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THIRD-PARTY LITIGATION FUNDING— A SIGNALING MODEL

Ronen Avraham* and Abraham Wickelgren†

INTRODUCTION

Elwin Francis settled his personal injury case for \$150,000 and walked away with \$111 from the settlement. Yes, the lawyers got their one-third, but this is not a story about attorney malpractice.¹ Mr. Francis's limited recovery stems from his involvement with the new kid in town: third-party litigation funders. Several years before the case settled, Mr. Francis borrowed money from LawCash and Lawbuck\$, two litigation funding companies, via nonrecourse loans. The nature of the loans meant that he only had to repay them if his case was successful. The catch was the extremely high interest rate—much higher than rates charged by credit card companies. All told, Mr. Francis borrowed \$27,000; however with the high interest rates, the amount due had swelled to \$96,000 by the time the case had settled.² Out of the \$150,000 settlement, LawCash and Lawbuck\$ received a profit of \$69,000 in interest that amounted to 46% of the settlement. The repayment of the principle of the loans represented another 18%, the attorney fees and expenses took a little more than one-third, and the plaintiff was left with nothing except for the money that had been advanced to him by the funding companies.³ Although this situation sounds like an extreme example, the loan arrangement is

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1. Indeed, a trial judge threw out Mr. Francis's malpractice suit against his attorneys. Joan C. Rogers, *Law Firm Wins Dismissal of Suit by Client Whose Litigation Loans Ate Up Settlement*, 29 *LAW. MAN. ON PROF. CONDUCT (ABA/BNA)* 53, 53 (Jan. 30, 2013), available at <http://www.bna.com/law-firm-wins-n17179872101/>.

2. Affirmation in Support of Cross Motion to Amend Complaint and in Opposition to Defendants' Motion to Dismiss at 2, 6, *Francis v. Mirman, Markovits, & Landau, P.C.*, No. 29993/10 (N.Y. Sup. Ct. Mar. 16, 2012).

3. *Id.* at 2. Specifically there were \$49,263 in legal fees, \$96,408 (which was reduced to \$94,000) due to LawBuck\$, \$4,415 to LawCash, \$2,211 in expenses, and \$111 due to the plaintiff. *Id.*

not unique, and is part of a larger trend of third-party litigation funding that has been sweeping across America in recent years.⁴

Should third-party litigation funding be allowed? Proponents of third-party funding mention the increased access to justice for plaintiffs—which allows them to avoid settling prematurely due to their need for cash—as one of the important benefits of allowing these funding arrangements. Funding also equalizes the bargaining power between defendants who are frequently involved in lawsuits and plaintiffs who lack the means to pay litigation costs.⁵ Litigation funding is also desirable because it allows plaintiffs to hedge risks that they are otherwise ill-suited to bear. Scholars have argued that third-party financing can help alleviate agency problems in the attorney–client relationship by aligning the incentives of each party.⁶ Increased third-party funding may even lead to a reduction in the amount of litigation due to more accurate evaluations of the strength of claims.⁷ Still, others have advocated for abandoning the doctrines that prohibit assignment or maintenance of legal claims by third parties as lacking any basis in corrective justice or public policy.⁸

4. See STEVEN GARBER, RAND CORP., ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWN, AND UNKNOWN 9 (2010), available at http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf; see also Binyamin Appelbaum, *Lawsuit Loans Add New Risk for the Injured*, N.Y. TIMES, Jan. 16, 2011, at A1 (discussing several specific examples and the general trends in the lawsuit lending market). In 2006, one plaintiff saw his loan grow by a factor of almost thirty. Joseph Gill was falsely arrested by the police and left with a serious back injury. William J. Gorta, *Bitten By Lawsuit ‘Sharks,’* N.Y. POST, Dec. 12, 2011, at 19. While his lawsuit against the police department was pending he needed money and so he borrowed \$4,000 via two loans from Lawbuck\$, a Brooklyn-based litigation financing firm that advances money to plaintiffs and only requires repayment if the plaintiff wins his case or receives a settlement. *Id.* Fortunately for Mr. Gill, the city settled the case for \$500,000 after a jury found in his favor, but after his victory LawBuck\$ demanded repayment of the money it had loaned him. After compounding monthly for five years at interest rates as high as 70%, the debt had swelled to \$116,000. *Id.* Mr. Gill was subsequently caught up in a second lawsuit with LawBuck\$, unable to put the incident behind him.

5. See Robert J. Rhee, *Tort Arbitrage*, 60 FLA. L. REV. 125, 145–46 (2008) (discussing how capital-scarce situations can lower the value of a case from the plaintiff’s perspective).

6. See Max Schanzenbach & David Dana, *How Would Third Party Financing Change the Face of American Tort Litigation? The Role of Agency Costs in the Attorney-Client Relationship* (Sept. 25, 2009) (unpublished paper presented at the Third Party Financing of Litigation Roundtable, Searle Ctr., Northwestern Univ. Law Sch., Sept. 2009) (on file with the Pritzker Legal Research Center Northwestern University Law School).

7. *Id.*

8. See Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 67 (2011). On the defendants’ side, papers have even gone so far as to propose a risk-transfer system that would allow for defendants in lawsuits to share their litigation risk with an investment company by paying the investor the expected value of the lawsuit plus a premium. See Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367, 375 (2009).

Opponents of third-party litigation funding are concerned that because the funder's sole interest in the lawsuit is financial, the funder will be concerned only with maximizing its return on its investment and will not be concerned with the plaintiff's rights.⁹ Funders desiring to protect their investment could undercut a plaintiff's control over the suit. Also, because the funder does not have a fiduciary relationship or privilege with the plaintiff, its involvement in the suit will eventually cause an unwanted relaxation of rules governing attorney-client privilege and attorney professional responsibility. Opponents reason that litigation will be unnecessarily prolonged because third-party funders introduce a disincentive for plaintiffs to settle below the funders' suggested amount.¹⁰ Lastly, some scholars have proposed that allowing third-party litigation funding will lead to an increase in litigation that will be harmful to the civil litigation system.¹¹

This Article observes that consumer legal funding serves a welfare-enhancing function in society because it: (1) allows plaintiffs to discharge parts of the risk of litigation to parties that are better suited to bear it; (2) allows plaintiffs with liquidity constraints to receive the funds they need; and (3) breaks the monopsony power that defendants have vis-à-vis plaintiffs' ability to sell their claim (i.e., to settle). The monopsony breakup benefits plaintiffs who can now sell part of their claim to a third party, which consequently buys them more time to get a better settlement with the defendant. 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.

We argue that these benefits could be enhanced significantly if third-party funding contracts were allowed to be admissible as evidence in courts. This will provide courts with a credible signal from the private market regarding the merits of the case because if the plaintiff loses the case, the funder gets nothing. Thus, funders will have incentives to invest in cases with the highest yield, and courts—and defendants—will infer that these cases have more merit. Not only will admitting these contracts in courts improve the accuracy of adjudication, it will also cause funders to charge lower interest rates in an effort to demonstrate to courts the strength of the plaintiff's claim.

9. See JOHN BEISNER ET AL., U.S. CHAMBER INST. FOR LEGAL REFORM, *SELLING LAWSUITS, BUYING TROUBLE: THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES* 1–2 (2009).

10. *Id.* at 4.

11. Paul H. Rubin, *Third-Party Financing of Litigation*, 38 N. KY. L. REV. 673, 675 (2011).

In a companion paper we develop a signaling model that analyzes the effect of admitting the consumer financing agreement to the court and making it part of the record of the case.¹² Below we explain how this model works informally. While the current system obviously is not perfect and can lead to situations in which a plaintiff is charged extremely high interest rates, the results from our signaling model are promising and lead us to two important conclusions about the benefits of consumer legal funding. First, our model demonstrates that the overall quality of litigation will improve if the loan agreements between plaintiffs and lenders are introduced to the court. Second, as a result of the introduction of the agreement to the court, the interest rates charged by third-party lenders will decrease. The reason for this is that the court will infer that the lower the interest rate the funder charges, the stronger the funder thinks the case is. Thus, charging lower interest rates increases the probability that the plaintiff, and therefore the funder, recovers. We therefore conclude that third-party funding need not be prohibited but rather encouraged and fully disclosed to courts.

After discussing the signaling model, we address how these agreements could be disclosed to the court. We demonstrate that there is no bulletproof way to accomplish this, and we discuss the advantages and disadvantages of the various ways of doing so. Part II of this Article lays out the structure of the consumer legal funding system in the United States. Beginning with an overview of the market, it then turns to the factors that funders use in making their decisions to loan money to plaintiffs. Part II.B gives the lay of the land by examining state variations in the legal treatment of third-party funding arrangements. Part II.C provides a similar overview, but this time by reviewing the previous scholarship on the topic of third-party litigation funding, situating this Article within the literature. Part III then presents our signaling model, which proposes using the funding contract to reduce loan interest rates and improve the accuracy of the court's decision on the merits. This can be achieved by admitting the funding contract to the court. In Part IV we look more closely at the model and address some of the potential concerns about its implementations.

12. Ronen Avraham & Abraham L. Wickelgren, *Admissible Third Party Litigation Funding Contracts as a Way to Constrain the Exploitation of Plaintiffs* (Univ. of Tex. Sch. of Law, Law and Economics Research Paper No. 242, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1986951.

