risk of contingency fee litigation).[99] It is why billion-dollar law firms are run as partnerships, why no law firm is publicly traded in the United States, and why law firms are arguably particularly fragile business entities especially prone to collapse during difficult economic times.[100] Organizational factors play a role too. Many major law firms are led by corporate and defense-side litigation counsel who made their careers on the billable hour and resist putting the firm's resources at risk so that other (frequently more junior) attorneys at the firm can pursue plaintiff-side litigation on a contingency fee.

Third, legal ethics rules also constrict the range of financial solutions that law firms may offer clients. Lawyers may provide *legal services* to clients in exchange for a contingent fee, and they may advance *court costs and expenses* of litigation (e.g., expert fees and filing fees).[101] But lawyers may not otherwise provide "financial assistance to a client in connection with pending or contemplated litigation."[102] In other words, the ethical rules prohibit lawyers from directly purchasing

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96. Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697, 738 (2005) ("[M]arkets for contingency lawyers exhibit little price competition, in part because litigants may interpret a low contingency fee as a signal of a low-quality lawyer."); Lester Brickman, *The Market for Contingent Fee-Financed Tort Litigation: Is It Price Competitive?*, 25 CARDOZO L. REV. 65, 126 (2003) (concluding that the market for contingent fee arrangements is not price competitive); Lester Brickman, *Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?*, 37 UCLA L. REV. 29, 105 (1989) (arguing in particular that the existence and durability of the standard one-third contingency fee reflects the lack of price competition among lawyers).

97. Shepherd & Stone, *supra* note 21, at 929–30.

98. *See* MODEL RULES OF PRO. CONDUCT r. 5.4(a) (AM. BAR ASS'N 2020) (stating that "[a] lawyer or law firm shall not share legal fees with a nonlawyer" other than in the case of certain narrow enumerated exceptions).

99. Shepherd & Stone, *supra* note 21, at 929–30.

100. *See* John Morley, *Why Law Firms Collapse*, 75 BUS. LAW. 1399 (2020).

101. MODEL RULES OF PRO. CONDUCT r. 1.5(c) (AM. BAR ASS'N 2020) (permitting lawyers to provide legal services in exchange for a contingent fee); *id.* r. 1.8(e) (permitting lawyers to advance court fees).

102. *Id.* r. 1.8(e).

a portion of the client's claims or from providing the client with operating capital they can use for general business purposes.[103] Thus while lawyers can help clients reduce their out-of-pocket costs of litigation (the equivalent of "fees and costs" funding provided by litigation funders), they cannot put money in their clients' pockets today.

Litigation finance addresses each of these limitations of the contingency fee arrangement. First, litigation financiers introduce greater competition into the market for legal services, allowing financiers and law firms to compete on price (i.e., the percentage interest in case proceeds payable upon success).[104] Second, litigation financiers provide capital that allows law firms to litigate plaintiff-side cases that they otherwise would be reluctant to pursue on a purely contingent fee basis.[105] Third, litigation financiers can provide a broader suite of options to liquidity- and risk-constrained clients. Distressed or risk-averse clients can obtain "working capital" to grow their business during the litigation, instead of waiting until the end of litigation to recover, by which time a damages award may be too late to save the company or individual from bankruptcy.[106]

II. A UNIFIED FRAMEWORK FOR EVALUATING LITIGATION FINANCE

The academic and regulatory debates about litigation finance reflect efforts to understand litigation finance and its impact on society. Our discussion to this point has defined litigation finance in relation to long-standing efforts by companies and people to obtain third-party financing, to pursue either litigation or any other corporate or personal goal. We now develop a framework for evaluating litigation finance's welfare effects.

Our central claim is that litigation finance casts broad shadows both before and after litigation: it influences parties' behaviors after a

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103. *See* Molot, *supra* note 9, at 91.

104. *See* de Morpurgo, *supra* note 26, at 380 ("[T]he benefits from a competitive market for litigation financing could be substantial, as competition among litigation financing companies would induce them to offer financing for percentages of awards closer to the real expected costs of financing.").

105. Shepherd & Stone, *supra* note 21, at 929–30.

106. *See* Wendel, *supra* note 11, at 14–15 (discussing how litigation finance alleviates working capital constraints for litigants who might not otherwise be able to bring expensive suits). Just as there are questions today about whether litigation finance violates prohibitions against champerty, contingency fee agreements were prohibited as champertous at common law in England and antebellum America. Painter, *supra* note 84, at 639; Velchik & Zhang, *supra* note 26, at 20. The agreements were gradually allowed, however, and by 1876 the United States Supreme Court declared that the permissibility of contingency fee agreements was "beyond legitimate controversy." Stanton v. Embrey, 93 U.S. 548, 556 (1876).

legal claim accrues and a party seeks funding, but it also influences behavior before a legal dispute ever arises. The existing scholarship focuses almost entirely on funding's "post-claim" shadow, studying how funding affects the legal system and the legal profession once a wrong has been committed and a litigant considers suit.[107] These insights are important, but they tell only half the story. A complete account of financing's welfare effects must also study in detail its impact on behavior *before* a legal claim accrues. Indeed, these "pre-claim" effects may be among the most important and lasting effects of litigation finance.

Our unified framework combines these pre- and post-claim effects of litigation finance. We do not purport to identify every effect that litigation finance has in the full variety of contexts and claims where it might be used. Instead, our goal is to illustrate that financing has both pre- and post-claim effects, to identify some of those most important effects, and to demonstrate how our unified framework might be used to evaluate litigation finance's welfare effects.

In developing and applying our framework, we limit the scope of our analysis in two ways. First, we discuss a particular legal context: the contract action. Contract actions provide an effective context for examining litigation finance's welfare effects because breach of contract suits are a leading subject of commercial litigation finance agreements and because two-party contracts present a simple example of a bilateral relationship between two parties whose conduct might vary depending on the presence of financing.[108]

Second, while we acknowledge that litigation finance may be evaluated using various normative lenses, we will evaluate its welfare implications using a law and economics framework.[109] Under this

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107. *See, e.g.*, sources cited *supra* note 21 (providing examples of existing scholarship that focuses on post-claim financing).

108. For example, contract actions typically provide the canvas for law-and-economics studies of the law, even if that school's insights extend to other areas of the law. *See*, *e.g.*, S. Todd Lowry, *Bargain and Contract Theory in Law and Economics*, J. ECON. ISSUES, Mar. 1976, at 1 (analyzing further the underlying concepts of Coase's bargaining theory); Richard Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581 (2004) (bringing contractual interpretation into the general discussion of contract formation); Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, J.L. ECON. & ORG., Apr. 2004, at 2–3 (discussing whether costly negotiation in contracting settings promotes efficiency).

109. The choice of which framework to apply is a classic problem in analyzing laws, reforms, and other interventions. It is not enough to simply identify behavioral changes. One must then apply a normative lens to evaluate whether those behavioral changes actually promote some end goal. Of course, these end goals are often not agreed on. In this Section, we simply choose one end goal (efficiency) and evaluate it using our framework to determine whether litigation finance promotes efficiency. *See* Russell B. Korobkin & Thomas S. Ulen, *Efficiency and Equity: What Can Be Gained by Combining Coase and Rawls?*, 73 WASH. L. REV. 329, 331 (1998) (arguing that

framework, a regulation, intervention, or action is welfare enhancing if it moves the system closer to Pareto efficiency.[110] Pareto efficiency is the state of affairs where nobody can be made better off without making somebody worse off.[111] We select a law and economics framework for several reasons. Law and economics is a natural fit for evaluating a financial marketplace transaction like a litigation finance investment.[112] Contracts are a frequent subject of the law and economics scholarship.[113] And an efficiency-based model may be most likely to speak to critics of litigation finance. At least at the national level, the chief critic is the United States Chamber of Commerce's Institute for Legal Reform, which otherwise touts the efficiency

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different lenses can even be utilized together to effectively evaluate legal institutions); Joseph Singer, *Normative Frameworks for Lawyers*, 56 UCLA L. REV. 899, 950–76 (2009) (discussing how various normative lenses can be useful to analyze legal rules).

110. Economics as a discipline is often seen as attempting to promote efficiency in the marketplace. *See* MICHAEL KATZ & HARVEY ROSEN, MICROECONOMICS 379–403 (3d ed. 1998) (discussing how promoting consumption, allocative, and production efficiency is the main goal of welfare economics); *see also* Jules Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 512–18 (1980) (detailing how economics conceptualizes and promotes efficiency). Law and economics scholarship is no different. *See* Robert D. Cooter, *The Best Right Laws: Value Foundations of the Economic Analysis of Law*, 64 NOTRE DAME L. REV. 817, 817 (1989) (describing the normative foundations of law and economics and its focus on efficiency as an evaluation tool). Of course, the primary factor of analysis is whether a specific legal rule promotes efficiency.

111. Pareto efficiency is the bedrock of economics scholarship. *See, e.g.*, Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 1–2 (1960) (discussing the reciprocal nature of harm inherent to many social problems). Pareto efficiency occurs when "allocations of commodities and inputs [exist] such that the only way to make one individual better off is to make another worse off." KATZ & ROSEN, *supra* note 110, at 380. This concept is closely related to allocative efficiency, where property is allocated such that one could not reallocate it without making somebody worse off. *See id.* at 557; *see also* Richard Markovits, *Legal Analysis and the Economic Analysis of Allocative Efficiency*, 8 HOFSTRA L. REV. 811 (1979) (applying Posner's allocative efficiency to various legal institutional rules). We also note that there are other forms of efficiency that economics appeal to, including Kaldor-Hicks efficiency. See *infra* note 119 for a more extended discussion of Kaldor-Hicks efficiency. Future work can and should apply other forms of efficiency to litigation finance using our unified framework.

112. Most work in finance journals uses a law and economics lens to evaluate various policy changes. *See, e.g.*, Eugene Fama, *Market Efficiency, Long-Term Returns, and Behavioral Finance*, 49 J. FIN. ECON. 283 (1998) (discussing how financial decisions and stock returns relate to efficiency); Stephen Rhoades, *Efficiency Effects of Horizontal (In-Market) Bank Mergers*, 17 J. BANKING & FIN. 411 (1993) (testing whether banks that do horizonal mergers achieve efficiency improvements relative to other firms); Joseph Finnerty, *Insiders and Market Efficiency*, 31 J. FIN. 1141 (1976) (testing the strong efficient market hypothesis using trades made by insiders); James Dow & Gary Gorton, *Stock Market Efficiency and Economic Efficiency: Is There a Connection?*, 52 J. FIN. 1087 (1997) (modeling the relationship between the allocation efficiency of the marketplace and secondary stock market prices).

