EXECUTIVE SUMMARY

- Third party litigation financing is big business in the United States and possibly the most important civil justice development in recent times.

- Third party litigation financing involves the financing of a lawsuit in exchange for a percentage of a damages award or settlement.

- State law used to forbid the buying and selling of lawsuits.

- With the relaxation of state laws prohibiting third party financing, the industry has exploded, but is still largely unregulated.

- The insertion of a third party funder into a lawsuit can lead to all sorts of mischief from creating perverse incentives and conflicts of interest to increasing frivolous litigation and court backlog.

- Third party financing operates in the shadows, as the Federal Rules of Civil Procedure do not currently require disclosure of a financing agreement.
What You Should Know

- Third party litigation financing (TPLF) involves the buying and selling of lawsuits. Third party financiers provide cash to plaintiffs or their attorneys in exchange for a share of any lawsuit recovery. Critics and proponents alike agree it is the most significant civil justice development of the era.¹

- Until recently, most states forbade parties from selling an interest in litigation. In the last few decades, however, states have loosened rules concerning the sale of a lawsuit. As a result, since the early 2010s, the TPLF industry has experienced “exponential growth.”²

- Today, the litigation financing industry is big business. It is composed of over forty different financial firms and estimated to be worth between 50 and 100 billion.³ The industry boasts lucrative returns. LexShares, for instance, was formed in 2014, and has a median net annualized return (after fees and expenses) of 47%.⁴

- State and federal regulations have not caught up to the litigation finance industry’s exponential growth. The insertion of a third-party funder into a lawsuit causes all sorts of mischief, from creating perverse incentives and conflicts of interest to increasing frivolous litigation and court backlog. Making matters worse, third party financing is often hidden from the court, from opposing counsel, and from other litigants.

Why You Should Care

- TPLF operates in the shadows. TPLF often operates in the shadows, preventing a court from being able to protect the parties from conflicts of interest and preventing the opposing party from knowing who is really calling the shots.

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TPLF results in more litigation. Academic studies have shown that TPLF increases the volume of litigation and backlog in court cases.

TPLF creates ethical issues. Funders owe a duty to their shareholders, rather than to the client in the case. TPLF often results in the waiver of attorney-client privilege, and funders often seek to control the litigation by selecting the attorney and having a say in settlement negotiations, to the potential detriment of the party to the lawsuit.

TPLF and class actions. TPLF is unnecessary in the class action context, and in fact, increases the risk imbalance whereby claimants have a small amount at stake but defendants face bet-the-company liability.

Background
Litigation financing has been behind many major lawsuits over the past decades. It was behind lawsuits over the 9/11 tragedy and it was behind the now infamous Ecuadorian environmental lawsuit against Chevron. Litigation funders provide money to individual litigants, to businesses, and to lawyers and law firms in exchange for part of any potential recovery. A typical contract is nonrecourse, meaning that, if the lawsuit is unsuccessful, the funder receives nothing. Historically, state laws prevented the buying and selling of lawsuits—for obvious reasons. State laws against champerty specifically prevented a third party from acquiring an interest in a lawsuit. These prohibitions date back to Medieval England when nobles would lend their name to a lawsuit (knowing that the judge would be likely to find in their favor) in exchange for a share of the proceeds. States continued to forbid the practice because they worried that allowing the buying and selling of lawsuits would lead to abuse of the judicial process and an increase in litigation.

In recent years, however, many states have eliminated the prohibition on champerty on the grounds that judicial independence and legal ethical requirements are sufficient to protect clients and the legal system. The erosion of state law prohibitions has resulted in an explosion of third-party litigation financing. Since 2013, there has been an estimated 414% increase in litigation finance by United States law firms. Julie Schindel, US Litigation Funding Arrangements: Towards Disclosure? 76 Intl. Law Products L. Rev. 6 (2020).
Capital, a leader in the TPLF industry, went from receiving 131 funding requests in 2009, its first year of operation, to 1,470 requests in 2018. In fact, an estimated 36% of large law firms used litigation finance in 2017. And according to Burford Capital’s 2018 litigation finance survey, seven in ten U.S. lawyers who had not yet used litigation finance expected to do so within two years.

Although litigation funding is a relatively new industry, it involves serious money. The industry is estimated to be worth between 50 and 100 billion and boasts eye-popping returns. In 2017, for example, Burford Capital reported a return on equity of 37%.

The industry has also evolved since the early days, when a funder might pay for a personal injury plaintiff’s living expenses, to today, where funders often finance massive case portfolios and class actions. Today, most funders contract directly with plaintiffs’ attorneys—they may invest in a particular case, in a class action, or in a portfolio of cases being litigated by a firm. It is increasingly common for funders to invest in a portfolio of cases, with an estimated 62% of commercial litigation finance in the United States involving portfolio funding.