II. BACKGROUND

A. Market Structure of Consumer Legal Funding in the United States

This subpart focuses briefly on the U.S. market structure for consumer legal funding and the factors companies consider when making funding decisions. According to the RAND study on third-party funding, as of 2010 there were twenty-nine companies making loans to consumers.¹³ Many of these companies are members of a trade group called the American Legal Finance Association (ALFA).¹⁴ There are two ways that a lender can obtain a stake in pending litigation.¹⁵ The first category of third-party litigation funding is consumer legal funding. This involves loans or advances made to individual plaintiffs—usually in personal injury or employment discrimination claims—while their case is pending, such as the loans made to Mr. Francis by Lawbuck\$ and LawCash. These loans are debt based because they involve a set amount of money to be paid back with interest if the litigation is successful. While a claim is pending, plaintiffs often lack financial resources, as the injuries that triggered the lawsuit may have rendered them unable to work and earn money. As a result, they can find themselves under tremendous pressure to settle with the defendant to get money as soon as possible. Other options, such as borrowing money from more traditional lenders or getting money advanced from their attorneys, are generally unavailable.¹⁶ The money is advanced as a nonrecourse loan: the firms charge a high fixed interest

13. GARBER, *supra* note 4, at 10, 11 tbl.1.

14. *Id.*

15. There is a third type of funding that is present in the United States and discussed in the RAND paper. This is when financing firms make loans directly to plaintiffs' law firms. *See id.* at 13. These are generally recourse loans that are collateralized via the firm's assets, including revenue from future case fees. Because they are recourse loans, they must be paid back and are subject to usury laws, which will be discussed later in the introduction. According to the RAND paper there is not a lot of information available about these lending practices, but it is likely that law firms who obtain these loans are doing so because they need money to finance their cases but they cannot get loans from more traditional lenders. *Id.* The firms that receive these loans are probably contingency fee firms that must invest their own resources into cases and only recover if their client wins. This means that there might not be steady paychecks coming in from hourly billings. This category of loans is not relevant to this Article because the loans are recourse loans and must be repaid, which makes them very different from the nonrecourse loans in consumer and commercial claim funding.

16. Lauren J. Grous, Note, *Causes of Action for Sale: The New Trend of Legal Gambling*, 61 U. MIAMI L. REV. 203, 206 (2006). There are specific rules that prevent attorneys from advancing money to their clients. *Id.* at 205–06; *see also* MODEL RULES OF PROF'L CONDUCT R. 1.8(e) (2013) (stating that a "lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation").

rate on the loan, usually between 2%–5% monthly, to be paid only upon the plaintiff's recovery.¹⁷

Because these loans are usually small, the amount of diligence required to make sure each personal injury lawsuit is worth more than a fixed amount is too high to justify a structure where the funder takes on a large amount of risk.¹⁸ Therefore, the loans generally top out at \$20,000 or 10% of the expected recovery, which reduces the risk to the funder.¹⁹ However, since there is still a chance the company will receive nothing if the plaintiff loses, litigation financing companies evaluate each request for funding based on information they receive about the claim and thereby make a determination about the strength of the claim.²⁰ With extremely high interest rates, one might believe that the risk of nonrecovery from these litigation loans is high. But that is generally not the case.²¹ Instead, these high interest rates turn into profits for the lender.

The RAND study reported that the majority of the lawsuits that receive funding from one of these companies involve automobile accidents.²² Further, the average size of the loan made by these companies is \$1,750–\$4,500, with a maximum advance of \$20,000.²³ As a

17. It is structured as a loan with the interest rate not dependent on the recovery to avoid champerty and maintenance restrictions, and on a nonrecourse basis to avoid usury restriction laws. Both champerty and maintenance involve third-party interference in a lawsuit that assists the plaintiff in bringing his or her claim. See Sebok, *supra* note 8, at 72–73. Champerty is a subset of maintenance, with the chief difference being that maintenance does not include a financial reward to the intermeddler, while champerty includes a financial stake for the third party. *Id.* Maintenance is defined as “assistance in prosecuting or defending a lawsuit given to a litigant by someone who has no bona fide interest in the case [or] meddling in someone else’s litigation.” *Id.* at 72 (alteration in original) (quoting BLACK’S LAW DICTIONARY 1039 (9th ed. 2009)). Champerty, a more specific variant on maintenance, is “[a]n agreement between an officious intermeddler in a lawsuit and a litigant by which the intermeddler helps pursue the litigant’s claim as consideration for receiving part of any judgment proceeds.” *Id.* at 73 (alteration in original) (quoting BLACK’S LAW DICTIONARY 262).

18. See Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 95 (2010).

19. GARBER, *supra* note 4, at 12; see also Grous, *supra* note 16, at 207.

20. Grous, *supra* note 16, at 208–09. The information that must be transmitted to the lending company often comes from the plaintiff’s attorney, which can lead to potential issues relating to the waiver of attorney-client privilege regarding anything shared with the third party. See BEISNER ET. AL., *supra* note 9, at 8.

21. See Courtney R. Barksdale, Note, *All That Glitters Isn’t Gold: Analyzing the Costs and Benefits of Litigation Finance*, 26 REV. LITIG. 707, 726–27 (2007) (discussing how litigation financing companies only accept cases with a high chance of success). One company which received \$250 million in loan applications over a two-year period was so selective that it only accepted 10% of the applications. *Id.* at 727.

22. GARBER, *supra* note 4, at 10. One reason for this might be that drivers in all states are required to carry insurance, and thus there is a defendant available to pay if the claim is successful.

23. *Id.* at 12.

result, consumer legal funders have been successful in their business; the companies advertise on the Internet, television, and in publications read by plaintiffs' attorneys.²⁴

The second type of loan involves investing in a commercial claim where the funder pays the costs of the litigation in return for a share of the proceeds from the lawsuit.²⁵ This can be thought of as equity-based financing because the plaintiff is essentially selling a portion of his or her recovery to the funder. These arrangements can be beneficial to plaintiffs, such as small companies with limited resources, because third-party funding levels the playing field between the plaintiff and a powerful defendant.²⁶ The claims in this category must be of a high potential value so that the investment is worthwhile. These types of lawsuits are typically antitrust, intellectual property, and contract disputes.²⁷

In a typical funding arrangement with a commercial party, a specialized funding company or a hedge fund will pay the plaintiff's legal fees (sometimes several million dollars) on an interim basis and later collect an interest rate of 25% or greater.²⁸ The funder's share can be calculated from several factors, including: the amount of money advanced, whether there are floors or ceilings, the length of time until recovery, the potential value of the case, and whether the case settles or goes to trial.²⁹ Commercial claims are funded in this riskier way because commercial claims are often larger than personal injury claims and therefore are worth the diligence required to reduce the funder's risk. One example of such an investment company is Juridica Investments Ltd., which has spent \$121.3 million to fund twenty-three cases.³⁰

1. *Factors Considered in Funding Decisions*

Funders of consumer legal loans claim to take into account a variety of factors when deciding whether to loan money to a plaintiff. One such company, Oasis Legal Finance, lists seven factors on its website:

[1.] **Damages.** In personal injury cases, these are generally severe injuries that require time off work and other obligations. Soft tissue injuries (sprains, and other muscle injuries) will be considered on a case by case basis.

24. *Id.*

25. *See id.* at 13; *see also* Molot, *supra* note 18, at 96.

26. *See* Rhee, *supra* note 5, at 145–46.

27. *See* GARBER, *supra* note 4, at 13.

28. Molot, *supra* note 18, at 98.

29. BEISNER ET AL., *supra* note 9, at 2.

30. GARBER, *supra* note 4, at 13 n.22.

[2.] **Liability.** It must be clear that the defendant has strong liability for causing the damage. Liability is a key factor in our decision to offer a lawsuit funding.

[3.] **Ability to Pay.** The defendant must have the ability to pay damages through insurance or other means. If the defendant can't pay a settlement, we can't offer lawsuit funding.

[4.] **Contingent Attorney Fee.** Your attorney must be compensated from the proceeds of the case rather than a retainer or hourly fee. He or she must be willing to assume the risk of winning the case to be paid for services, just as Oasis is to be repaid for the lawsuit funding.

[5.] **Sufficient Margin for Investment.** When deciding whether to extend lawsuit funding in your case, we consider what other expenses will be paid from the proceeds of the settlement. These may include medical bills and liens. We may check public records to find liens on cases we are considering for legal funding. We need to assure ourselves there will be sufficient funds available for all parties.

[6.] **Background.** We check records to make sure any past legal proceedings of the applicant are discharged or explainable and will not affect the outcome of the current lawsuit before we authorize lawsuit funding.

[7.] **State of Residence.** Oasis is able to extend lawsuit funding in most states. Those state [sic] in which we do not extend legal funding at this time are; Arkansas, Colorado, Kansas, Maryland or North Carolina.³¹

The second factor (liability) is the most obvious one that needs to be evaluated. It is arguably the only factor that requires a judgment call on the part of the funder, because the other factors are either present or they are not. For example, factors four (requiring that the attorney be on a contingent fee) and seven (disallowing loans in some states) are mere boxes that need to be checked. Other factors, like five (liens and medical bills) and six (previous litigation by the plaintiff), may not be relevant to many of the cases. As to the type of injury (factor one), some, like soft tissue injuries, are evaluated on a case-by-case basis, but many, such as quadriplegia, are likely approved because they fall within a certain category. Finally, factor three (ability to pay) will likely be met if the defendant has insurance. The liability determination, however, is something that will never be uncontested, or else the lawsuit would probably have already settled.

31. *The Approval Factors for Funding Personal Injury Lawsuits*, OASIS LEGAL FIN., http://www.oasislegal.com/legal_finance_services/lawsuit_funding_approval_factors (last visited Aug. 24, 2013).