113. *See supra* note 108 (describing law and economics analyses of contract law).

of market solutions, rather than government regulations, for economic problems.[114]

Although we focus on contract actions through a law and economics lens, we expect that our insights will apply to other causes of action and normative value structures, as we discuss in Part III.

A. Pre-Claim Effects

Litigation finance will likely affect at least three "pre-claim" categories of contracting behavior: the likelihood that a party will breach its contract, the likelihood that parties will contract in the first place, and the design and price of the parties' contract. The precise impact that financing may have on these decisions will vary depending on the parties' liquidity constraints, risk constraints, bargaining power, and other characteristics. But, by identifying these effects and shifting the discussion of litigation finance to earlier in the contracting phase, we hope this Section provides a road map for economists and empiricists to document how and to what extent litigation finance affects parties' behaviors before a legal claim accrues.

Our arguments proceed from the insight that litigation finance operates as what we call an "enforcement mechanism," making it more likely that a party can successfully enforce its legal rights. Litigation finance does this in two ways. First, it makes it more likely that liquidity- or risk-constrained litigants will be able to sue to enforce their rights. Second, litigation finance allows litigants to *better* enforce their rights by providing them the resources to hire more qualified counsel, pursue a more robust litigation strategy, and resist financial pressure to settle for less than the full value of their claim.

1. Fewer Inefficient Breaches

Our first hypothesis is that litigation finance will affect the rate at which parties breach their contracts.[115] Sophisticated corporate

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114. For example, although the Chamber of Commerce and its Institute for Legal Reform advocate increased regulation of the litigation finance market, they otherwise support the deregulation of other financial markets. *See Financial Regulation*, U.S. CHAMBER COM., https://www.uschamber.com/financial-regulation (last visited Dec. 10, 2020) [https://perma.cc/5PGP-GYW2] ("Excessive and unnecessary banking and securities regulations constrain access to capital for businesses, making it harder for them to form and grow. The Chamber believes a free and efficient capital market system is essential to economic growth and innovation.").

115. A few scholars have briefly noted in passing that litigation funding may deter wrongdoing, but they have not elaborated on how and why deterrence might occur, nor have they discussed how funding may affect the incidence of efficient or inefficient breaches. *See, e.g.*, David Tyler Adams, Note, *Laissez Fair: The Case for Alternative Litigation Funding and Assignment of*

entities usually breach contracts for economically rational reasons, when the expected benefits of breach exceed the costs.[116] Even more, some have claimed that contracts are simply promises to pay expectation damages[117] and that it is sometimes preferable for a party to breach rather than follow its contract.[118] These welfare-maximizing breaches are called "efficient breaches."[119] An efficient breach is one where the total costs of a party abiding by its contract exceed the costs of that party breaching the contract, paying damages, and engaging in another more efficient economic transaction.[120] These are breaches that

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Lawsuit Proceeds in Georgia, 49 GA. L. REV. 1121, 1154–57 (2015) (briefly discussing deterrent effects); Avraham & Wickelgren, *supra* note 21, at 235 ("The monopsony breakup also causes future defendants to more accurately internalize the costs of their conduct and therefore to take due care, as they know they will not be able to discharge their liability easily by settling cheaply."); Fitzpatrick, *supra* note 9, at 115 (suggesting that the presence of financing might better achieve a substantive law's prescribed level of deterrence); Hylton, *supra* note 21, at 709–10 (suggesting that litigation finance might have limited deterrent effect over time).

116. The reasons why the benefits of breach may exceed the costs are varied, including that the contract is no longer financially viable or the promisor has access to more attractive uses for its finite resources.

117. Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else."). *But see* Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 FORDHAM L. REV. 1085, 1087 (2000) (arguing that Holmes meant that a contractual breach is a legal wrong in the same way a tort is a legal wrong).

118. The moral weight we attach to the decision to breach might vary. Some scholars argue that contracts are promises that parties have a moral obligation to uphold. *See, e.g.*, CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION 1 (1981) ("The promise principle, . . . the moral basis of contract law, is that principle by which persons may impose on themselves obligations where none existed before."). Other scholars, principally from the law and economics school, argue that the decision whether to breach a contract has no moral weight. *See, e.g.*, Richard A. Posner, *Let Us Never Blame a Contract Breaker*, 107 MICH. L. REV. 1349, 1349–50 (2009) ("[C]oncepts of fault or blame . . . are not useful addenda to the doctrines of contract law."). Of course, even law and economics scholars argue that the decision to breach and *not pay the damages owed* would be wrong. *Id.* at 1350 ("*As long as you pay the damages awarded by the court* in the promisee's suit for breach of contract . . . no blame can attach to your not performing even if it was deliberate . . . ." (emphasis added)).

119. Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977) (popularizing the term "efficient breach"); *see also* Coase, *supra* note 111, at 27 ("What has to be decided is whether the gain from preventing the harm is greater than the loss which would be suffered elsewhere as a result of stopping the action which produces the harm."); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 89–90 (2d ed. 1977) (analyzing examples of efficient breaches and the incentives to which they respond).

120. *See* Peter Linzer, *On the Amorality of Contract Remedies—Efficiency, Equity, and the Second Restatement,* 81 COLUM. L. REV. 111, 114 (1981) ("[E]fficiency theory suggests that promisors who breach increase society's welfare if their benefit exceeds the losses of their promisees."); *see also* Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 953–69 (1982) (arguing that the concept of the simple efficient breach damage theory, although well-situated in law and economics, is a fallacy with respect to specific performance).

many legal practitioners (and certainly economists) would actually encourage.[121]

One important issue, however, often goes unacknowledged in discussions of efficient breach: the efficient breach theory presumes that a party breaches *and pays damages*.[122] Thus a theoretical model of expectation damages assumes that the probability of paying damages for a breach is 1. In the real world, this assumption does not hold.[123] When a promisor breaches her contract, she typically does not mail the promisee a check for expectation damages plus interest.

Indeed, it may be economically *irrational* for the promisor to immediately pay damages, because there are many reasons she is unlikely to pay the full amount of damages she caused the promisee.

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121. Many law and economic scholars view contractual relationships as ways to increase the efficiency of the marketplace. *See* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 241 (1979) [hereinafter Williamson, *Transaction-Cost Economics*] (articulating that contracting is a way to decrease cost for both parties and hence increase efficiency in the marketplace); Oliver E. Williamson, *The Theory of the Firm as Governance Structure: From Choice to Contract*, 16 J. ECON. PERSPS. 171, 189–91 (2002) [hereinafter Williamson, *The Theory of the Firm as Governance Structure*] (expanding the concept of the firm boundaries as simply a question of contracting efficiency). Diving deeper into the "efficient" aspect of efficient breach, one can tie the theory to Pareto efficiency. Pareto efficiency holds that an efficient reallocation of resources exists if a party can be made better off without making a party worse off. This is the exact sort of efficiency that an efficient breach seeks to attain. Compare this to Kaldor-Hicks efficiency, which is less restrictive and exists when a winning party can compensate a losing party such that after compensation there would be Pareto efficiency. But it does not require actual compensation, only the possibility of it. For a more detailed discussion of Kaldor-Hicks efficiency and contractual breaches, see Frank Menetrez, *Consequentialism, Promissory Obligation, and the Theory of Efficient Breach*, 47 UCLA L. REV. 859, 859–82 (2000) (examining the theory of efficient breach from the perspective of moral philosophy). Of course, this view of efficiency in contractual breaches is skeptically viewed by moral philosophers who argue that contracts are moral promises which cannot be defended on simple economic principles. Rather, breaching a contract is a moral decision and entails morally problematic behavior. For a discussion of contracts as moral promises, see FRIED, *supra* note 118, at 7–16, and Seana Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708, 729–48 (2007) (arguing that current treatment of contract law has abandoned the viewpoint that contracts are moral promises).

122. *See* Holmes, *supra* note 117, at 462 (describing contractual duty as a "prediction," for which compensatory damages are the agreed-on contingency); Posner, *supra* note 118, at 1349–50 (explaining how Holmes characterized a contract as an "option" between performance and paying damages); *see also*, *e.g.*, Avery Katz, *Virtue Ethics and Efficient Breach*, 45 SUFFOLK U. L. REV. 777, 777 (2012) (defining an efficient breach as "the idea that a contracting party should be encouraged to breach a contract and pay damages if doing so would be more efficient than performance").

123. This is only one assumption of efficient breach theory that often does not hold empirically. Some have argued that still other assumptions necessary for efficient breach theory do not readily hold empirically. Macneil, *supra* note 120, argues that efficient breach theory assumes that the only way for the efficient set of conditions to arise is for a breaching party to not honor its contract. *Id.* at 950–53. In reality, however, there are other ways in which the conditions created by an efficient breach can be replicated without a contractual breach. See *infra* page 595 and accompanying model to see why probability equaling 1 is necessary for efficient breach. *See also* Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 YALE L.J. 568 (2006) (arguing that efficiency in contractual settings need not rely on efficient breach, but rather moral conceptions of contracting can also fit in the framework of market efficiency).

The breach may go undetected, for example if the promisor secretly misappropriated the promisee's trade secrets. Even if the breach is detected, the promisee may not challenge the breach, perhaps because her liquidity or risk constraints are so severe that she cannot or will not sue, or perhaps because her expected litigation costs exceed the damages amount, making dispute resolution inefficient. Even if the promisee seeks legal relief, dispute resolution is often quite costly, and its outcomes are fallible.[124] The promisee's liquidity or risk constraints may prevent her from hiring the highly skilled counsel she needs to win, or her constraints might force her to settle for less than the full value of her claim. Even if she litigates through trial, the judge or jury may find that no breach occurred or award less than the full amount of damages.

If the probability of paying damages does not equal 1, then breaches will not be efficient, ceteris paribus. This is because people will breach their contracts when their expected benefits exceed their *expected* costs, and the expected cost is some discounted value of the actual cost that the promisor imposes on the defendant (and on society).

A model illustrates the point. Take the following decision of whether a promisor will breach its contract:[125]

$$P(B_{y1} = 1) = P(N_{y1} > C_{y1})$$

Where $P(B_{y1} = 1)$ is the probability that the promisor (y_1) will engage in a generic breach, and $P(N_{y1} > C_{y1})$ is the probability that the benefits of breaching (N_{y1}) will be greater than the costs of breaching (C_{y1}). These costs are best thought of as the actual damages that y_1 expects it will have to pay in the event of a breach. We can then model an "efficient breach" as the following:

124. *See, e.g.*, Macneil, *supra* note 120, at 968–69 (" '[T]alking after a breach' may be one of the more expensive forms of conversation to be found, involving, as it so often does, engaging high priced lawyers, and gambits like starting litigation, engaging in discovery, and even trying and appealing cases."); Dawinder S. Sidhu, *The Immorality and Inefficiency of an Efficient Breach*, 8 TRANSACTIONS: TENN. J. BUS. L. 61, 89 (2006) (highlighting the transaction costs associated with contract breaches, including "the expenses incurred by both parties in resolving their dispute through negotiation, arbitration, or litigation").