A cautionary tale involving TPLF is told by an Australian case, Campbells Cash and Carry Pty Limited v Fostif. In that case, a third-party financier invested in Australia’s form of a class action in exchange for one third of any recovery. The third-party funder initiated and controlled the case. It recruited plaintiffs, chose the attorney (who thought the fund was its client), and was authorized to settle with defendants for seventy-five cents on the dollar. In short, the financier controlled the litigation.

The TPLF industry “is so new that the most relevant existing legal frameworks are woefully inapplicable.” The existence of funding is most always hidden from the court, opposing counsel, and other litigants. And TPLF can create conflicts of interest and perverse incentives leading to frivolous litigation and court backlog.

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8 Baker, supra note 3.
9 Id.
11 Campbells Cash and Carry Pty Limited v Fostif Pty Limited, [2006] HCA 41 (Austl.).
Myths About Third Party Litigation Funding

MYTH #1—Third Party Financing is Necessary to Increase “Access to Justice”

A. Proponents of TPLF argue that increased access to capital will make the court system more accessible to under-resourced plaintiffs. But, of course, an increase in litigation is not itself a public good. Both the quantity and quality of lawsuits matters (and as noted below, TPLF may increase unmeritorious lawsuits). In all events, numerous features of American law suggest that this is unnecessary:

- First, the United States has a vibrant, active, and colorful plaintiffs’ bar. That attorneys in the United States can charge enormous contingency fees, whereby they take up to forty percent of any recovery, gives them incentives to represent cash-strapped or risk-averse plaintiffs for free.

- Further, the class action device allows the aggregation of small claims which would otherwise not be worth pursuing. And while even successful class action plaintiffs receive paltry awards, their attorneys are often awarded fees in the millions, which again incentivizes lawyers to represent plaintiffs who might not otherwise pursue their claims.

- Finally, in contrast to loser-pay systems of justice (like the one in Great Britain) where the losing party must pay both sides attorneys’ fees, each party to an American lawsuit typically bears their own costs, which reduces the risk of litigation, particularly if a litigant can get a lawyer to take the case on a contingency basis.

MYTH #2—Third Party Financing Is No Different Than Insurance

A. Proponents of TPLF argue that third-party financing is like litigation insurance because it transfers the risks associated with civil litigation. But TPLF and liability insurance are not created equal.

- At the outset, the primary purpose of an insurance contract is not litigation; insurers defend, while third party litigation funders fund.

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Second, liability insurance ordinarily is purchased before litigation, and, as a result, the insurer’s involvement is automatic, not an investment decision.15

Third, once a lawsuit has been filed, the policyholder and insurer are co-defendants and the policyholder must cooperate with the insurer.16

More recently, however, third-party finance firms have begun to argue that TPLF agreements should remain shrouded in secrecy because TPLF is different from liability insurance.17 At the very least, the TPLF industry cannot have it both ways, if TPLF is like insurance, then it too should be disclosed.

"The TPLF industry cannot have it both ways, if TPLF is like insurance, then it too should be disclosed." 

Arguments Against Third Party Financing
1. Third Party Financing Interferes With A Client’s Control Of Her Lawsuit—Litigation funders attempt to protect their investments by writing into the funding contract such powers as the ability to choose counsel, direct litigation strategy, or control settlement negotiations.18 There is no question that litigation funders are “exercising influence.”19 And this influence “interferes substantially with a lawyer’s independent professional judgment,” and may run afoul of model rules of professional conduct.20 A funder’s profit motive can put it at odds with the clients it is bankrolling. This conflict of interest may be particularly stark when the plaintiff is a state or other governmental entity. The state has a responsibility to its citizens and may seek a remedy other than money, such as remediation or an injunction, where the funder’s interest is only in settling for money. Further, according to the American Bar Association, portfolio financing makes it “more difficult to avoid or manage perceived conflicts of interest where a disagreement arises between the funder and one of the funded clients in the portfolio.”21

15 Id.
16 Id.
18 Glickman, supra note 12 at 1061-63.
20 Glickman, supra note 12, at 1062.
21 American Bar Association, supra note 2, at 6.
Even under typical contingency fee arrangements, there is a potential for a conflict of interest between counsel and client. A lawyer operating on a contingency fee has a desire to maximize recovery—but a plaintiff may have other goals. TPLF “complicates the principal-agent problem by adding a new principal.”

But the conflict of interest that arises when a lawyer takes a case on contingency is mitigated by the ethics that govern the legal profession. Lawyers are bound by a duty to faithfully represent their client’s interests. Hedge funds and other third-party financiers are not so bound. Instead, they owe a duty to their investors to maximize returns. This profit motive can and does put them at odds with their clients. As the Chief Investment Officer of IMF Bentham has acknowledged, third party litigation funding “make[s] it harder and more expensive to settle cases.”