As a result, this factor should play a large part in the funder's determination of the interest rate and amount to be loaned.³²

Other academics have come to similar conclusions about the factors that funders consider. For example, Nicholas Beydler asserted that funders

vet the claim, looking at whether the plaintiff bears some responsibility for the injury that is the subject of the litigation, the physical evidence of damage and "bright blood" injuries, the sum of the plaintiff's medical and other bills associated with the injury, the result and jury verdict amounts in cases involving similar injuries, and even the skill of the attorney handling the case.³³

These factors follow the information on the Oasis Legal Finance website.

While information on consumer legal funding is not widely available, it has been argued in the commercial claim context that rates vary greatly depending on the strength of the claim, the amount to be invested, the duration of the investment, and any risk in collecting the money.³⁴ The funding agreements are often individually negotiated between the plaintiff and the lender and will vary greatly based upon the facts of a case.³⁵ As one would expect, funding for a weaker claim (and hence a riskier investment) will come with a higher interest rate or larger contingency percentage. Essentially, the funder is being asked to assume some of the plaintiff's risk, and the more risk the funder is subjected to—either via a higher loan amount or a higher chance of loss—the higher the interest rate must be to compensate. This is similar to what we expect to see for third-party funding in the consumer legal funding context.

B. Legal Background

The litigation funding industry is a new and growing business in the United States.³⁶ As litigation financing has grown, a secondary mar-

32. Although the evaluation process likely varies by funder, in one of our interviews we were told that the lender looks at who the lawyers are and reviews some of the documents concerning the merits of the case before making the funding decision. *Cf. id.*

33. Nicholas Beydler, Comment, *Risky Business: Examining Approaches to Regulating Consumer Litigation Funding*, 80 UMKC L. REV. 1159, 1164 (2012).

34. Aaron Katz & Steven Schoenfeld, *Third-party Litigation Financing: Commercial Claims as an Asset Class*, PRAC. L.J., Mar. 2012, at 36, 45, available at http://www.parabellumcap.com/docs/March2012_ThirdPartyLitigation.pdf.

35. *Id.*

36. See BEISNER ET AL., *supra* note 9, at 3. Factors contributing to its emergence are the growth of the industry in foreign countries, the rising costs of litigation, the lack of capital in the traditional lending market to fund litigation, and the relaxation of rules that traditionally limited litigation financing. *Id.*

ket in legal claims has also been created where funders go public and sell shares of legal-claims-backed securities to the public.³⁷ There are also at least two publically traded companies that invest in legal claims.³⁸

Some foreign common law systems have already shown acceptance of third-party litigation funding, although to varying degrees. Australia, for example, has a well-developed system of litigation financiers.³⁹ In 1990, the Australian High Court decided the landmark case *Campbells Cash and Carry Pty Ltd. v. Fostif Pty Ltd.*, in which third-party funding was permitted even when the funder had broad powers to control the litigation.⁴⁰ In contrast, in 2005 the English Court of Appeals held that third-party funding was acceptable only so long as the claimant remained in control of the litigation.⁴¹ While the third-party funding industry in Great Britain is not as advanced as in Australia, it is reportedly developing quickly.⁴² Courts in South Africa⁴³ and New Zealand⁴⁴ have also accepted the practice. The U.S legal system, however, is different from the systems in those countries in two important respects. First, in the United States most of the lawsuits subject to third-party funding are paid on a contingency fee basis and not on hourly rates. Second, in the United States the winner of the case bears its own legal costs, whereas in other countries they are borne by the losing party.

American courts have approached third-party litigation financing with mixed attitudes. Some courts enforce obstacles against this type of financing, typically using doctrines prohibiting champerty and usury. Champerty is a form of maintaining, supporting, or promoting another party's litigation when the money provided for litigation is later exchanged for a portion of the proceeds.⁴⁵ Usury, an unrelated

37. Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1282 (2011).

38. See GARBER, *supra* note 4, at 16 (reviewing publically available information about litigation financing companies that invest in commercial claims).

39. See, e.g., *Campbells Cash & Carry Pty Ltd. v Fostif Pty Ltd.* (2006) 229 CLR 386 (Austl.); Susan Lorde Martin, *Litigation Financing: Another Subprime Industry that Has a Place in the United States Market*, 53 VILL. L. REV. 83, 107 (2008).

40. *Fostif*, 229 CLR 386; see also Steinitz, *supra* note 37, at 1288–89.

41. *Arkin v. Borchard Lines Ltd.*, [2005] EWCA (Civ) 655, [40] (Eng); see also Steinitz, *supra* note 37, at 1281.

42. Martin, *supra* note 39, at 112–13.

43. See *Price Waterhouse Coopers Inc. v. Nat'l Potato Coop. Ltd.* 2004 (6) SA 66 (SCA).

44. See *Re Nautilus Devs. Ltd. (In Liquidation)* [2000] 2 NZLR 505 (HC).

45. See 7 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 15:1 (4th ed. 2010).

doctrine, is when a lender takes more compensation (usually in the form of interest) than is legal in exchange for a loan.⁴⁶

Not every jurisdiction has adopted champerty restrictions. For example, New Jersey has never adopted any limitations.⁴⁷ Connecticut has not adopted any either, though courts there test whether a litigation finance agreement is against public policy.⁴⁸ Kansas has only adopted restrictions in cases wherein parties frequently initiate litigation.⁴⁹ Indeed, more states have taken steps towards rejecting these types of restrictions. In 1997, the Massachusetts Supreme Judicial Court abolished them in *Saladini v. Righellis*, reasoning that while the purpose of champerty laws is to combat excessive litigation, other doctrines—such as public policy against unreasonable contingency fees or the prohibitions against frivolous lawsuits—can do a better job.⁵⁰ The court explained that it will look to factors such as the respective bargaining power and awareness of the parties, the borrower's ability to pursue the lawsuit without the funds, and whether the total amount paid to the funder (if she is successful) would be unreasonable.⁵¹

The Supreme Court of South Carolina similarly decided to abolish champerty restrictions and use other doctrines to battle the evils that champerty was designed to target.⁵² The court used similar factors and added, noticeably, whether the funder is an “officious intermeddler.”⁵³ Although both Massachusetts and South Carolina abandoned restrictions, courts in these states still look to see if the funder exercises too much control over the litigation. Texas takes this approach as well; Texas courts will examine whether funding agreements are predatory, the extent of control exercised by the funder, and the extent to which similar agreements would burden the judicial system.⁵⁴ Florida has reached a similar end by limiting champerty laws to funders that act as officious intermeddlers.⁵⁵ The Ohio legislature passed a law in 2008 allowing and regulating litigation financing agreements, requiring financing contracts to explicitly state that the funder

46. 44B AM. JUR. 2D *Interest and Usury* § 81 (2007).

47. See *Schomp v. Schenck*, 40 N.J.L. 195, 197–98 (1878).

48. See *Robertson v. Town of Stonington*, 750 A.2d 460, 463 (Conn. 2000) (citing *Rice v. Farrell*, 28 A.2d 7, 8 (Conn. 1942)).

49. See *Boettcher v. Criscione*, 299 P.2d 806, 811 (Kan. 1956).

50. *Saladini v. Righellis*, 687 N.E.2d 1224, 1225–27 (Mass. 1997). Other doctrines include utilizing public policy against unreasonable fees, sanctions for misconduct, the standards of fair dealing, and the doctrines of unconscionability, duress, and good faith. *Id.* at 1227.

51. *Id.*

52. See *Osprey, Inc. v. Cabana Ltd. P'ship*, 532 S.E.2d 269, 277 (S.C. 2000).

53. *Id.* at 278.

54. See *Anglo-Dutch Petroleum Int'l, Inc. v. Haskell*, 193 S.W.3d 87, 104 (Tex. App. 2006).

55. See *Kraft v. Mason*, 668 So. 2d 679, 682 (Fla. Dist. Ct. App. 1996).

can exercise no control over the litigation or settlement discussions.⁵⁶ Maine takes a similar approach.⁵⁷

Despite the trend towards abandoning champerty laws, some states have strongly stood by them. Notably in *Johnson v. Wright*, the Minnesota Court of Appeals asserted its support of champerty laws, though it discussed only one other modern case from outside its jurisdiction which voided a third-party litigation agreement as champertous.⁵⁸ In sum, as far as champerty is concerned, the trend is to abolish restrictions on, or at least avoid applying them to, third-party litigation financing arrangements where there is no good public policy argument against the agreement and the funder does not take advantage of the borrower (for instance, by controlling the litigation or having the ability to force an early settlement). That said, most jurisdictions have not yet addressed the issue, and many of those traditionally enforce doctrines against champerty.

The usury doctrine has also been used to a limited extent to challenge third-party financing arrangements. It prohibits charging excessive interest in exchange for a loan of money or property.⁵⁹ A common element of usury is an absolute obligation to repay.⁶⁰ 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. Accordingly, prohibitions against usury are generally avoided.⁶¹

Indeed, many courts classify financing agreements as something other than loans because of their contingent nature; this, therefore, removes them from the realm of usury.⁶² One New York trial court found a third-party funding agreement to be usurious because repayment was obligatory, but then adjusted the interest rate to make it

56. Act of May 28, 2008, § 1(B)(3), 2008 Ohio Laws 86 (codified at OHIO REV. CODE ANN. § 1349.55(B)(3) (LexisNexis 2008)).

57. See BEISNER ET AL., *supra* note 9, at 3–4.

58. *Johnson v. Wright*, 682 N.W.2d 671, 679–80 (Minn. Ct. App. 2004) (citing *Rancman v. Interim Settlement Funding Corp.*, 789 N.E.2d 217 (Ohio 2003)). In *Rancman*, the Supreme Court of Ohio voided an agreement as champertous and explicitly supported ongoing enforcement of the doctrine. *Rancman*, 789 N.E.2d at 221.