125. For simplicity's sake, we assume that the only costs are those borne by the nonbreaching party, though we acknowledge that there are other social costs and externalities that are sometimes included in contractual breach calculations. We use a simple model here with no external social costs to make the intuition clear. Our analysis does hold as we make the decision to breach a contract more complex and realistic.

$$P(B^{*} = 1) = P(N_{y1} > C_{y2})$$ [126]

Where $P(B^{*} = 1)$ is the probability that any given generic breach will be an efficient breach, and $P(N_{y1} > C_{y2})$ is the probability that N_{y1} will be greater than the total costs to the promisee (y_2) of y_1's breach (C_{y2}). This is the most basic form of efficient breach, where the promisor must pay damages equal to expectation damages (e.g., the damages that the promisee suffers as a result of the breach).

Further, we can express the relationship between the damages payable by y_1 and the damages suffered by y_2 as:

$$C_{y1} = a * C_{y2}$$

Where a is a discount factor equaling the probability that y_1 will actually pay the expectation damages of y_2. We can therefore express when a generic breach will be an efficient breach:

$$\textit{if } a = 1 \textit{ then } P(B_{y1}) = P(B^{*}) \textit{ iff } C_{y1} = C_{y2}$$

A generic breach becomes an efficient breach *if and only if* the damages paid by the promisor are equal to the actual damages suffered by the promisee. In effect, a breach is only efficient when the promisor pays expectation damages, either due to court compulsion, moral suasion, or some other factor.[127]

In the real world, a often does not equal 1. We have just noted many reasons why it may be that $a < 1$.[128] For example, the promisee may not have the funding to sue, the promisee's attorneys may not litigate the breach effectively, or a court may incorrectly calculate the promisee's damages. Given the likelihood that each of those and other events may transpire to prevent the payment of full damages, a will almost always be less than 1. It follows:

126. Note that efficiency here is meant to capture Pareto efficiency rather than Kaldor-Hicks efficiency. Pareto efficiency is often the underlying requirement to create an efficient breach. Note that a breach can be Kaldor-Hicks efficient, but not Pareto efficient, even if the breaching party does not pay full damages. Kaldor-Hicks efficiency only requires the possibility of payment, rather than actual payment. For further discussion of Pareto versus Kaldor-Hicks, see *supra* notes 112 and 121.

127. *See supra* notes 119–120 and accompanying text (discussing efficient breach theory and how it presupposes that compensatory damages will be paid out of the "benefit" incurred).

128. *See supra* note 124 and accompanying text (discussing the high transaction costs of dispute resolution).

$$when\ a < 1\ then\ C_{y1} < C_{y2}\ hence\ P(B_{y1}) > P(B^{*})$$

When $a < 1$, the probability of full expectation damages being paid decreases. This in turn decreases the expected damages that a promisor will have to pay. Therefore, the probability of a generic breach becomes higher than the probability of an efficient breach. In other words, most breaches are not going to be efficient under these conditions, and therefore, strictly economically speaking, most breaches should not take place.

This is where litigation finance makes a difference. Litigation finance changes the discount rate because it increases the likelihood that the promisee will successfully challenge a breach. Funding makes the amount of damages that the breaching party expects to pay more closely approximate the amount of damages actually incurred by the nonbreaching party.[129] Litigation finance does this because it operates as an enforcement mechanism, eroding some of the reasons the breaching party may not pay the full quantum of damages. Promisees that would otherwise not sue due to liquidity or risk constraints are now more likely to sue. Once the suit is commenced, promisees may be able to retain higher-quality counsel who is more likely to secure a judgment for the full value of the claim. And promisees are less likely to settle for less than that full value because litigation finance helps reduce or eliminate the liquidity or risk constraints that often lead parties to settle for a suboptimal amount.

By increasing the discount rate, litigation finance forces promisors to more accurately consider the full costs of a breach. The greater the value ascribed to the cost of breach (C_{y1}), the more likely that value will exceed the benefits of breaching (N_{y1}). It follows that litigation finance will likely result in fewer instances in which the benefits of breaching exceed the costs, thus having a net deterrent effect against contract breaches. But litigation finance is unlikely to deter bona fide efficient breaches. The breaches that we identified would be deterred are *inefficient* breaches: instances where a promisor would not

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129. Litigation finance thus puts less wealthy claimholders on a more level playing field with wealthier claimholders, whose wealth serves an in terrorem effect against contract breach. *See* Jeremy Kidd, *Modeling the Likely Effects of Litigation Financing*, 47 LOY. U. CHI. L.J. 1239, 1256–57 (2016):

> Wealthy individuals are less likely to become victims of wrongful behavior because a potential tortfeasor will take more care to avoid a victim that can afford a lawsuit. The poorer one is, therefore, the more likely it is that he will bear the cost of increased wrongful conduct. Consequently, those sectors that rely on individuals and businesses with lower incomes—as consumers or as workers—will also be negatively impacted.

(footnote omitted).

have breached but for her assumption that she is unlikely to pay full damages to a counterparty. In short, funding should decrease the likelihood of inefficient breaches without deterring actual efficient breaches.

The foregoing analysis suggests that litigation finance will, on balance, promote efficiency when it comes to the question of whether parties will breach contracts. At first blush, litigation finance should tend to discourage a class of inefficient breaches without disturbing the likelihood that parties will engage in an efficient breach. Litigation finance should therefore help change the nature of breaches so that they approach Pareto efficiency. When the nature of breaches approaches a more Pareto-efficient outcome, this promotes welfare in the marketplace.

2. More Contracting

Our second hypothesis is that litigation finance is likely to increase the incidence of contracting. A contract is an agreement between parties that the law will enforce.[130] A promisee's willingness to enter into a contract is thus a function of at least two factors: first, the promisee's confidence that the promisor will adhere to its promise; and second, the promisee's confidence that, if the promisor breaches, the promisee will obtain redress (usually, money damages or specific performance) for the breach.[131] Litigation finance is likely to increase a promisee's confidence on both scores and thus is likely on balance to increase the incidence of contracting.

Our first point—that litigation finance will increase a party's confidence that its counterparty will adhere to its promises—follows from what has just been discussed. Litigation finance deters a category of inefficient breaches, thereby giving promisees more confidence that the promisors will abide by their promise. Promisors tempted to breach their contract know that even if the promisee is liquidity or risk constrained, the promisee may obtain litigation finance to pursue the claim.

This point may be situated within a broader understanding of counterparty risk. A contractual relationship is often a complicated and

130. *See* Wallace K. Lightsey, *A Critique of the Promise Model of Contract*, 26 WM. & MARY L. REV. 45, 45 (1984) (examining theories of contract law).

131. *See generally* STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 366–67 (2004) (detailing how risk aversion in the enforcement of promises affects a party's likelihood of contracting in the first instance).

involved endeavor.[132] Counterparty risk is one uncertain variable that can affect the decision of whether to contract with a party in the first place. In just about all contractual relationships, parties depend on their counterparty to perform in good faith. Therefore, potential parties to a contract will want to understand their counterparty as much as possible.

Uncertainties frequently exist concerning who the counterparty is, how it operates, and, most importantly, whether it will honor its contract. For example, it is riskier to contract with a new counterparty than with a long-standing partner.[133] The lower the contractual risk one perceives with the counterparty, the less risky the contractual relationship. Thus, for example, cultural norms and customs, particularly for transactions among members of the same tight-knit community, might provide some reassurance that a contract will be performed regardless of whether an impartial court system exists to enforce the contract.[134]

If parties can decrease the uncertainty associated with counterparties, they will be more likely to enter into a contract in the

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132. Many disciplines have weighed in on how contractual relationships come into existence, including law, philosophy, and business. *See, e.g.*, SIMON DEAKIN & JOHNATHAN MICHIE, CONTRACTS, CO-OPERATION, AND COMPETITION: STUDIES IN ECONOMICS, MANAGEMENT, AND LAW (1997) (arguing for a balancing of cooperation and self-interested competition in private and public sector contracting); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980) (arguing that the firm is essentially a set of contracts); KATZ & ROSEN, *supra* note 110, at 379–88 (creating a game theoretic model for contractual negotiations); Jeffery M. Lipshaw, *Contingency and Contracts: A Philosophy of Complex Business Transactions*, 54 DEPAUL L. REV. 1077 (2005) (drawing on pragmatist theory to explain the need to deal with contingency in commercial transactions); Eric Rasmusen, *Agency Law and Contract Formation*, 6 AM. L. & ECON. REV. 369 (2004) (detailing the efficiency of agents making contracts with third parties on behalf of a principle).

133. For one, repeat players garner trust and cooperation in contracting. *See* Kenneth S. Corts & Jasjit Singh, *The Effect of Repeated Interaction on Contract Choice: Evidence from Offshore Drilling*, 20 J.L. ECON. & ORG. 230, 232 (2004) (empirically showing that repeated interactions are often substitutes for high-powered formal contracts); Armin Falk, Simon Gächter & Judit Kovács, *Intrinsic Motivation and Extrinsic Incentives in a Repeated Game with Incomplete Contracts*, 20 J. ECON. PSYCH. 251, 273–275 (1999) (showing that counterparty effort increases over repeated exposures in the context of incomplete contracts); Bruce Lyons & Judith Mehta, *Contracts, Opportunism and Trust: Self-Interest and Social Orientation*, 21 CAMBRIDGE J. ECON. 239, 243–46 (1997) (theorizing on two forms of trust that are created in contracting via repeated exchanges); Bart S. Vanneste & Phanish Puranam, *Repeated Interactions and Contractual Detail: Identifying the Learning Effect*, 21 ORG. SCI. 186, 198 (2010) (showing that organizations that interact repeatedly are better at writing more detailed contracts due to learning about their counterparties).