Relatedly, a funder can be motivated by something other than a profit motive, such as revenge. So-called “revenge” funding happens when the funder foots the bill for a litigant to sue a third party based on a desire to punish that person or business. As one commentator noted to the American Bar Association, “[r]evenge litigation funding utilizes third-party litigation funding to weaponize torts against a specific target; using the legal system to carry out a vendetta versus an interest in the return on investment.”

2. Third Party Financing Harms Clients By Waiving Attorney Client Privilege—TPLF often harms clients by waiving attorney client privilege. As the American Bar Association recognizes, “[t]ypically, funders will want access to case information to evaluate whether to make [a]n investment.”

This is because the third party investor owes a duty of due diligence to its own shareholders to evaluate the merits of a claim. That investigation will likely require confidential information about the strengths and weaknesses of the case. When such information is shared, it waives the attorney client and attorney work product

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24 Campbells Cash and Carry Pty Limited HCA 41.
26 American Bar Association, supra note 2, at 9.
27 Id. at 5.
privileges. The American Bar Association explains, “No attorney should disclose confidential client information to a litigation funder without client consent. In order for that consent to be informed, the attorney should advise the client of the risk that a disclosure to a funder might be deemed a waiver of the attorney-client privilege.”

3. Third Party Financing Promotes Frivolous Lawsuits—Third party litigation funding can lead to an increase in the number of meritless claims. As the Chamber of Commerce has argued, TPLF firms base funding decisions on the present value of the expected return. This means that, even where a lawsuit has little or no merit, it may be a worthwhile investment if there is a possibility (however small) of recovering a very large sum of money. Further, as portfolio investing increases, this allows parties to invest in a number of unlikely lawsuits in the chance that one of them might generate a large recovery.

Academic studies bear out the litigation-increasing nature of TPLF. An Australian study concluded that TPL increased the amount and length of litigation. As one would expect, this also contributes to a backlog of court cases. In fact, research shows that states with a larger proportionate share of litigation funding have a greater court backlog, fewer resolved cases, and an increase in court expenditures.

4. Third Party Financing Remains Shrouded in Secrecy—Third party litigation funders often hide in the background. Although as much as 100 billion dollars have been invested in lawsuits, funders are largely unregulated and most often operate in secret. As one federal district court put it in the class action context, “A “sunshine” rule [for TPLF] is essential to protect the interests of the public, the class, and the honor of the legal profession.” The Court of Appeals agreed, writing “in all future class actions counsel must inform the court of the existence of a fee sharing

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29 American Bar Association, supra note 2, at 5.
34 Id.
35 Id.
agreement at the time it is formulated."37 Disclosure of third-party financing would put financing on the same footing as insurance coverage which must be disclosed under Federal Rule of Civil Procedure 26.38 The Advisory Committee Notes to Rule 26 provide that: “[d]isclosure of insurance coverage . . . enable[s] counsel for both sides to make the same realistic appraisal of the case, so that settlement and litigation strategy are based on knowledge and not speculation.”39 This argument applies equally to TPLF.

5. Third Party Financing Is Unnecessary in the Class Action Context—Third Party Litigation Financing makes little sense in the class action context because such funding does not even the playing field. Class actions exist in the first place to aggregate claims that are too small to bring on their own. Thus, class action plaintiffs do not pay legal fees and are not usually risk averse. Class action defendants, on the other hand, often face bet-the-company liability. A single case can resolve thousands of claims making loss particularly risky to defendants.40 TPLF exacerbates the risk imbalance that already exists in this context. As a result, the Northern District of California now requires “disclosure [of] any person or entity that is funding the prosecution of any claim or counterclaim.”41

What We Can Do

Various proposals from Congress have aimed to mandate disclosure of third party financing in all federal civil lawsuits. Many proposals require that funding contracts be disclosed both to federal court judges and to opposing counsel to increase transparency and allow for oversight of TPLF. Similarly, California and Wisconsin have required that parties’ disclose funding arrangements in state court lawsuits. And the Federal Advisory Committee on the Rules of Civil Procedure has been asked to amend Federal Rule 26 to require disclosure of third party funding.

Conclusion

Third Party Litigation Funding may be the most important development in the American legal system in decades. And, yet, it remains largely unregulated, its harms largely unknown to the American people. This mechanism for infusing lawsuits with cash has the potential to pit funders against clients, to waive attorney client privilege, and to violate state law. As numerous courts and states are beginning to recognize, TPLF should be disclosed in order to protect the court, litigants, and judicial system.

37 Jack B. Weinstein, The Democratization of Mass Actions in the Internet Age, 45 Colum. J.L. & Soc. Probs. 451, 468 (2012); Agent Orange, 818 F.2d at 226 (2d Cir. 1987).