59. 44B AM. JUR. 2D *Interest and Usury* § 81 (2007).

60. See, e.g., *Jones v. Wells Fargo Bank*, 112 Cal. App. 4th 1527, 1537 (2003).

61. BEISNER ET AL., *supra* note 9, at 2.

62. See, e.g., *Dopp v. Yari*, 927 F. Supp. 814, 823 (D.N.J. 1996); *In re Transcapital Fin. Corp.*, 433 B.R. 900, 910 (Bankr. S.D. Fla. 2010); *Kraft v. Mason*, 668 So. 2d 679, 684 (Fla. Dist. Ct. App. 1996); *Aldrich v. Aldrich*, 260 Ill. App. 333, 358–61 (1931); *Lawsuit Fin., L.L.C. v. Curry*, 683 N.W.2d 233, 239 (Mich. Ct. App. 2004); *Vinch v. Lawsuit Fin., Inc.*, No. 2004-3963-CK, 2005 WL 5872300, at *2, *5 (Mich. Cir. Ct., Aug. 26, 2005); *Nyquist v. Nyquist*, 841 P.2d 515, 518 (Mont. 1992); *Anglo-Dutch Petroleum Int'l, Inc. v. Haskell*, 193 S.W.3d 87, 101 (Tex. App. 2006).

legal instead of voiding the agreement altogether.⁶³ North Carolina has broad usury laws that cover loans with unconditional obligations to repay the principal as well as advances. In *Odell v. Legal Bucks, LLC*, the North Carolina Court of Appeals found an agreement to be invalid because, although it was contingent, it was an advance.⁶⁴

Recently, some state legislatures have begun to address the issue. Legislatures in Maine,⁶⁵ Nebraska,⁶⁶ and Ohio⁶⁷ have passed laws to govern the third-party funding industry. The new laws often require licensing and annual reports, which can shed light on industry practices. In fact, the primary goal of these laws is more about increasing transparency than reducing consumer interest rates.⁶⁸ The statutes require notice and disclosure to consumers, and also require that the plaintiff's attorney be involved in the lending process.⁶⁹ But none of the statutes limit the interest rate that a lender may charge.⁷⁰ Proposed legislation in other states would go much further in restricting the fees charged by lenders, but so far none of these proposals have been enacted.⁷¹

C. Scholarly Treatment of Third-Party Funding

Scholars have also been split about the virtues of the litigation finance industry. Susan Lorde Martin favors a regulation regime that would allow litigation financing so long as licensing regimes be established to ensure accountability and transparency of financing agreements.⁷² Douglas R. Richmond favors litigation financing because it can provide assistance without posing serious ethical issues.⁷³ He contends that to minimize risk of violations of norms of professional responsibility, attorneys should insist that funding companies will not interfere with the litigation and that the funding company will take all reasonable steps to protect confidential information.⁷⁴ Maya Steinitz writes that while laws traditionally curbing third-party funding in the

63. *Echeverria v. Estate of Lindner*, 7 Misc. 3d 1019(A), 801 N.Y.S.2d 233 (Sup. Ct. 2005).

64. *Odell v. Legal Bucks, LLC*, 665 S.E.2d 767, 776–78 (N.C. Ct. App. 2008).

65. ME. REV. STAT. tit. 9-A, §§ 12-101 to -107 (2007).

66. NEB. REV. STAT. §§ 25-3301 to -3309 (2010).

67. OHIO REV. CODE ANN. § 1349.55 (LexisNexis 2008).

68. Beydler, *supra* note 33, at 1179.

69. *Id.* at 1179–80.

70. See ME. REV. STAT. tit. 9-A, §§ 12-106 to-107; NEB. REV. STAT. §§ 25-3307 to -3309; OHIO REV. CODE ANN. § 1349.55; see also Beydler, *supra* note 33, at 1180.

71. See Beydler, *supra* note 33, at 1181.

72. See Martin, *supra* note 39.

73. Douglas R. Richmond, *Other People's Money: The Ethics of Litigation Funding*, 56 MERCER L. REV. 649, 681 (2005).

74. *Id.* at 681–82.

United States were meant to maintain integrity in the practice of law, they actually achieved the opposite by excluding society's "have-nots" from full use of the court system.⁷⁵ She maintains that while the practice does raise concerns, an overall prohibition on the industry is unnecessary.⁷⁶

Jonathan Molot also advocates for third-party litigation funding to increase settlements on the merits.⁷⁷ He writes that weaker parties, who are less able to bear the cost of litigation and are more risk-averse, often settle lower than they otherwise would in order to avoid worst-case loss.⁷⁸ Creating a more robust market in litigation funding would help solve the problem of inaccurate settlements by making settlements more like market transactions.⁷⁹

Julia McLaughlin is more suspect of the industry. While she acknowledges its value in providing litigants with financial assistance, she believes there are more appropriate ways of achieving this goal.⁸⁰ For example, she recommends creating pools of public funds to support needy plaintiffs.⁸¹ She therefore believes financing agreements should still be prohibited, or at least regulated.⁸²

Jeremy Kidd proposes that an additional danger of third-party funding results from the evolving nature of the American common law system.⁸³ Kidd argues that litigation financiers are incentivized to invest in cases that will cause courts to create new areas of tort claims.⁸⁴

75. See Steinitz, *supra* note 37, at 1299–1300.

76. *Id.* at 1272. Steinitz advocates a five-pronged reform: (1) Eliminate the champerty prohibition; (2) reform the attorney-client-funder relationship and extend protection to the funder-client relationship; (3) apply consumer protections and contract design principles to funding agreements; (4) require court supervision over attorney-client-funder arrangements and; (5) tailor securities regulation to legal-claims-backed securities. *Id.* at 1325–34.

Steinitz also addresses some of the concerns illuminating the U.S. Chamber of Commerce's opposition to litigation financing. First, she notes that it is unlikely that more nonmeritorious cases will be filed because funders must make a rational economic decision to invest in a claim and would not do so if the claim was unlikely to succeed. *Id.* at 1327. Next, by creating a fiduciary relationship on the part of the funder to the client, the funder must consider what is best for the plaintiff and disclose any conflicts of interest. *See id.* at 1328–29. Overall, she notes that a prohibition on litigation funding is a serious imposition on the freedom to contract, and that careful regulation can insure that the industry does not run contrary to public policy. *Id.* at 1331–32.

77. Molot, *supra* note 18, at 101.

78. *Id.* at 84.

79. *Id.* at 73.

80. See Julia H. McLaughlin, *Litigation Funding: Charting a Legal and Ethical Course*, 31 Vt. L. REV. 615, 627 (2007).

81. *Id.* at 661.

82. *Id.* at 656–57.

83. See 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 (2012).

84. *Id.* at 630–31.

Once the precedent for new tort law is established, these financiers will then be available for future funding, meaning that more loans can be made. These pressures on the court system will be driven by monetary incentives—not the interests of justice.⁸⁵ According to this view, the monetary incentives of the parties will be distorted by the presence of the third-party funder.⁸⁶ This may be a valid concern about third-party funding generally, but it is not clear that this is an issue in the consumer legal funding market.

While scholarship about litigation financing is sparse, some suggestions have been made as to how courts and legislatures should address the industry. However, there is no significant work on the effect that admitting third-party funding contracts in courts would have on the litigation world.

III. THE SOLUTION

Courts and legislatures have been unable to protect consumers from the high interest rates charged by third-party financiers. Where state legislatures have acted—as in Maine, Nebraska, and Ohio—the laws have not included fee caps. The main alleged benefit of these laws is that they create transparency, but it is unlikely that they will reduce the interest rates and fees paid by plaintiffs. It is also not clear that legislatures will be able to find the correct balance between access to funding and high interest rates. Where state courts have acted, they have been “successful” in eliminating high rates by banning third-party financing arrangements using the common law principles of champerty and usury. But this is not necessarily the best solution for the plaintiff either. There is a reason that plaintiffs are seeking third-party financing: they need the money. That need does not go away when these loans are banned.

Thus, we propose the opposite: Not only should states not ban these loans, they should make the terms of the loans available to courts. This Article proposes that third-party financing contracts be admitted to the court as evidence of the strength of the plaintiff’s claim as embedded in the interest rate on the loan. We show that, in most cases, admitting the contract in courts will decrease the interest rate the funders require.

85. *Id.* at 631–32.

86. *Id.* at 632.

A. *The Benefits*

Admitting the financing contract into evidence would be beneficial in two ways. First, as shown in our signaling model, it will lower interest rates. This has a direct benefit to society: facilitating more transfers from highly liquid (or risk-neutral) funders to less liquid (or risk-averse) plaintiffs. It obviously has a benefit to the plaintiff, who will retain a larger share of any recovery. Second, the contract will improve the court's ability to evaluate a plaintiff's case and come to the correct decision regarding liability and damages. This is because the third-party financier has conducted its own evaluation of the claim, and the decision to fund the litigation credibly shows the plaintiff has a strong case. Of course, the signal the contract sends to the court varies based upon the interest rate charged by the lender. The court sees this interest rate when the plaintiff introduces the contract into evidence. A high interest rate is associated with a riskier investment, likely resulting from a weaker case. A low interest rate, for a safer investment, is evidence of a stronger claim.