134. *See* Michael Trebilcock & Jing Leng, *The Role of Formal Contract Law and Enforcement in Economic Development*, 92 VA. L. REV. 1517, 1573 (2006) ("Often because of ethnic, religious, or cultural ties, informal transacting norms arise and are enforced through informal, extra-legal sanctions.").

first place.[135] A simple example comes from the insurance world. Insurers face moral hazard and information asymmetry problems when presented with a request for insurance. When insurers price contracts, they need relevant risk information to efficiently write insurance contracts. But much of this needed information is often latent rather than observed. (Consider, for example, the middle-aged person who requests life insurance and may conceal a life-threatening ailment.) As such, insurance companies, and contracting parties at large, seek ways to lower this information asymmetry to decrease counterparty risk.[136] They often learn what they can about a counterparty—including their business models (or personal health), their financial incentives, and who they have worked with in the past—prior to contracting.[137]

Litigation finance also decreases counterparty risk because litigation finance increases contractual compliance by deterring a class of inefficient breaches. Sophisticated parties following a game theoretic model would likely take this increase in compliance into account when deciding whether to contract.[138] Knowing that the availability of litigation finance will make a counterparty less likely to breach decreases the risk that parties (especially those who are liquidity or risk

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135. Various scholars identify counterparty risk as problematic. *See* Bruno Biais, Florian Heider & Marie Hoerova, *Risk Sharing or Risk Taking? Counterparty Risk, Incentives, and Margins*, 71 J. FIN. 1669 (2016) (showing that parties seek strategies that decrease counterparty risk); James R. Thompson, *Counterparty Risk in Financial Contracts: Should the Insured Worry About the Insurer?*, 125 Q.J. ECON. 1195 (2010) (arguing that the insured party in financial insurance contracts are exposed to excessive counterparty risk); Nicholas Vause, *Counterparty Risk and Contract Volumes in the Credit Default Swap Market*, BIS Q. REV., Dec. 2010, at 59, 60 (arguing that the decrease in credit default swap instances is due to the desire to decrease counterparty risk that was otherwise underestimated).

136. *See, e.g.*, Eric W. Bond & Keith J. Crocker, *Smoking, Skydiving, and Knitting: The Endogenous Categorization of Risks in Insurance Markets with Asymmetric Information*, 99 J. POL. ECON. 177 (1991) (arguing that insurance strategies of categorizing otherwise heterogeneous consumers into various risk buckets can help the market reach Nash equilibria); Alma Cohen, *Asymmetric Information and Learning: Evidence from the Automobile Insurance Market*, 87 REV. ECON. & STAT. 197 (2005) (finding that asymmetric information in the insurance market exists and causes new customers to gain information advantages over issuers). *But see* James H. Cardon & Igal Hendel, *Asymmetric Information in Health Insurance: Evidence from the National Medical Expenditure Survey*, 32 RAND J. ECON. 408 (2001) (arguing that there is lack of evidence that the insurance market contains asymmetries with respect to risk profiles).

137. Ali Fatemi & Iraj Fooladi, *Credit Risk Management: A Survey of Practices*, 32 MANAGERIAL FIN. 227 (2006) (surveying the ways in which financial institutions manage counterparty risk); David A. Hoffman & Tess Wilkinson-Ryan, *The Psychology of Contract Precautions*, 80 U. CHI. L. REV. 395, 408–18 (2013) (empirically showing that parties engage in precautions before contracting and the precautions they take rely in part on the psychological frame in which they enter into negotiations).

138. For discussions of how parties use game theoretic intuition in negotiating contracts, see KATZ & ROSEN, *supra* note 110, at 379–88; and Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1644–45 (2003).

constrained) bear by entering into a contract (especially where the counterparty faces fewer liquidity or risk constraints).[139]

We turn now to the second reason litigation finance is likely to increase contracting: parties will have increased confidence that if their counterparty breaches the contract, they will be able to enforce that promise in court. To see this point, it is helpful to review the role of access to the courts in a contract system. There is widespread agreement among commentators that a system of impartial courts to enforce agreements is an essential ingredient to a functioning system of contracts.[140] Hobbes made this point, arguing that in the state of nature, contracts cannot be relied on because society lacks "some coercive Power" to enforce the contract.[141] More recently, Douglass North has argued that "the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World."[142]

One need not accept the strongest version of North's argument to agree that a stable legal system that will enforce contracts is an important ingredient to a flourishing commercial system. Of course, it is not enough that courts exist. For one, the courts must be impartial. If judges are regularly bribed, or grant favors to preferred litigants, or sit in cases where they have conflicts of interest, parties may be less likely to have faith that they will be able to enforce their contracts.[143] The courts must also be effective at interpreting the parties' intent. The application of established rules of contract interpretation and settled

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139. One might argue that this phenomenon will deter contracting by parties who are likely to breach their contracts, or that it might deter good-faith parties from contracting for fear of a strike suit if the contract's purposes are not realized. From an efficiency standpoint, deterring contracting by parties who plan to commit inefficient breaches is not a bad thing. And while it is possible that some parties may be deterred from entering into contracts for fear of a strike suit, the magnitude of this effect is likely to be quite small, particularly since courts should be expected to weed out most meritless claims.

140. *See* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 54 (1990) (noting that the level of imperfection in enforcement mechanisms affects the transaction costs of the exchange); Trebilcock & Leng, *supra* note 134, at 1522 (explaining Douglass North's position that third-party enforcement of contracts is essential).

141. THOMAS HOBBES, LEVIATHAN 97 (A.R. Waller ed., Cambridge Univ. Press 1904) (1651).

142. NORTH, *supra* note 140, at 54.

143. *See, e.g.*, Caperton v. A.T. Massey Coal Co., 556 U.S. 868, 889 (2009) ("The citizen's respect for judgments depends in turn upon the issuing court's absolute probity. Judicial integrity is, in consequence, a state interest of the highest order." (quoting Republican Party of Minn. v. White, 536 U.S. 765, 793 (2002) (Kennedy, J., concurring))).

precedents is generally regarded as improving commercial parties' faith in their contracts.[144]

A party's ability to access the courts is also key, which is why North emphasized that it was not enough that courts exist, but that these courts must provide a "low-cost" enforcement mechanism. The most stable court system with the most impartial judges is useless to a litigant who cannot afford access to those courts. Litigation finance increases the likelihood that a party will be able to enforce its contract by suing over a breach.

In this way, litigation finance plays a similar role in our legal system as do norms against oppressively high court filing fees, prohibitions on judges presiding over cases where they have a conflict of interest, and stable bodies of precedent about how contracts are interpreted. Each in its own way contributes towards the creation of a legal system where parties that enter into contracts can have confidence that their agreements will be enforced.

If we are correct that litigation finance increases the likelihood that parties will contract, this should be a Pareto-improving development.[145] Contracting allows parties to allocate risk to third parties that can best withstand that risk. If a firm can itself do very easily what it is contracting out, then it would be in the best interest of the firm to not contract. This is the standard way economists have viewed contracting. That is, parties will "outsource," via a contractual relationship, those activities that they do not want to engage in within the firm.[146] If they can make themselves better off by outsourcing

144. *See* Thomas R. Lee, *Stare Decisis in Historical Perspective: From the Founding Era to the Rehnquist Court*, 52 VAND. L. REV. 647, 652–53 (1999) (discussing precedent's role in "assuring stability in commercial relationships," and arguing that "[i]n some cases, contracts or title to property may be premised on a rule established by case law; overruling such precedent would undermine vested contract and property rights"); *see also* Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting) ("Stare decisis is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right.").

145. For a discussion of the Pareto-efficient frontier, see KATZ & ROSEN, *supra* note 110, at 386–94. Pareto-improving moves, by definition, shift distribution among parties towards a Pareto-efficient frontier (where there can be no Pareto-improving moves). Allocations, however, can be changed such that even though a party is made worse off, the equilibrium still gets closer to the Pareto-efficient point, so such moves still help drive towards efficient outcomes.

146. The classic argument for why and how firms decide between engaging in contracts is detailed by Oliver Williamson. *See* Williamson, *Transaction-Cost Economics*, *supra* note 121, at 240 (arguing that firms seek to engage in contract relationships when they recognize that it is cheaper and more cost effective to outsource an activity rather than perform that activity in-house, and providing that " transaction-specific savings can accrue at the interface between supplier and buyer as contracts" adapt to unfolding events and are periodically renewed). *See also* Williamson, *The Theory of the Firm as Governance Structure*, *supra* note 121 (analyzing the existence of organization structures via a contractual relationship approach).

activity to another firm via a contract, then, all else held constant, they will.[147]

Therefore, if litigation finance promotes contracting by increasing the incidence of contractual relationships, it allows firms to engage in a type of behavior that makes them better off. And contracting presents both counterparties with these same opportunities. Thus, when two parties engage in a contract, they are creating Pareto-improving moves because both recognize that they would be worse off had they not agreed to outsource the respective activities to their counterparty.[148] Litigation finance then makes all parties better off (by promoting Pareto efficiency) when it increases the likelihood that parties will contract.

3. Contract Price and Design

Our third hypothesis is that litigation finance will affect the result of the contractual bargaining process, including the contract's price and nonprice terms. There is disagreement in the literature about how bargaining power affects "contract design," or the nonprice terms of a contract.[149] The law and economics literature generally adopts what has been called the "irrelevance theory" of bargaining power, which posits that bargaining power affects price terms but not nonprice terms.[150] On this view, the parties will adopt whatever nonprice terms maximize total efficiency, with the parties then dividing up that efficiency through the contract's price according to each party's bargaining power. If, for example, Party A derives more value from litigating in her home state than Party B would derive from litigating in his home state, the parties will choose a forum selection clause with Party A's home state, even if Party B has more bargaining power, with

147. *See* Williamson, *Transaction-Cost Economics*, *supra* note 121, at 250–53 (explaining relational contracting, including bilateral and unified structures).

148. Williamson's framework for determining whether contracting will take place is inexorably tied to changes in distributions that move closer to Pareto efficiency. *See, e.g.*, Yeon-Koo Che & Donald B. Hausch, *Cooperative Investments and the Value of Contracting*, 89 AM. ECON. REV. 125 (1999) (acknowledging that contracting creates more efficient outcomes but only under certain conditions); Steinar Holden, *Renegotiation and the Efficiency of Investments*, 30 RAND J. ECON. 106 (1999) (showing that even breaches of contractual relationships can lead to efficient outcomes via renegotiation); Schwartz & Watson, *supra* note 108 (discussing the impact of costly contract negotiation on efficiency).

149. For a helpful summary of this debate, see Spencer Williams, *Venture Capital Contract Design: An Empirical Analysis of the Connection Between Bargaining Power and Venture Financing Contract Terms*, 23 FORDHAM J. CORP. & FIN. L. 105, 106–23 (2017).

150. Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665, 1678–80 (2012); Williams, *supra* note 149, at 110–13.