B. *A Sketch of the Signaling Model*

We begin with the conventional premise that a plaintiff must prove its case by a preponderance of the evidence. This is the standard used in almost all civil trials and it requires that the court be at least 51% confident that the plaintiff is entitled to recover. Without using numbers, this is referred to as being "more likely than not." If it is a tie—meaning the court is only 50% confident—then the plaintiff has not met his or her burden, and the defendant will prevail. In our model, a plaintiff's case is either strong (legally entitled to recover) or weak (not legally entitled to recover). Before any investigation, we assume that all parties share a common belief that any given plaintiff's case has a given probability, which we call π , of being strong. That is, we simply assume that there is some level of general information that the judge begins with, and that he or she will then update this probability with new signals that are received during the litigation of a specific case. The judge will do this by using Bayes's rule—a mathematical equation that provides a way to update one's baseline probability with new signals.⁸⁷ The updated information is called the "posterior probability."⁸⁸

87. For a discussion of how Bayes's rule can be applied to the introduction of evidence into court, see generally Richard O. Lempert, *Modeling Relevance*, 75 MICH. L. REV. 1021 (1977).

88. A good example can be found at *Bayes Theorem (aka, Bayes Rule)*, STAT TREK, <http://stat.trek.com/probability/bayes-theorem.aspx> (last visited Dec. 5, 2013). In the example, we learn that on average a certain wedding venue has rain only 5 days of the year, or 1.4% of the time (5/

For simplicity, we represent all of the information that the court receives during the course of the litigation as a single signal of the strength of the plaintiff's case. This signal is based on the presentations at trial (the evidence, the testimonies, etc.) and is, in effect, a reduction of all these presentations into a number between zero and one. Higher values of this signal are more likely if the plaintiff's case is actually strong, while lower values are more likely if the plaintiff's case is actually weak. Thus, if the court only had access to its own signal, it would rule for the plaintiff if the value of its signal exceeded some cutoff level. The exact value of the cutoff will depend on π , the overall probability that any plaintiff has a strong case. The higher π is, the lower will be the signal required to ensure that the final probability that the plaintiff has a strong case exceeds 50% (this follows simply from Bayes's rule).

So far, we have simply reduced the court's conventional practice into a mathematical representation without adding anything new to what might already happen in a hypothetical court. With this mathematical representation of a court's decision-making process in mind, we advocate for the addition of a second signal into the equation by allowing the court to update its analysis by incorporating the funder's signal (i.e., the funder's assessment of the strength of the case).

To keep the exposition as simple as possible, we assume that the funder's investigation of the plaintiff's case provides it with a binary signal of the strength of the case. That is, the funder can get either a low or a high signal. The probability that the funder's signal is correct is $q > 1/2$. That is, if the plaintiff's case is, in fact, strong (weak), the funder will obtain a high (low) signal with probability q . The novel, and important, part of our model is that we show that the funding contract can reveal this signal to the court. Ultimately, the court can use this signal to make a more informed decision on the merits.

The way the funding contract (credibly) reveals the funder's signal is through the interest rate that the plaintiff received from the funder. For example, the funder will only offer a contract with a relatively low interest rate if the funder believes there is a high probability the plaintiff will prevail (because the funder received a high signal). In con-

365). However, a weatherman who is accurate 90% of the time has forecasted rain for the day of the wedding. From reading this example one might be very concerned that it would rain on the day of the wedding if one puts lots of weight on the weatherman. On the other hand, one might be too confident if one puts lots of weight on the baseline probability and little weight on the weatherman. Bayes's rule provides a way to combine the pieces of information taking into account the known accuracy of the weatherman. In the weatherman example, we would only predict an 11% chance that it will rain on that day. This perhaps counterintuitive result occurs because of the very low baseline probability of rain.

trast, if the funder believes the plaintiff has a somewhat lower probability of prevailing (because it received a low signal), then the funder will require the plaintiff to pay a higher interest rate to receive funding since the funder is less likely to be paid back. In sum, the interest rate will reveal the funder's true signal because the funder's profit-maximizing interest rate will vary based on the signal it receives.⁸⁹

The relationship between risk and interest rates is one that should be accessible to a judge and even a jury. Anyone who has taken out a loan to purchase a car or a home should know that one's interest rate for borrowing money varies based upon the riskiness of the loan. One can easily compare a home mortgage, in which the house is listed as collateral and makes the loan less risky, with a credit card, which involves no collateral, and see that the interest rate for the credit card must be higher to compensate for the increased risk that the loan will not be repaid. In other words, the task that our signaling model asks of the judge reflects a very intuitive concept.

Under the assumptions of our signaling model, if, based on the presentations made at trial, the plaintiff's case is weak, that is the court receives a very low signal from the plaintiff's case, then no signal—not even a high one—from the funder will cause the court to change its mind and find for the plaintiff (unless the baseline probability, π , that the plaintiff's case is strong is quite high). In contrast, if the court receives a high signal from the plaintiff's case, then a low signal from the funding contract could cause the court to *not* find for the plaintiff (again, if π is not too high). Of course, if the court's signal was very high, then a low signal from the funder would be much less likely to cause the court to rule against the plaintiff.⁹⁰

89. Of course, the funder would like to charge everyone as high an interest rate as possible, but the higher the rate the funder charges, the less likely the plaintiff will accept the funding contract. How far the funder is willing to lower its rate to make sure it makes the loan will depend on how risky the loan is. If the loan is less risky, the funder will be more willing to offer a lower interest rate in order to ensure it can make the loan.

90. The actual evaluation done by the court will be more complicated than this paragraph makes it seem, but courts are able to manage difficult data points in litigation. *See, e.g.*, Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economics Analysis*, 73 TEX. L. REV. 787, 830–31 (1995). In one example of a court displaying acuity in dealing with interest rates, several plaintiffs brought suit alleging discriminatory mortgage lending practices, which manifested in discriminatory lending terms and conditions toward African-American borrowers. *Edwards v. Flagstar Bank*, 109 F. Supp. 2d 691, 693 (E.D. Mich. 2000). Discussing the complexity of evidence presented at trial, the court reflected: "Plaintiffs introduced scores of documents into evidence, including plaintiffs' application files with Flagstar, other customer files of mortgage loans with Flagstar, correspondence and guidelines, underwriting standards, testing data and data provided to the government by Flagstar under the Home Mortgage Disclosure Act (HMDA), commonly known as HMDA data." *Id.* at 694 (citation omitted). More specifically,

The additional information provided by the funding contract will be most important when the plaintiff's case provides the court with a marginal signal (where what is marginal will depend on π). Even a small shift in favor of the plaintiff will cause the plaintiff to win if the court is close to having 50% confidence in favor of the plaintiff. In such a case, a high signal would give the plaintiff the extra boost that she needs to prevail in court. On the other hand, if the court's signal gives it just barely over 50% confidence that the plaintiff should prevail, then a low signal from the funder could cause the plaintiff to lose.

As a general matter, the main direct benefit from a funding contract, even before the question of admitting it into court arises, is that it shifts money from a less liquidity-constrained (or less risk-averse) party to a more liquidity-constrained (or more risk-averse) party. The transfer has welfare enhancing effects because the plaintiff seeking the loans values the money she will receive now more than the funder values the money it will receive later (if it receives it at all). The model accounts for this valuations differential by providing only the plaintiff with a positive discount rate, which discounts the future value of the money due to his or her present need for money to pay bills. However, even with a positive discount rate, there are still plaintiffs that will reject a loan from a litigation funder if the interest rate is too high.

But what are the benefits of allowing the contract to be *admitted* in court? The potential benefits are two-fold. First, and most obviously, the inclusion of a second signal should make the court's decision more accurate. As with any evaluation, we assume there is some margin of error, meaning that the court might incorrectly evaluate a case as being slightly more likely to be weak than strong even though it is actually a strong case. For example, one could easily imagine the court's own signal leading it to think the chances that the plaintiff is legally entitled to recover is only 45% even though the plaintiff is, objectively if all the facts were known, legally entitled to recover. In fact, this should happen 45% of the time. In such cases, the funder's signal should usually be high (because, remember, the funder is right more often than it is wrong), and this will assist the court in making the correct determination. Of course, the funder does not know what the court's signal will be at the time it makes the loan; thus, the interest

the court commented that the statistical analysis demonstrated divergent rates of rejections between white and African-American borrowers. *Id.* at 700. (“[The expert] expressed the opinion that there was a significant difference in rate of denial for white applicants and African-American applicants in favor of white applicants.”).

rate it charges will reflect only its own evaluation of the strength of the plaintiff's case.

Second, and more importantly in the bigger scheme of third-party funding, is that the plaintiff with a strong case will get a lower interest rate because the funder will want to send a strong signal to the court via its funding contract when it believes the plaintiff has a strong case. Why does the funder have to lower its interest rate relative to its profit-maximizing level if the funding contract were not admissible? The reason is that lower rates are now more profitable because they will increase the funder's chance of recovery. The problem is that it is now more profitable for everyone—funders who received a high signal as well as funders who received a low signal. As a result, a funder who received a high signal, and would have previously charged a higher rate, has an incentive to lower its interest rate to try to convince the court that it really did receive a high signal. In other words, the funder who received a high signal will lower its interest rate to distinguish itself from a funder who received a low signal and is just trying to fool the court into believing it received a high one. To avoid being fooled, then, the court will require an even lower rate to believe that the funder really did receive a high signal. The rate has to be low enough that a funder with a low signal would not want to offer the plaintiff this interest rate even if doing so would fool the court because overall it will not be profitable for it to do so. As a result, in order to fully distinguish its signal, the funder who received the high signal has to charge an even lower interest rate than it would have charged had the contract not been admissible in court.