Party B extracting value through a more favorable contract price.[151] The "direct effect theory," by contrast, argues that bargaining power will affect nonprice as well as price terms, such that this contract would select Party B's home state because Party B had greater bargaining power. [152]

Our goal here is not to advocate that one theory of bargaining is correct, but rather to illustrate how litigation finance may affect the bargaining over nonprice terms. Our analysis assumes the irrelevance theory. We do not purport to identify the full range of effects that litigation finance may have on the price and nonprice terms of a contract, but only to identify that an effect will occur and to briefly identify through an example how that effect might occur.

Litigation finance may alter the parties' preferences for certain nonprice terms. For example, the presence of financing may affect the value that parties place on dispute-resolution provisions of a contract, such as arbitration clauses, choice of law and venue provisions, and limitation-of-liability provisions. Litigation finance may also affect the value parties place on the contractual provisions that are most likely to be the subject of litigation, such as the language permitting one party to use another's trade secrets or the language describing the reasonable efforts that each party to a joint venture must make in pursuing the joint venture's ends.

Consider the example of a proposed contractual provision that would prohibit any party from recovering consequential damages. Assume promisee, *P*, is significantly liquidity or risk constrained and thus unlikely, without third-party financing, to mount a successful breach of contract claim if promisor, *D*, breaches. Moreover, assume *D* should have little difficulty litigating a contract action as either the plaintiff or defendant and that *D* is more likely to be the breaching party (perhaps because only *P* is sharing its trade secrets).

In a world without litigation finance, *P* may only be willing to pay $10 for a contract that has no liability cap, since *P* is unlikely to obtain significant damages even if *D* breaches. *D* might have incomplete but partial knowledge of *P*'s liquidity or risk constraints, so it may be willing to pay $20 for a contract with a limitation of liability provision. In this scenario, we would expect the contract to contain the limitation

151. *See* Williams, *supra* note 149, at 112 (discussing a similar hypothetical negotiation of an arbitration location in the sale of a used car).

152. Choi & Triantis, *supra* note 150 at 1669; Williams, *supra* note 149, at 113–17.

of liability provision, for a price change in *P*'s favor, the amount depending on the parties' relative bargaining power.[153]

In a world where *P* may obtain litigation finance for at least some breaches by *D*, the parties might value this provision differently. For example, *P* might place increased value on having no liability cap so that it might recover the full quantum of its damages. Meanwhile, *D* might also place greater value on the limitation of liability provision, given that *P* is more likely to enforce the contract. In this world, *P* may be willing to pay $40 for a contract that does not contain a limitation of liability, and *D* may be willing to pay $30 for a contract that does. In this scenario, under the irrelevance theory, we would expect the contract to *not* contain the limitation of liability provision, for a price change in *D*'s favor.[154]

In addition to affecting contract design, litigation finance may also affect the parties' bargaining power. Bargaining power is typically understood as a function of a party's "best alternative to a negotiated agreement," or "BATNA."[155] Albert Choi and George Triantis have argued that a party's BATNA is usually a function of five factors, including demand and supply conditions, market concentration, private information, patience and risk aversion, and negotiating skills and strategy.[156]

Litigation finance may affect several of these levers, perhaps most significantly demand and supply conditions. We argued earlier that litigation finance is likely to increase the incidence of contracting by making a party more likely to contract with a wider range of counterparties, including with less liquidity- or risk-constrained counterparties and with counterparties that may seem more likely to breach a contract.[157] Assuming competitive conditions exist, a party may, for example, be willing to enter into a supply contract with a wider range of potential suppliers. This would on balance introduce greater competition into the contract market, giving the party with access to financing greater bargaining power in any given transaction.

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153. *See* Williams, *supra* note 149, at 112 (explaining in the context of a similar hypothetical that although a certain contract term may have a distributional effect, "the relative bargaining power of the parties does not affect its optimal form").

154. *See id.* at 111 (positing that under irrelevance theory, parties will use the most efficient contract design to extract the highest value).

155. *See* ROGER FISHER, WILLIAM URY & BRUCE PATTON, GETTING TO YES: NEGOTIATING AGREEMENT WITHOUT GIVING IN 97–105 (Penguin Books 2d ed. 1991) (1981) ("[T]he relative negotiating power of two parties depends primarily upon how attractive to each is the option of not reaching agreement.").

156. Choi & Triantis, *supra* note 150, at 1675.

157. *See supra* Section II.A.2 (reasoning that litigation finance would increase the promisee's confidence that the promisor will adhere to its promise and that if the promisor breaches its promise, the promisee will obtain redress for the breach).

At first blush, our analysis might not lead to obvious efficiency gains; it may just change the price and nonprice terms of a contract. But the terms in a world with litigation finance are more likely to approximate the most efficient terms. Recall that the negotiation that happens in a world without litigation finance is a world where contracting parties (and the weaker contracting party in particular) cannot access capital markets to efficiently allocate the cost and risk of bringing litigation. Litigation finance allows for the efficient contract price and nonprice terms in a world where both parties have relatively unimpeded access to the capital markets, and thus will tend to provide a more efficient set of contract terms.

B. Post-Claim Effects

Now that we have identified several pre-claim effects of litigation finance, we turn to the topic that has received scholarly attention: litigation finance's post-claim effects. Our objective here is not to comprehensively review the existing scholarship on litigation finance. Instead, our goal is to identify the most important post-claim effects that should be considered as part of any effort to understand litigation finance's total welfare impact and to briefly identify how those effects should be evaluated through a law and economics lens.

1. Whether and Which Legal Claims Are Brought

For many observers of litigation finance, it is almost a truism that financing will result in an increase in the amount of litigation.[158] Paul Rubin argues that an increase in litigation is an "obvious effect of increased third-party financing."[159] Maya Steinitz claims that "[t]he primary import of the industry is its propensity to increase the number of cases brought."[160] "The broad assumption," Jeremy Kidd asserts, "is that there will be an increase in the volume of cases brought; proponents and opponents disagree only on whether those cases will be meritorious or frivolous."[161] Kidd's own analysis concludes that

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158. For an exception to this line of thinking, see Shepherd & Stone, *supra* note 21, at 953 ("The ultimate effect of third-party litigation financing on total litigation costs is quite complex and an empirical question that we do not endeavor to resolve. We merely note that it is anything but clear that litigation finance net *increases* litigation costs.").

159. Rubin, *supra* note 10, at 677.

160. Steinitz, *supra* note 6, at 1084.

161. Kidd, *supra* note 129, at 1241.

"[i]ncreased money to finance litigation should guarantee some increase in litigation," though he has questioned the magnitude of that impact.[162]

It is tempting to assume that litigation finance will result in more litigation. After all, both funding's opponents and supporters emphasize its ability to allow claimholders to bring claims that they would otherwise abandon without access to third-party financing.[163] But there are reasons to doubt financing will result in much, if any, net increase in litigation.

First, and most importantly, predictions that litigation finance will result in an increase in litigation suffer from the same limitation we addressed earlier in this Article, namely that they look only to financing's post-claim effects. We have suggested that, at least in the context of business contracts, litigation finance will likely (a) decrease the number of contract breaches, (b) increase the number of contracts entered into, and (c) affect contract price and design.[164] A decrease in the number of contract breaches would suggest a decrease in the amount of litigation. An increase in the number of contracts could result in a net increase in litigation simply because there is more commercial activity that might go awry—which would lead to the result predicted by scholars (more litigation), but for a very different reason (more commercial activity, not necessarily a greater rate of litigated contract disputes). Finally, changes in contract price and design could have various effects on the likelihood of litigation, with some contract designs being more or less likely to promote litigation.[165] For example, if litigation finance resulted in more contracts having arbitration provisions, in-court litigations might decline, though arbitrations might increase. Similarly, if litigation finance resulted in more contracts having limitation of liability provisions, fewer cases may be filed because the expected value of those cases with a limitation of liability provision would be too low.

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162. *Id.* at 1258. One early empirical study of litigation financing's impact in Australia has concluded that the rise of litigation finance was correlated with an increase in the number of lawsuits filed. David S. Abrams & Daniel L. Chen, *A Market for Justice: A First Empirical Look at Third Party Litigation Funding*, 15 U. PA. J. BUS. L. 1075, 1106 (2013).

163. Steinitz, *supra* note 21, at 1338 ("Third-party financing of litigation will increase access to justice and encourage private enforcement of the law."); de Morpurgo, *supra* note 26, at 381–82 (identifying access to justice as a positive externality of litigation finance); *see also* Lawsuit Funding, LLC v. Lessoff, No. 650757/2012, 2013 WL 6409971, at *6 (N.Y. Sup. Ct. Dec. 4, 2013) ("[L]itigation funding allows lawsuits to be decided on their merits, and not based on which party has deeper pockets or stronger appetite for protracted litigation.").

164. *See supra* Section II.A (discussing the pre-claim effects of litigation financing).

165. *Cf.* Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 818 (2005) ("The choice between precise terms and vague terms thus reduces to who chooses the relevant evidentiary proxies and when they are chosen: the parties at the time of contracting or the court at trial.").

Second, there are good reasons to question how many cases would not be filed but for the presence of litigation finance.[166] At least in the commercial litigation finance market, only a small minority of cases are "investment grade" for litigation financiers.[167] Commercial litigation financiers reject the vast majority (even ninety percent or more) of financing requests that they receive.[168] And many, if not most, of the cases that receive financing would likely be litigated by a law firm on a full contingency fee but for the presence of litigation finance.[169]

Third, balanced against funding's tendency to allow litigants to bring some claims they would not otherwise bring, litigation finance is also likely to prevent at least some claims from being filed. Scholars have noted that litigation finance may act as a signaling mechanism, indicating to courts and defendants which claims have merit and which do not.[170] A signal can be sent to prospective litigants too. If a claimholder and law firm seek financing but are unable to secure funding, they may view this as a signal about the merits of the case and decline to self-finance the matter.

Perhaps the most important point from a law and economics perspective is that the mere fact that more or fewer cases are filed tells us little about whether litigation finance has a net positive or negative impact on welfare. Like Goldilocks, we need to understand whether the pre-funding world has too little, too much, or just enough litigation. If litigation finance leads to a net increase in suits that are filed, this may

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166. For example, Jeremy Kidd has suggested that litigation finance may only make a difference in whether a case is brought when the plaintiff is so liquidity constrained that it cannot afford to litigate or where cases are brought for strategic goals. Kidd, *supra* note 129, at 1241; *see also* Sebok, *supra* note 48, at 112 ("[Litigation financing] may not have any effect on the outcome of the litigation (either because it is not directly or indirectly being used to fund litigation-related expenses or because there were other resources at hand that would have been used had the funding not existed).").

167. Shepherd & Stone, *supra* note 21, at 936.

168. *See, e.g.*, BURFORD CAPITAL, *supra* note 40, at 17 (stating that in 2018 and 2019, Burford invested in 5.9% and 7%, respectively, of inbound requests for funding). An empirical study of one consumer litigation funder found that the funder invested in fifty percent of matters where funding was requested, which suggests very different selection criteria between commercial and consumer litigation funders. Avraham & Sebok, *supra* note 44, at 1145.

169. *See* Rubin, *supra* note 10, at 679–80 (arguing that sufficient incentives already exist for claimholders to bring meritorious litigation). Of course, this does not mean that a litigant is agnostic as to working with a contingency fee lawyer rather than a funder, particularly in light of a funder's ability to monetize a claim. And this does not mean litigation finance has no effect on our legal system. As we will discuss below, funding may have a great impact on how claims are litigated and resolved, even if it has a lesser impact on whether cases are brought. *See infra* Section II.B.2 (reasoning that litigation financing can ease financial pressure on cash-strapped or risk-averse litigants who might otherwise settle for less than the full value of their claims).

170. Avraham & Wickelgren, *supra* note 21, at 249–50, 256.

be because the previous level of financing was suboptimal due to the exclusion of too many liquidity- or risk-constrained plaintiffs.[171]

Some commentators argue that litigation finance will result in an increase in the amount of frivolous litigation, particularly cases that are unlikely to succeed but would present a large payout if they do succeed.[172] Supporters of litigation finance respond that financiers invest only in the strongest claims, and those who back frivolous cases will not remain in business for long.[173] Moreover, this critique of funding is probably especially weak in the context of breach of contract cases, where punitive damages generally are unavailable, limiting the financial upside compared to, say, billion-dollar class actions. Finally, to the extent a contract action (or any other action, including a class action) does present outsized awards, it is likely that the case will be brought regardless of the existence of litigation funding by a lawyer willing to take the case on a full contingency.

While the net welfare impact of litigation finance on which claims are brought is difficult to predict, litigation finance is likely to improve efficiency. We should expect litigation finance to result in the pursuit of more claims with an expected positive value, though financing will also affect how many such claims exist through a variety of mechanisms, including by increasing contracting, deterring breach, and providing the resources to nudge some cases from having a negative expected value to a positive expected value. Of course, some underlying legal regimes promote inefficiency rather than efficiency, and allowing more litigation under these legal regimes may result in net

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171. Fitzpatrick, *supra* note 9, at 121–22 ("[I]f financing leads to more litigation, it would seem to do so only because, as I explained, the financing disadvantages of plaintiffs have led them to file too few cases now. Thus, this is really not a cost of claim investing, but a benefit."); Sebok, *The Inauthentic Claim*, *supra* note 21, at 68:

> Even if [litigation finance resulted in an increase of claims], why would this be a bad thing? If the malpractice claims that would be assigned were not fraudulent and reflected claims based on valid law, why would it be a bad thing for these cases to increase in number, since that would mean that more legal wrongs would be repaired and more wrongdoers held to account?

172. *See, e.g.*, Beisner, Miller & Rubin, *supra* note 77, at 5–7; Rubin, *supra* note 10, at 675; Abramowicz, *supra* note 71, at 211 (arguing that litigation finance may promote frivolous litigation and suggesting a fee cap to limit incentives to invest in litigation where the plaintiff is unlikely to prevail).

173. Molot, *supra* note 9, at 106 ("Although opponents of third-party financing predict that such financing might encourage meritless filings rather than meritorious ones, the claim makes little sense."); Anthony Sebok, *Betting on Tort Suits After the Event: From Champerty to Insurance*, 60 DEPAUL L. REV. 453, 453–55 (2011) (describing as "far-fetched" the "fear that a market in champerty will result in lawsuits that are more likely to be frivolous"); Victoria A. Shannon, *Harmonizing Third-Party Litigation Funding Regulation*, 36 CARDOZO L. REV. 861, 875 (2015) ("It is not in the funder's interest to fund frivolous cases, because the funder would incur only costs without benefits when the case fails, and a court may sanction the funded party for bringing a frivolous case.").

inefficiencies. But an objection to this effect is more precisely an objection to the underlying legal regime, not to litigation finance.[174] Assuming that our system of contract laws promotes rather than reduces efficiency, an increase in litigation over contract breaches may well increase efficiency.

2. How Claims Are Litigated and Resolved

Litigation finance may have a more profound effect on how claims are litigated and resolved, rather than on whether claims are brought. How financing may affect the resolution of legal claims has received significant attention from scholars. One seminal article contends that litigation finance eases financial pressure on cash-strapped or risk-averse litigants to settle their claims for less than full value.[175] Other scholars have tracked this analysis to conclude that litigation finance is likely to improve social welfare by expanding the market for settlements.[176] Critics of this viewpoint counter that at least in some circumstances, litigants will push for inefficiently high case resolutions—perhaps rejecting reasonable settlement offers or proceeding to trial, inefficiently wasting resources—because the financing contract is structured to incentivize the claimholder to seek a "home run" rather than accept a reasonable settlement.[177]

Litigation finance will affect how claims are litigated in a number of respects. First, litigation finance will allow claimholders to hire better counsel. One obvious way this will happen is that financiers provide additional capital to retain higher-quality counsel. But litigation finance also expands the universe of law firms that are able to litigate plaintiff-side matters. We previously explained that many large law firms are ill-equipped to litigate matters on a full contingency, but they are able to take on matters where a funder pays some or all of

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174. Shepherd & Stone, *supra* note 21, at 952 ("[T]hese potential objections instead focus on either the social benefits of the underlying rules of decision or the inefficiency of the civil justice system. These are serious and substantial problems, but neither of these problems has anything to do with third-party litigation financing.").

175. Molot, *supra* note 9, at 101 (arguing that when third-party capital providers provide risk-averse plaintiffs with a market alternative to settling with a defendant, plaintiffs "would be better able to hold out for higher settlements that are closer to the mean expected damages award").

176. Avraham & Wicklegren, *supra* note 21, at 235; Glickman, *supra* note 30, at 1064 (arguing that litigation finance essentially removes one party's competitive advantage of access to capital, and thus "level[s] the playing field by enabling companies with valid claims or defenses but few resources to obtain fair settlements").

177. Rodak, *supra* note 41, at 513–24 (discussing funding's effect on settlement incentives); *see also* Joanna M. Shepherd, *Ideal Versus Reality in Third-Party Litigation Financing*, 8 J.L. ECON. & POL'Y 593, 600 (2012) (arguing that litigation funders are incentivized to finance cases that seek inefficiently large damages awards or settlements).

the firm's legal fees.[178] Many law firms that were unable to compete in the "full contingency" litigation market are now able to compete in the "partial contingency" market that litigation financiers help create. Litigation finance will also result in the allocation of additional resources to litigate cases. Claimholders who might previously have pursued their litigation on a shoestring can now afford higher-quality support services, including the full complement of experts they need to maximize their claim's value.

This does not necessarily mean that the amount of resources spent on litigation will increase. For example, while financiers may *commit* additional resources to litigation, meritorious cases may *resolve* more quickly (and without as much expense) than they might otherwise. As the plaintiff's likelihood of success increases, the defendant's willingness to settle should also increase. Indeed, Jef De Mot and Michael Fuare have argued that for the most meritorious cases, litigation finance may result in a net decrease in expenditures, because defendants are more likely to settle quickly.[179]

As with the question of whether financing results in a net increase in cases filed, even if financing results in costlier litigation or higher settlement amounts, that tells us little about whether financing has a net positive or negative impact on social welfare.[180] Settlement figures or legal expenditures might have been too low, at least for the cases that are likely to receive litigation finance. But at least to the extent that litigation finance results in settlement values that more accurately reflect the damage caused by the defendant to the plaintiff, we would expect for litigation finance to enhance net welfare.

3. The Price of Legal Services

Litigation finance is also likely to affect the price of legal services, that is, the amount of up-front cash and the percentage of case

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178. *See supra* note 61 and accompanying text.

179. Jef De Mot & Michael G. Faure, *Third-Party Financing and Litigation Expenditures*, 12 N.Y.U. J.L. & BUS. 751, 771 (2016) (explaining that litigation finance may decrease the amount spent on meritorious litigation because "when the plaintiff spends more, the case becomes even less close and it becomes less valuable for the defendant to spend more," though also arguing that litigation finance may increase total expenditure on cases that are relatively weak); *see also* Shepherd & Stone, *supra* note 21, at 954 ("[T]hird-party litigation financing has a complicated relationship with overall litigation levels: it causes some cases to exist that otherwise would not, and encourages some cases to settle that might otherwise go to trial.").

180. Fitzpatrick, *supra* note 9, at 122 (acknowledging "the worry that claim investing will cause litigation to last longer, thereby consuming greater resources of the parties and the court system," but arguing that "even if it is true, again, it would seem to do so only because a world without claim investing led parties to settle cases too quickly for lack of resources or lack of risk tolerance").

proceeds a claimholder must pay to secure the legal services necessary to bring her case. We previously noted some scholars' suspicion that lawyers tend to charge supracompetitive contingency fee rates than they would be able to charge in a purely competitive market.[181] Litigation finance introduces further price competition in at least three ways. First, litigation financiers directly compete with lawyers for the right to "purchase" an entitlement to a portion of case proceeds in exchange for providing the capital to litigate a matter. Second, as noted, litigation financiers allow for more lawyers to enter the market for plaintiff-side litigation, introducing further price competition among lawyers. Third, litigation financiers are repeat players with an expertise in efficiently bringing litigation. Repeat players in any transaction often gain valuable experience that allows them to better and more easily navigate a similar subsequent transaction. We expect that these repeat players in the litigation context will have more experience and be better at navigating the litigation process, hence leading to a lower cost of litigating than a one-time plaintiff, allowing financiers to further drive down the cost of legal services.[182]

The efficiency effects here are clear: price competition is generally a good thing that enhances social welfare. Litigation finance is likely to allow claimholders to pay fewer transaction costs to bring their suit, enhancing efficiency. Note that as the price of legal services decreases, this too will have secondary effects in the market: it may, for example, further increase the likelihood that parties will enforce breaches, in turn further decreasing the rate at which inefficient breaches will occur, though potentially also leading to an increase in the consumption of legal services as price falls.

4. The Allocation of Risk

Once a legal claim accrues, litigation finance will certainly affect who bears the legal risk. As we argued earlier, one of litigation finance's two principal purposes is to help risk-constrained litigants share litigation risk.[183] Litigation finance helps bring a crucial function of the capital markets to litigation: it allows the risk of a capital-intensive project (here, the pursuit of litigation) to be borne by the parties most

181. *See supra* note 96 and accompanying text (discussing the contingency fee issue).