Observe that the funder with the high signal is willing to reduce its rate to a lower level than a funder with a low signal because it is more likely to be paid back than a funder with a low signal. Even if a funder who receives a low signal convinces the court that it actually received a high signal, this does not change the true strength of the plaintiff's case. The funder with a true low signal knows (when it provides the loan) that the court is more likely to receive a lower signal than it would be if the funder's true signal were high; this will cause the plaintiff to lose more often even if the court was misled to believe the funder's signal was high. So, even after fooling the court, the funding contract is still riskier for the funder with the low signal than it is for a funder with a high signal. This means the funder with the low signal will not be willing to reduce its interest rate as low as it would if it actually received a high signal.

This need to lower interest rates to distinguish a truly high signal from a low signal that might otherwise pretend to be high suppresses

the monopoly power that the funder currently has in setting interest rates. The funder who receives a high signal about the strength of the plaintiff's case cannot charge the otherwise profit-maximizing interest rate, because the court would then interpret this as a low signal of the strength of the plaintiff's case. We show in our formal model that this reduction in the probability that the plaintiff would win will cost the funder more than the benefit it would obtain from charging a higher interest rate. Thus, introducing the funding contract into evidence effectively increases the probability that the plaintiff with a strong case will prevail while at the same time decreasing the interest rate that she must pay. Because the loans are nonrecourse, the funder can only profit if the plaintiff wins. When the funding contract is admissible, the probability is larger when the funder charges a lower interest rate. This incentivizes the funder to lower its interest rates for plaintiffs with strong cases.

In sum, the signaling model explicitly considers that the funder may try to trick the court by giving an artificially low interest rate such that it sends the signal that the case is strong when, in actuality, the funder's signal is of low strength. Because the court is aware of this fact, it will believe the funder really thinks the case is strong only if the interest rate is low enough that a funder who thinks the case is low strength would not find it profitable to lower the interest rate to this level even if doing so would convince the court the funder thought the case was strong.

External constraints facilitate the court in making the correct inference. First and most obvious, we must remember that the funder is trying to make money by investing its capital. If, for example, it can get a risk-free return of 3%, then it will never give an interest rate lower than that rate to any plaintiff, no matter how strong the case, because there is always some risk that the judge will incorrectly evaluate the case and therefore cause the funder to lose its investment. Second, as we explained above, riskier cases must be charged higher interest rates to account for their higher risk of total loss because the court uses its own signal, as well as the implied signal from the interest rate on the loan. If the funder tried to charge too low a rate to trick the court when the plaintiff's case was weak, the likelihood that the court's signal would be high enough to find for the plaintiff would be too low to make this profitable. In fact, it is precisely this condition that determines by how much a funder who receives a high signal must lower its interest rate for the court to believe the funder actually received a high signal. It has to lower it just enough that no funder

with a low signal would want to charge such a low rate, even though doing so would increase its probability of prevailing.

Lastly, our model recognizes that the court will be aware of the funder's incentives to mislead it and will weight its evaluation accordingly. The model finds the conditions for the existence of an equilibrium—where the court knows the true strength of the case in the eye of the funder based on the interest rate the funder charges because it will never be profitable for the funder to charge this interest rate if the case is, in fact, weaker.

IV. POTENTIAL CONCERNS WITH THE MODEL

Although the model has shown that admitting the contract into evidence is helpful in both lowering interest rates and improving courts' decision-making accuracy, we note that there are several concerns related to the model's workings and the plaintiff's ability to get the funding contract before the court.

A. The Court and the Financier Should Come to the Same Determination

One can argue that the funder and the court should arrive at the same decision concerning the merits of the plaintiff's case. If they come to different decisions, one might question whether the system is working because one has clearly made an incorrect determination of the merits of the plaintiff's case. Should the funder and the court come to the same determination, then one question logically follows: How does looking at both the funder's signal and the court's determination provide any benefit? If we assume that the two evaluations will always be the same, then it would seem that nothing is gained.

The most basic response to this concern is that the funder and the court will not necessarily come to the same conclusion. There are several reasons to believe not only that they will come to different decisions, but further, that the funder's decision will be the more accurate one. One reason is that the funder may have access to information not available to the court, such as hearsay evidence. This would give the funder a knowledge advantage. Of course, the funder will only consider this evidence to the extent it indicates the plaintiff is more likely to prevail in court, because this is ultimately what the funder cares about. This may be the case for two reasons. First, there are various exceptions to hearsay exclusions. Thus, the funder may believe there is some chance the hearsay evidence will be admissible, even if it ultimately is not. Second, hearsay evidence that tends to

prove the plaintiff has a strong case is likely to be positively correlated with the plaintiff's ability to produce other evidence that strengthens its case. Accordingly, a funder should give positive weight to such evidence even if the funder believes this evidence itself will likely be inadmissible.

In addition, the funder may have more incentives to make the right decision, especially in the commercial litigation funding context where it will invest millions of dollars. It is often said that a trial judge wants to make the right decision to avoid being overturned on appeal, but the prospect of losing a multimillion dollar investment (in the commercial context) is likely a stronger motivator. Lastly, more decision makers are better than one whenever each decision maker is imperfect.⁹¹ The funder's signal reflects a different view of the available evidence by a highly motivated observer. Consideration of this view can only increase the accuracy of court decisions. Furthermore, this benefit should exceed the benefit of having multi-judge panels because the funder's view is completely independent and not subject to groupthink biases.⁹²

B. Is the Funder Predicting the Case or Predicting the Court?

Another related concern with the model is that the funder will be predicting the court, and not predicting the case. In other words, the funder will give a low interest rate only to cases that are likely to be found strong by the court. This makes sense from a business perspective, because under our model the court must conclude that the plaintiff has a strong case for the funder to recover its investment. But this means that the funder's determination of the strength of the case might not be independent. If the funder is simply trying to predict what the court will do, then one may argue that the funder is reinforcing the court's decision in a circular fashion instead of guiding the court to a more accurate decision.

This concern reflects a potential misunderstanding of how the model works. If we assume that the court is not biased against either

91. There is both theoretical and empirical support for this in many contexts. See, e.g., Max Wolf et al., *Accurate Decisions in an Uncertain World: Collective Cognition Increases True Positives While Decreasing False Positives*, 280 *PROC. ROYAL SOC'Y B: BIOLOGICAL SCI.* 2777 (2013).

92. Of course if it is a jury, rather than a judge, making the decision for the court, then this last argument is less forceful because the total number of decision makers will increase less dramatically. If we count the funder as one entity, then adding the funder's evaluation to the judge's evaluation gives us double the number of evaluations of the case. With a jury, the number of people who will evaluate the case only increases from, say, twelve (the jury) to thirteen (the jury plus the funding entity). Still, the incentives of the funder to get it right might be stronger than those of all the jurors combined.

the plaintiff or the defendant, then the court will try to make the correct determination. This means that the best way for the funder to predict the court is to predict the right decision based on the evidence. When viewed this way, the reasoning is no longer circular, but rather reinforcing. Because everyone, even judges and juries, can make mistakes, the funder's decision may be beneficial to the court in assisting with correctly evaluating the case.

In addition, given that most cases settle, the funder's signal can be very helpful in facilitating accurate settlements. If the defendant knows that the funder's contract will be admissible evidence in court, then the defendant will also use the interest rate in the contract as an indication of how the court might decide the case. This will reduce the potential for disagreements about the likely outcome and provide the plaintiff a way to credibly reveal the strength of its case. Just as the interest rate can provide valuable and credible information to the court, it can also provide this information to defendants in the context of settlement negotiations. In fact, this information will be even more valuable in settlement negotiations than at trial because the defendant may not have as accurate of a signal as the court will have about the strength of the plaintiff's case. By reducing the asymmetry of information between the parties, making the contract admissible in court will both facilitate settlement in general and at a level that more accurately reflects the true strength of the plaintiff's case.

C. Can the Funding Contract Be Admitted in Court?

One final concern with the model, and the one most likely to delay its implementation, is that the model does not conform to the premises of the American legal system. Our system is not based on the court being a Bayesian fact finder that updates its prior evaluation based on evidence. More, our system definitely does not take into account third parties' beliefs about the strength of the case. Nor is there empirical evidence to suggest that our legal system is best described, or modeled, as such. One operational upshot from this mismatch between our model and the way our legal system operates is that it is hard to see how these funding contracts, which contain the interest rate, could be submitted to the court, even if one is willing to take the conceptual leap required to bridge between the current American legal system and our model. Because these contracts have not historically been admitted to the court, there is no precedent on how it could be done. In order for the funding contract to be reliably admitted into court, lawmakers will likely have to enact a specific law, and Congress is unlikely to do this any time soon.

Therefore, we engage below in a thought experiment and offer two possible ways that these contracts might be admitted to the court assuming no change in the law. These methods are meant to suggest how the funding contract could possibly fit within the current evidentiary system.

Before getting into the details, we would like to make two notes. First, there is some evidence from other common law legal systems that courts are willing to make some inference about the strength of the case from the existence of a reputable third-party litigation funder. In one case, the funder was the Israeli agency which regulates securities, the equivalent to the American SEC.⁹³ Second, and closer to home, it is worth mentioning that courts have long been influenced by factors that are not technically admissible in court. For example, it is often stated that judges consider an attorney's reputation when evaluating his or her legal argument.⁹⁴ Although this should not make a difference to the judge, the evidence shows that it does. Allowing third-party funding may allow a plaintiff to obtain better counsel because a financed plaintiff can offer a better deal to attract a good lawyer, unlike a plaintiff who gets no financing. Further, admitting the contract in court allows the plaintiff to send a strong signal to the court without having to offer a sweeter deal to his or her lawyer.