182. Hylton, *supra* note 21, at 732 ("[T]o the extent third-party enforcers are more efficient litigators than are original victims, social welfare can be enhanced through a reduction in the resources devoted to litigation.").

183. *See supra* Section I.B.

capable of bearing that risk.[184] Consider the small business that manufacturers widgets for a Fortune 100 company. The small business's shareholders and executives may have been happy to bear the *business risks* associated with a supply contract with a Fortune 100 company, but once the contract is breached, other entities may be better situated to bear the financial costs and risks of the litigation.[185] Part of the reason for this is that accurately pricing legal claims is hard, and so the financing of those claims may best be left to those with more expertise in that area.[186]

Moreover, scholars have recognized that firms face an allocation problem in the face of a contract dispute. They have to decide how much money to allocate towards a lawsuit in a context where their funds are limited. As such, the decision of where to allocate money is an important one. All things being equal, firms would want to allocate money to the next best available resource until the return on any marginal dollar invested is zero. In other words, they would want to reach allocation efficiency, where the marginal cost of a project should equal its marginal revenue.[187]

The lack of liquidity and the high cost of litigation makes this allocation decision difficult for firms facing budget constraints.[188] Litigation finance, however, helps firms effectively allocate resources to other areas of their business while not losing the opportunity to fund litigation.[189] This increases the allocative efficiency of the company. The

184. *Cf.* Yesha Yadav, *How Algorithmic Trading Undermines Efficiency in Capital Markets*, 68 VAND. L. REV. 1607, 1631–32 (2015) ("According to established economic theory, markets speak through prices. When traders transact rationally with one another, their interactions reveal what they know about a security and how much they wish to pay to buy or sell it based on their knowledge and risk preferences.").

185. Hylton, *supra* note 21, at 733 ("The original victim may be risk-averse and the financier could spread risk across a portfolio of investments. When the victim sells his claim to the financier, social welfare is enhanced by the reallocation of risk from a risk-averse party to a risk-neutral party.").

186. Molot, *supra* note 21, at 380–85; Maya Steinitz, *How Much Is That Lawsuit in the Window? Pricing Legal Claims*, 66 VAND. L. REV. 1889, 1903–06 (2013).

187. This is the classic definition of allocation efficiency: "An allocation of goods such that the marginal rate of transformation between any two goods is equal to consumers' common value of the marginal rate of substitution between the two goods." KATZ & ROSEN, *supra* note 110, at 387. Of course, in the firm case, the goods are "projects," including "litigation," and the consumers are "firms."

188. *See* Molot, *supra* note 21, at 370–71 ("The company may ask its lawyers at the outset how much the lawsuit will cost (in legal fees and payments to the plaintiff), but the lawyers will only be able to make predictions, and very likely there will be more than one trajectory that the lawsuit may follow.").

189. *See, e.g.*, *id.* at 105 ("Lawyers may be better suited . . . to identify pools of cases in need of risk transfers, to price those risk transfers, and to allocate litigation resources efficiently over the pool, but lawyers are not necessarily as well equipped to supply the requisite risk capital and bear

company is not specialized in litigation, and hence every dollar spent on litigation does not reap as much of a benefit as dollars spent on other projects where it has more specialized expertise. A litigation funder's expertise is litigation, and hence it is a better party to allocate resources to the litigant's dispute.[190] Therefore, litigation finance produces a more efficient allocation of resources to financing litigation.

In addition to allocation decisions, the decisions about when to sue, when to settle, when to go to trial, and so on are usually borne by claimants and their lawyers. These decisions are frequently wrought with behavioral biases and emotions.[191] Having a third party weigh in on the decision whether to sue infuses a type of economic efficiency into the litigation process.[192] This is because litigation financiers have large portfolios of lawsuits that they fund, and like those that invest in stock portfolios, financiers seek to maximize their return given the risk associated with litigation.[193] In effect, litigation finance brings a type of rigorous economic cost-benefit decisionmaking to the legal market.[194]

5. Effects on the Legal Profession

The effects of litigation finance on the legal profession may be the most challenging issue to address from a law and economics

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all of the litigation risk."); Molot, *supra* note 9, at 82–90 (arguing that litigation finance serves a risk allocation purpose that is necessary to counteract the skewing of settlements from their merits); Shepherd & Stone, *supra* note 21, at 945–48 (arguing that ultimately litigation finance allows companies and plaintiffs to allocate capital efficiently).

190. *See* De Mot & Faure, *supra* note 179, at 764–77 (detailing a formal model for how allocating money to litigation finance is more efficiently done by a financier than the party seeking to enforce its contractual right).

191. *See* Linda Babcock & Greg Pogarsky, *Damage Caps and Settlement: A Behavioral Approach*, 28 J. LEGAL STUD. 341, 367–70 (1999) (detailing a model that shows how biases affect settlement decisions in litigation); Donald Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1506–20 (1998) (providing a detailed survey of all the ways behavioral biases affect legal decisions); Brian Spangler, *Heads I Win, Tails You Lose: The Psychological Barriers to Economically Efficient Civil Settlement and a Case for Third-Party Mediation*, 2012 WIS. L. REV. 1435, 1441–46, 1463–65 (2012) (arguing that firms are not economically rational decisionmakers with respect to civil litigation settlements); Andrew Wistrich & Jeffrey Rachlinski, *How Lawyers' Intuitions Prolong Litigation*, 86 S. CAL. L. REV. 571, 620–22 (2012) (arguing that there are several lawyer-driven, nonfinance, reasons that litigation can be prolonged).

192. Litigation funders may not, however, control litigation strategy or settlement decisions. That authority is reserved to the counsel and claimant. *See* MODEL RULES OF PRO. CONDUCT r. 1.2 (AM. BAR ASS'N 2020) (lawyer must "abide by a client's decisions concerning the objectives of representation" and "[a] lawyer shall abide by a client's decision whether to settle a matter"); *id.* r. 2.1 ("In representing a client, a lawyer shall exercise independent professional judgment and render candid advice.").

193. *See generally* Molot, *supra* note 9, at 82–101. Molot argues that applying a more market-driven mindset to litigation decisions would provide more efficient outcomes.

194. *See* Heaton, *supra* note 42, at 329–30 (demonstrating that litigation finance moves outcomes closer to ones that are risk neutral).

perspective. The legal ethics rules are often thought of as "moral" or "ethical" rules not susceptible to a law and economics analysis. Some scholars, however, have invited a law and economics analysis of the ethics rules, particularly to the extent the legal ethics rules are cynically viewed as protectionist measures by lawyers to insulate themselves from competition.[195]

From a law and economics perspective, Jonathan Macey and Geoffrey Miller have argued that, as a general rule, "supply-reducing rules" are likely to be inefficient because "the welfare loss associated with the reduction in supply is greater than the welfare benefit that might be achieved by providing quality assurance."[196] Meanwhile, "cost-reducing rules" are likely to be efficient "because the bar's interest in reducing the cost of providing legal services aligns well with the public's interest in efficient contracting."[197] They argue that "[e]fficient ethics rules are those that reduce contracting costs between lawyers and their clients by supplying reasonable terms to which lawyer and client would agree, in most cases, if they were to bargain over the issue."[198]

Many of the most contentious debates about litigation finance concern its impact on the legal profession.[199] For example, there is controversy over whether Model Rule 5.4, which provides that a lawyer generally "shall not share legal fees with a nonlawyer,"[200] prohibits portfolio litigation finance agreements between funders and law firms (as opposed to deals between funders and *claimholders*, which do not implicate Rule 5.4).[201] The Chamber of Commerce's Institute for Legal Reform has separately argued that litigation finance might impair a

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195. *See* Jonathan R. Macey & Geoffrey P. Miller, *An Economic Analysis of Conflict of Interest Regulation*, 82 IOWA L. REV. 965, 965–66 (1997) (arguing that treating the lawyer-client relationship like an agency contract will allow the bar to set regulations to achieve more efficient outcomes).

196. *Id.* at 966.

197. *Id.* at 966–67.

198. *Id.* at 967.

199. For discussions of the ethical issues presented by litigation finance, see the sources cited *supra* note 11.

200. MODEL RULES OF PRO. CONDUCT r. 5.4(a) (AM. BAR ASS'N 2020).

201. A nonbinding 2018 opinion of the New York City Bar Association concluded that Rule 5.4 of the New York Rules of Professional Conduct (which exists in substantially similar form in all fifty states) prohibits lawyers from entering into funding agreements with funders where the lawyer's future payments are contingent on the lawyer's receipt of legal fees in one or more matters. *See* Ass'n of the Bar of the City of N.Y. Comm. on Prof'l Ethics, Formal Op. 2018-5 (2018) ("Litigation Funders' Contingent Interest in Legal Fees"). That opinion was controversial and prompted the New York City Bar to quickly convene a working group to address the issue. The working group's final report concluded that law firm funding benefits clients, and it recommended that Rule 5.4 be explicitly amended to permit funding directly between law firms and funders. NEW YORK CITY BAR ASS'N, REPORT TO THE PRESIDENT BY THE NEW YORK CITY BAR ASSOCIATION WORKING GROUP ON LITIGATION FUNDING 20–33 (Feb. 2020). For a discussion of the Rule 5.4 issue, see Sebok, *Selling Attorneys' Fees*, *supra* note 21, at 1217–20.

litigant's control over litigation and undermine the attorney's independence.[202]

Viewing these rules from a law and economics lens, litigation finance seems to undermine "supply-reducing" rules that constrain the supply, and thus increase the price, of legal services. This is most obviously the case with respect to Rule 5.4's ban on fee sharing, which limits the supply of third-party investment in the legal sphere, resulting in decreased competition that is likely to both increase the price and decrease the quality of service. The introduction of litigation finance—which will increase the supply of legal services and competition on price—would thus increase efficiency by reducing price, as we have already discussed.

From an efficiency perspective, it is particularly difficult to justify reading these ethical rules to prohibit litigation finance where these rules do not prohibit the various methods of third-party financing that our legal system already *does* permit.[203] For example, the prohibitions against fee sharing and against nonparty control of litigation do not stand in the way of contingency fee litigation, pro bono litigation, the assignment of claims, the practice of raising equity or debt financing to bring a legal claim, moving a legal claim into a special purpose vehicle, or selling a special class of shares backed only by a company's litigation, as discussed in Section I.C. The ethical rules thus do not stand as a wall against third-party financing, but they may prevent the most efficient ways of achieving that third-party financing. Realizing these efficiency gains may be particularly justified in contract actions involving sophisticated corporate litigants, who may have less need for the consumer protection features of the ethics rules than individuals.