Given that evidence rules vary by state, our brief look at the admissibility of the third-party funding interest rates will focus on the Federal Rules of Evidence. As a general matter, Rules 401 and 402 require that evidence admissible in court be relevant. Relevance is defined in Rule 401 as evidence that has "any tendency to make a fact

93. According to the Israel class action law from 2006, a plaintiff in a securities class action can ask the Israeli equivalent to the SEC to fund her lawsuit. The agency may fund the suit if it is convinced that there is public interest in the suit and that there is a reasonable chance that the court will approve the suit as a class action. In *Success—The Consumer Movement for Advancing a Fair Econ. Soc'y v. Cohen* the court said:

on its face, there is some weight to the agency's decision to help fund the lawsuit.

When such a decision is given by the agency, which is an objective and informed body, it means the lawsuit is not meritless. The decision of the agency supports the thesis the plaintiff advances and on its face suggests it is a worthy suit. It is worth mentioning that until now the agency exercised its discretion very carefully. From 2002 to today it helped fund 18 class actions and 2 derivative actions. This data suggests meticulousness and carefulness on the side of the agency and show that it does not rush into funding suits which it believes have no merits.

File No. 2484-09-12 District Court (TA), *Success—The Consumer Movement for Advancing a Fair Econ. Soc'y v. Cohen* (Feb. 18, 2013), Nevo Legal Database (by subscription) (Isr.) (author translation).

94. See Stephen D. Easton, *My Last Lecture: Unsolicited Advice for Future and Current Lawyers*, 56 S.C. L. REV. 229, 248 (2004) ("A lawyer's single most important asset is his or her reputation. If judges and jurors trust you, they will believe your arguments and will be more likely to find in your favor." (footnote omitted)).

more or less probable than it would be without the evidence” and requires that “the fact is of consequence in determining the action.”⁹⁵ Rule 402 then provides that relevant evidence is admissible unless the Constitution, a federal statute, the Federal Rules of Evidence, or other rules prescribed by the Supreme Court provide otherwise.⁹⁶

1. *Expert Testimony or Written Exhibit*

Expert testimony and expert reports are governed by Article VII of the Federal Rules of Evidence, which covers opinions and expert testimony. Rule 702 allows testimony by witnesses that the court has deemed qualified as experts if, among other things, the testimony is based on sufficient facts or data and the expert’s specialized knowledge will help the trier of fact understand the case.⁹⁷ An expert’s testimony is even allowed to embrace the ultimate issue of the case⁹⁸ and can be based upon facts or data that the expert is personally aware of, regardless of whether that information would otherwise be admissible in court.⁹⁹ The information that forms the basis of the report—here the interest rate—is admissible, even if it were otherwise inadmissible, if its “probative value in helping the jury evaluate the [expert’s] opinion substantially outweighs [its] prejudicial effect.”¹⁰⁰ The court will make this determination, but because the funder has a financial incentive to make the interest rate reflect the strength of the case, one could argue that there will be minimal prejudicial effects; any such effects will be substantially outweighed by the benefit the interest rate provides to the jury or judge in correctly deciding the case.

95. FED. R. EVID. 401.

96. FED. R. EVID. 402. It should also be noted that while Federal Rule of Evidence 408 bars the admission of compromise offers and negotiations, *see* FED. R. EVID. 408, the reasoning behind the rule does not apply to funding contracts. Rule 408 is meant to encourage compromise and settlement between the plaintiff and the defendant, a rationale not applicable to a contract between the plaintiff and a third party. The agreement between the plaintiff and the funder is not a settlement of the claim, but rather a loan contingent on the outcome of the case.

97. FED. R. EVID. 702.

98. FED. R. EVID. 704. In most jurisdictions this is true of factual conclusions, but legal conclusions by experts may be barred by the judge. For example, in *United States v. Zipkin*, the Sixth Circuit ruled that a bankruptcy judge’s expert testimony on the requirements of the law was impermissible. *United States v. Zipkin*, 729 F.2d 384, 386–87 (6th Cir. 1984). During his testimony, the bankruptcy judge answered questions about the ability of a receiver to receive interim fees under the Bankruptcy Act. *Id.* at 386. In disqualifying the expert testimony, the court commented: “It is the function of the trial judge to determine the law of the case. It is impermissible to delegate that function to a jury through the submission of testimony on controlling legal principles.” *Id.* at 387.

99. FED. R. EVID. 703.

100. *Id.*

Expert testimony from a third-party lender on the interest rate would most likely be a conclusion on a mixed issue of law and fact, meaning it would be admissible in some, but not all, jurisdictions.¹⁰¹ While there are concerns about expert testimony on the ultimate issue of the case, “[i]n a majority of state courts, an expert may now state his opinion on an ultimate fact.”¹⁰² Rule 704 similarly provides that testimony in the form of “an opinion is not objectionable just because it embraces an ultimate issue” to be decided by the trier of fact.¹⁰³ Despite these broad statements, it is also true that testimony on the ultimate issue may still be rejected. For example, Rules 701 and 702 require that a witness’s testimony be helpful, and a statement that the plaintiff should prevail is simply not useful.¹⁰⁴ Assuming the testimony would be allowed, the lender would testify about his analysis of the factual arguments in the case, how the law applies to those facts, and the resulting evaluation of the strength of the plaintiff’s case, as expressed through the interest rate. Provided that the third-party lender has some expertise in analyzing the particular type of legal claim at issue in the case, the testimony is similar to expert testimony by accountants or doctors admitted in other cases.¹⁰⁵ The best way to

101. Expert testimony on mixed question of law and facts is treated differently across jurisdictions. Such testimony is expressly admissible in the Second Circuit, Fifth Circuit, Texas, and Maine. *See, e.g.,* *Fiataruolo v. United States*, 8 F.3d 930, 941 (2d Cir. 1993) (“Experts may testify on questions of fact as well as mixed questions of fact and law.”); *Askanase v. Fatjo*, 130 F.3d 657, 673 (5th Cir. 1997) (holding that an attorney could testify on a question of mixed law and fact, but not on purely legal matters); *Birchfield v. Texarkana Mem’l Hosp.*, 747 S.W.2d 361, 365 (Tex. 1987) (“Fairness and efficiency dictate that an expert may state an opinion on a mixed question of law and fact as long as the opinion is confined to the relevant issues and is based on proper legal concepts.”); *Castine Energy Constr., Inc. v. T.T. Dunphy, Inc.*, 861 A.2d 671, 677 (Me. 2004) (finding it “permissible for an expert to testify regarding factual issues that also concern legal standards”). However many other jurisdictions have expressly rejected expert testimony on mixed questions of law and fact, including Iowa, Georgia, Massachusetts, Minnesota, and New Hampshire. *See, e.g.,* *Grismore v. Consol. Prods. Co.*, 5 N.W.2d 646, 663 (Iowa 1942) (holding that expert testimony on mixed questions of law and fact is not admissible); *Lawhorne v. Soltis*, 384 S.E.2d 662, 664 (Ga. 1989) (holding that expert testimony is inadmissible if “the inference drawn is a mixture of law and fact”); *Mattoon v. City of Pittsfield*, 775 N.E.2d 770, 781 (Mass. App. Ct. 2002) (“Lay and expert witnesses are precluded from giving an opinion, for the most part, that involves a conclusion of law or in regard to a mixed question of fact and law.”); *State v. Saldana*, 324 N.W.2d 227, 230 (Minn. 1982) (“[O]pinions involving a legal analysis or mixed questions of law and fact are deemed to be of no use to the jury.”); *Johnston ex rel. Johnston v. Lynch*, 574 A.2d 934, 939–40 (N.H. 1990).

102. 1 KENNETH S. BROWN ET AL., MCCORMICK ON EVIDENCE § 12, at 61 (6th ed. 2006).

103. FED. R. EVID. 704(a).

104. 1 BROWN ET AL., *supra* note 102, § 12, at 61 n.12.

105. *Cf., e.g.,* *Fiataruolo*, 8 F.3d at 941 (upholding the trial court’s admission of expert testimony from a certified public accountant for a mixed question of law and fact in a tax refund case); *Isern v. Watson*, 942 S.W.2d 186, 193–94 (Tex. App. 1997) (upholding the trial court’s admission of expert testimony from doctors on a mixed question of law and fact in a medical malpractice case).

establish the required expertise would be to call to the witness stand a lender with a background in the subject matter of the case, but it may also be established by showing that the lender has experience analyzing similar legal claims.

Aside from simply using expert testimony, a party may also use an expert to introduce the funding contract as a written exhibit. The contract alone would likely not be useful to the jury without an explanation of the methodology and meaning behind the interest rate. For that reason, it would be best to introduce it along with expert testimony as to its meaning. To be admissible as a written exhibit, the funding contract must meet the basic foundations of admissibility: relevance, authenticity, and nonhearsay. As previously discussed, the funding contract is relevant to the jury's decision because it provides additional information that can help inform the jury's decision.¹⁰⁶ To satisfy authenticity, assuming that the expert on the stand was one of the parties to the funding contract, the expert could testify to the authenticity of the contract, which would probably satisfy that requirement under Rule 901. One could also imagine an economics expert testifying as to why the interest rate in the contract provides relevant and unbiased information about the strength of the plaintiff's case.

There are, of course, a number of issues with using expert testimony to admit the funding contract. In most jurisdictions, an expert witness's compensation cannot be contingent on the outcome of the case.¹⁰⁷ One could argue that because the witness works for the funding company, and the funding company will only recover its investment if the plaintiff is successful, then the witness is essentially being compensated upon a victory for the plaintiff, which would violate this rule. On the other hand, it could also be argued that the witness herself is not receiving any compensation for her testimony, and thus this rule is not violated. This side of the argument is stronger if the witness is a salaried employee (rather than, for example, the owner) of the funding company. If the bias were not such that it automatically barred the witness from testifying, the witness's potential financial bias is still something that could be used to impeach her on cross-examination.¹⁰⁸

106. *See supra* notes 95–96 and accompanying text.