III. OTHER CONTEXTS AND LENSES IN APPLYING THE UNIFIED FRAMEWORK

Our analysis suggests that, at least when we apply our unified framework through a law and economics efficiency lens to contract cases, litigation finance on balance appears to promote both pre- and post-dispute efficiency. In this Part, we briefly provide some thoughts on other types of disputes where litigation finance might play a factor and on how other normative lenses may be applied using our unified framework.

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202. Beisner & Rubin, *supra* note 12, at 1–2.

203. *See supra* Section I.C (discussing the novel aspects of litigation finance).

A. Other Contextual Settings of Litigation Finance

Throughout this Article, we have assumed a hypothetical contractual relationship and asked how litigation finance affects various aspects of the relationship from its inception to the resolution of a contractual breach. While many lawsuits supported by litigation funding involve contract claims, financing can be used for virtually any lawsuit. Our unified framework can be applied to these other domains as well.

For example, litigation finance has been used in civil class action lawsuits.[204] Financiers have backed consumers and plaintiff-side law firms in funding what are often extremely expensive lawsuits. These lawsuits sometimes create large settlements or verdicts, the proceeds of which may be used in part to reward financiers for their risk-taking. Class action litigation funding may affect a significant range of pre- and post-claim incentives, including the behaviors of both consumers and companies. For example, if firms know that it is easier to bring class action lawsuits, they may seek to take more precaution in their business activities. Whether this extra level of precaution is justified or beneficial to the marketplace is something that future work should elaborate on.[205] In addition, firms' extra precaution may be accompanied by riskier behaviors by consumers knowing that they can more easily sue a company for damages. Our unified framework can be applied to civil class action lawsuits in the same way we have applied it to contract relationships.

In addition, there has been an increase in the instances of class action false advertising litigation due in part to advances in empirical methodologies of estimating damages.[206] Given that these lawsuits are often expensive and consumers do not have the financial wherewithal

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204. *See generally* Fitzpatrick, *supra* note 9 (discussing the social costs and benefits of third-party litigation financing of class action suits); Molot, *supra* note 9 (discussing the intricacies of third-party financing, including examples of class action suits); Steinitz, *supra* note 21 (discussing, as an example, corporate litigants as consumers of third-party financing to defend against class action suits).

205. Much legal scholarship has been devoted to analyzing the requisite amount of precaution that firms should take when engaging in behavior that affects consumers. *See, e.g.*, STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 175–76 (1987) (discussing the incentives of limited liability on firm precaution); STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 263–64 (2004) (discussing the basic theory of bearing risk under accident law); Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1, 4 (1980) (describing the differences in precaution taken under negligence rules).

206. *See generally* Suneal Bedi & David Reibstein, *Damaged Damages: Errors in Patent and False Advertising Litigation* (Kelley Sch. of Bus. Rsch. Paper, Paper No. 19-40, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3440817 [https://perma.cc/N62X-5DTS] (discussing how choice-based conjoint methods are currently misapplied in estimating damages and the consequences of such misapplication).

to bring these lawsuits, litigation finance may increase this species of litigation. This in turn may have incentive-based consequences to brands when they decide what kinds of advertising campaigns to launch.

Litigation finance is also increasingly common in patent infringement lawsuits. Patent rights are readily alienable, and a market has long existed where patent owners can sell their patents to more efficient enforcers of the patent rights. There is a lively debate about whether nonpracticing entities or "patent trolls" are a net positive for the patent system.[207] Whatever the merits of that debate, the Patent Act expressly authorizes the transfer of patents, which are given "the attributes of personal property."[208] If this is so, then at least from an efficiency perspective, we might be agnostic as to whether the patent is financed through an outright *sale* of the patent to a third-party willing to bear litigation costs or through a litigation finance agreement that does not actually transfer ownership. Even if the latter route is banned, the former is still permissible, and so we might prefer to allow the patentholder to pursue whichever of the two paths is most efficient.

One further example: civil lawsuits against government entities (states, national, cities, etc.) may also be advanced with the help of litigation finance.[209] The ability of citizens to more easily and cheaply sue governments raises several interesting questions around accountability and precautionary measures. Even though it is currently rare for litigation finance to be used against a public entity, our unified framework can still be applied to such a relationship because we predict that there would be behavioral effects before, during, and after a potential dispute, even when the dispute is against a governing entity.

B. Other Normative Lens to Apply the Unified Framework

In this Article, we have asked whether litigation finance promotes efficiency. But there are other values the legal system can promote. A fruitful avenue for further research would be to apply our

207. For discussions of the "patent troll" debate, see, for example, John R. Allison, Mark A. Lemley & Joshua Walker, *Extreme Value or Trolls on Top? The Characteristics of the Most-Litigated Patents*, 158 U. PA. L. REV. 1 (2009) (analyzing the features of common patent litigation to describe the role of patent owners); Tun-Jen Chiang, *Trolls and Orphans*, 96 B.U. L. REV. 691 (2016) (discussing the implications of holdup within patent law); Oskar Liivak & Eduardo M. Peñalver, *The Right Not to Use in Property and Patent Law*, 98 CORNELL L. REV. 1437, 1450 (2013) (describing the ease of patent assertion).

208. 35 U.S.C. § 261.

209. Qui tam suits are one area where third-party funding appears to be particularly prevalent. *See* Ruckh v. Salus Rehabilitation, LLC, 963 F.3d 1089, 1101–03 (11th Cir. 2020) (holding that the False Claims Act does not bar third-party funding and that accepting third-party funding did not deprive a relator of standing to sue).

unified framework to evaluate litigation finance through these various other normative lenses.

For example, when it comes to welfare distributions, efficiency seeks to foster Pareto efficient distributions. A Rawlsian framework, however, would advocate for a very different set of distributional principles. John Rawls prescribed a distribution principle where any inequalities must be set up so as to benefit the least well-off in society.[210] This is Rawls's so called "difference principle," which he arrives at from his original position.[211] According to Rawls, we should tolerate inequities as long as they help the poorest in society. On his theory, the difference principle justifies things such as redistribution of income by government entities, taxation, charitable giving, and so on.[212]

Viewing litigation finance through a Rawlsian lens might prescribe different policy outcomes than those suggested by our efficiency lens. For example, some have argued that litigation finance encourages frivolous lawsuits and hence creates inefficiencies. Assuming these arguments have merit, the inefficiencies and frivolous lawsuits, under a Rawlsian lens, may be tolerable so long as litigation finance otherwise helps those who are least well-off advance their legal claims.

In contrast to Rawls, we could also apply a libertarian lens similar to that espoused by Robert Nozick. Nozick's distributional requirements are quite minimal. Under his account, as long as parties have acquired their wealth through legal means, there should be no form of redistribution.[213] Nozick might view any government

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210. JOHN RAWLS, A THEORY OF JUSTICE 75 (1971) (introducing the difference principle).

211. The original position consists of citizens coming together to make decisions on how institutions should run a society. In this original position, all citizens operate under a veil of ignorance where they do not know their endowments (race, gender, income level, education level, etc.). Rawls posits then that acting under rational decisionmaking, this uncertainty would cause everyone to agree on at least a few rules, including the difference principle—that any inequities that arise should be structured to benefit the least well off. *Id.* at 137–41; *see also* Samuel Freeman, *Original Position*, STAN. ENCYC. PHIL., https://plato.stanford.edu/archives/sum2019/entries/original-position (last updated Apr. 3, 2019) [https://perma.cc/N29Z-4KNC] (discussing Rawls's original position theory).

212. Legal scholarship has adopted a Rawlsian lens in many contexts. *See e.g.*, David Douglas, *Towards a Just and Fair Internet: Applying Rawls' Principles of Justice to Internet Regulation*, 17 ETHICS & INFO. TECH. 57, 58–60 (2015); Robert Hayden, *Social Theory and Legal Practice: Intuition, Discourse, and Legal Scholarship*, 83 NW. U. L. REV. 461, 463 (1989) (discussing the Rawlsian theory's potential susceptibility from within); Steven Shiffrin, *Liberalism, Radicalism, and Legal Scholarship*, 30 UCLA L. REV. 1103, 1126 (1983) (considering Rawlsian theory in the context of ethical liberalism). *But see* Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821 (2000) (arguing against a type of redistribution for the poor).

213. ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 183–235 (1974) (arguing against the Rawlsian theory on redistribution); *see also* Eric Mack, *Robert Nozick's Political Philosophy*, STAN.

restrictions on third-party financing of litigation as inefficient and unwarranted, and thus might oppose any and all regulations of litigation finance.

Still yet, general concepts of justice might evaluate litigation finance differently than the economic efficiency we used above. While we argued above that lawsuits would be more efficiently run with financiers, a staunch supporter of individual civil justice may argue that this takes away power from those individuals who are personally aggrieved by the defendant's wrongful conduct. For this lens, justice is more than just an efficient state of affairs. Rather, the value is allowing a party to actively participate in seeking justice for herself. This normative lens would favorably view litigation finance's ability to help poorer claimholders to vindicate their rights, though it might disapprove of the fact that the claimholder might receive a smaller portion of case proceeds as a result of the third party's assistance.

The point we make here is simply that more work still needs to be done before we can fully understand how litigation finance descriptively and normatively affects our legal system. We have concluded that, in applying a law and economics lens to a contractual relationship, litigation finance promotes efficiency in the legal system and the marketplace at large. Future scholars should use our unified framework and apply it to other legal claims and normative lenses.

CONCLUSION

In this Article, we have provided the first unified framework for evaluating the welfare implications of litigation finance. Importantly, this framework combines existing scholarship that focuses on the post-claim effects of litigation finance with the largely unnoticed and undeveloped pre-claim effects of litigation finance.

In highlighting these pre-claim effects and providing a unified framework, we draw attention to what is new about litigation finance, and we attempt to raise awareness of funding among regulators, lawyers, and financiers. Ultimately, we argue that our unified framework leads us to conclude that litigation finance does promote welfare and increase efficiency in the marketplace. We hope our analysis encourages future scholarship to (1) empirically measure the pre-claim and post-claim effects we highlight and measure their welfare impact, and (2) apply our unified framework in different legal contexts and with different normative lenses.

ENCYC. PHIL., https://plato.stanford.edu/archives/sum2018/entries/nozick-political (last updated June 15, 2018) [https://perma.cc/7W7G-YL5T].

To better evaluate funding, regulators and scholars need a complete picture of the welfare implications of this growing form of financing. Only when there is a robust scholarship fully evaluating all the behavioral implications of litigation finance can we uncover the complete picture and hence be confident that we have the right policy treatment for litigation finance.