107. *Crowe v. Bolduc*, 334 F.3d 124, 132 (1st Cir. 2003) (“The majority rule in this country is that an expert witness may not collect compensation which by agreement was contingent on the outcome of a controversy. That rule was adopted precisely to avoid even potential bias.”).

108. 1 KENNETH S. BROWN ET AL, *McCORMICK ON EVIDENCE* § 39 (7th ed. 2013); *see also* 4 MICHAEL H. GRAHAM, *HANDBOOK OF FEDERAL EVIDENCE* § 607:7 (7th ed. 2012) (collecting cases on bias stemming from a financial interest in a civil suit).

Next, we address the hearsay rule, which bars admission of any statement that was (1) not made while testifying at the current trial, and (2) offered to prove the truth of the matter asserted in the statement, unless an exclusion or exception applies.¹⁰⁹ Even though the funding contract would be considered a statement that was not made while testifying at the trial—sometimes referred to as an out of court statement—it could potentially still be admitted. One option is to argue that the funding contract falls within the business records exception in Rule 803(6). Under the business records exception, the “records of a regularly conducted activity” are admissible as a hearsay exception if they meet certain criteria.¹¹⁰ The idea behind the business records exception is that self-reliance provides a signal that the evidence is credible,¹¹¹ and this concept applies to the third-party funding contract and weighs in favor of its admissibility. It is also possible that economic expert testimony might be required to support the business record. But if so, this would create other issues because such testimony would arguably overtake the judge or jury’s role in evaluating the case and therefore exceed the permissible scope of witness testimony.¹¹²

Finally, one may be concerned about the attorney-client work-product doctrine and its applicability to the funding contract’s admissibility. It is possible that the funder’s evaluation of the plaintiff’s case may be covered under the work-product extension to the attorney-client privilege.¹¹³ If it is covered, this means that the funding contract

109. FED. R. EVID. 801(c).

110. FED. R. EVID. 803(6). To satisfy these criteria the plaintiff would need to satisfy the following requirements:

- (A) the record was made at or near the time by—or from information transmitted by—someone with knowledge;
- (B) the record was kept in the course of a regularly conducted activity of a business, organization, occupation, or calling, whether or not for profit;
- (C) making the record was a regular practice of that activity;
- (D) all these conditions are shown by the testimony of the custodian or another qualified witness, or by a certification that complies with Rule 902(11) or (12) or with a statute permitting certification; and
- (E) neither the source of information nor the method or circumstances of preparation indicate a lack of trustworthiness.

Id.

111. 1 BROWN ET AL., *supra* note 102, § 286.

112. For a discussion of economic expert witnesses, see generally Richard A. Posner, *The Law and Economics of the Economic Expert Witness*, J. ECON. PERSP. Spring 1999, at 91.

113. See 1 BROWN ET AL., *supra* note 102, § 96. On the one hand, Federal Rule of Civil Procedure 26(b)(3) states that the document sought to be protected under the work-product doctrine must have been “prepared in anticipation of litigation or for trial.” *Id.* (quoting FED. R. CIV. P. 26(b)(3)(A)). Although the funding contract was prepared in relation to litigation, it is not clear that it was prepared for trial in this sense and therefore may not be covered. On the

could be privileged and therefore not admissible in court without the plaintiff's consent. However, given that the introduction of the funding contract is shown to help the plaintiff, especially if the interest rate demonstrates a strong case, the plaintiff would probably agree to waive the attorney-client privilege so the funding contract can be introduced.¹¹⁴ This could be done by a clause within the funding contract, or by an evidentiary law that required mandatory waiver under certain circumstances.

2. *Amicus Curiae*

Amicus curiae is a Latin phrase that means "friend of the court," as distinguished from an advocate before the court.¹¹⁵ Given that an amicus's purpose is to help the court make its decision, it is within the sole discretion of the court to decide whether an amicus can participate in the litigation.¹¹⁶ While most appellate courts have specific rules that govern amicus briefs,¹¹⁷ there is no rule in the Federal Rules of Civil Procedure or most state rules of procedure on the topic. Trial courts have declared that there is no inherent right to file an amicus brief, and that the decision is left to the discretion of the judge.¹¹⁸ While the original idea of an amicus was solely as a friend of the court, it is now accepted that an amicus may play an adversarial role in the litigation.¹¹⁹ Judge Richard Posner has stated that leave to file an amicus brief should be granted "when the amicus has unique information or perspective that can help the court beyond the help that the lawyers for the parties are able to provide."¹²⁰

Based on the court's inherent power, it may be possible for a third-party funder to submit the funding contract with the interest rate to the court as part of an amicus brief. Following Judge Posner's logic, since the amicus brief will provide the court with information the court is otherwise unable to obtain, leave to file the brief should be granted. Therefore, the amicus brief may provide another way to

other hand, the judge is "directed to 'protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.'" *Id.* (emphasis added) (quoting FED. R. CIV. P. 26(b)(3)(B)). The third-party funder does seem to fit within this part of the rule, which has been referred to as "opinion" work product (as opposed to fact work product). *Id.* § 96, at 439 n.33 (citing Comment, *The Potential for Discovery of Opinion Work Product Under Rule 26(b)(3)*, 64 IOWA L. REV. 103 (1978)).

114. See *supra* Part III.

115. See *Clark v. Sandusky*, 205 F.2d 915, 917 (7th Cir. 1953).

116. *N. Sec. Co. v. United States*, 191 U.S. 555 (1903).

117. See, e.g., FED. R. APP. P. 29; N.Y. RULES OF COURT § 500.23 (McKinney 2010).

118. E.g., *Long v. Coast Resorts, Inc.*, 49 F. Supp. 2d 1177, 1178 (D. Nev. 1999).

119. *Ryan v. Commodity Futures Trading Comm'n*, 125 F.3d 1062, 1063 (7th Cir. 1997).

120. *Id.*

have the interest rate admitted into the record for the judge to evaluate.

However, courts have been wary of attempts to use amicus briefs as an end run around the standard, and generally more rigorous, methods for admitting evidence. For example, in *Kitzmiller v. Dover Area School District*, the judge struck from the record an amicus brief that had been filed on behalf of the defendant.¹²¹ The brief was submitted by Meyer, who was previously retained as an expert by the defendant, and the brief attached Meyer's expert report that was prepared while he was still retained.¹²² The judge held that submission of an expert report in this fashion, without the usual procedures of cross-examination, was inappropriate.¹²³ Specifically, the court would not condone a "back door" attempt to include expert testimony in the record.¹²⁴

Applying this logic to the admission of third-party funding contracts, it may be necessary to allow some form of cross-examination to determine exactly why a certain interest rate was awarded in a given case. This might mean that a typical amicus brief is not the best way to admit the funding contract, as the testimony of the funder might be needed. In that case, maybe expert testimony is a better avenue. On the other hand, the court has discretion to allow amicus briefs, and may be acting within its power if it decides to allow the submission of a brief that includes the interest rate in the funding contract.

V. CONCLUSION

We argued that third-party litigation funding contracts are desirable, and that allowing their admittance in courts has some further direct socially desirable effect such as neutralizing to some extent the funder's monopoly power over the borrower, and improving courts' decision making. There are a few issues, however, that we have left out of the model. First, as was mentioned above, a secondary market for litigation funding has been recently developed. Should the funder be allowed to securitize its claim and sell it in a second market? Such packaging of legal-claim-backed securities might change the funders' incentives. For instance, assuming the funder has control or a veto power on whether to settle or litigate, it might be more likely to litigate (as he reduces risk through diversification) and perhaps even more likely to purchase "junk" cases, mistakenly hoping that in a well-

121. *Kitzmiller v. Dover Area Sch. Dist.*, No. 4:04-cv-02688 (M.D. Penn. Oct. 24, 2005) (order granting motion to strike amicus briefs).

122. *Id.* at 1–2.

123. *Id.* at 3.

124. *Id.* at 4.

diversified portfolio everything will work well at the end.¹²⁵ Ultimately, selling the case in the secondary market might dilute the signaling property of the regime.

Second, the third-party litigation funding regime might distort plaintiffs' incentives to seek other nonmonetary remedies, such as an injunction. Funders will not be interested in funding such cases, and plaintiffs will lose the signaling benefit of a funder. As a result, they will seek more damage awards than before. That said, plaintiffs with an immediate need for money, those most likely to seek third-party litigation funding, are probably those that are least likely to seek injunctive remedies in the first place. Thus, making third-party funding contracts admissible in court should lower interest rates, reduce the incidence of frivolous suits, and improve the defendants' incentives to take care.

Finally, and most importantly, there is a question regarding the extent to which third-party funding increases social welfare. Obviously, even without admissibility, allowing third-party funding should increase the number of lawsuits because it gives plaintiffs a choice that may (or ought to) make such lawsuits more attractive. If the funding contract were admissible evidence, this would make lawsuits that can receive relatively low interest rate funding even more attractive. That said, if juries were allowed to draw adverse inferences from the non-introduction of a third-party funding contract, this would make weak lawsuits even less attractive than before. Thus, our model implies that the average quality of the cases filed will increase while the total number of lawsuits need not increase. This in turn will incentivize the defendant to take more care, which might eventually lead to fewer accidents and fewer claims filed, improving social welfare.

125. This is similar to what occurred in the recent housing crisis.