

TILTED SCALES OF JUSTICE? THE CONSEQUENCES OF THIRD-PARTY FINANCING OF AMERICAN LITIGATION

ABSTRACT

Third-party financing of commercial litigation is a relatively new phenomenon in the United States. Recently, there has been a substantial increase in the amount of money that third parties have invested in commercial lawsuits. Many new investment management groups have been formed in cities such as New York, London, and Sydney looking to finance the endless stream of American litigation. These groups are for-profit entities that fund all or a portion of a plaintiff's legal fees in exchange for a share of any recovery that might result from the underlying lawsuit. The third-party litigation funders, as they are often called, put their "skin in the game" by risking the loss of their investment if the underlying claim is unsuccessful. The calculated risk these third-party litigation funders take has systematically resulted in astronomical returns for the companies and their investors.

In the process of seeking these astronomical returns, third-party litigation funders are causing a disparate impact on the American legal system by tipping the scales of justice in favor of plaintiffs at the expense of defendants. Supporters of third-party litigation financing in the legal community argue that, by allowing plaintiffs to seek outside financial support, barriers to justice are reduced because the funding enables cash-strapped plaintiffs to have their day in court. However, in reality, third-party litigation funders have little incentive to fund plaintiffs facing substantial barriers to justice. Third-party litigation funders invest in cases where the risk is the lowest and the possible return is the highest. Using the law to their favor, third-party litigation funders invest in cases where the underlying law giving rise to the plaintiff's claim already gives substantial advantages to plaintiffs in the form of low evidentiary thresholds and large statutory damage awards. Third-party litigation financing only magnifies these advantages by allowing plaintiffs to offload risk, increasing the number of cases adjudicated in the courts and raising the threshold amount required for plaintiffs to settle a case because of third-party funders' return requirements. Overall, third-party litigation financing threatens the compensatory and deterrent functions of the legal system while increasing inefficiency in the process.

This Comment addresses third-party litigation financing's threat to the legal system by proposing three possible solutions. First, this Comment argues that caps should be imposed on the percentage of any damage award a third-party litigation funder could receive. The result of a cap on recovery for third-party litigation funders would be a decrease in the concentration of funding for only the lawsuits with the highest potential damages, which, in turn, would decrease the amount required for settlement. Plaintiffs would be less likely to go to court because their well-funded backers would have lower investment limits in order to keep their return targets on track, and many plaintiffs could not afford the cost of pursuing litigation themselves. Second, this Comment suggests that a national registration requirement be imposed for third-party litigation funders to increase accountability within the industry and inform potential consumers of third-party financing. Third, this Comment advocates for the expansion of already enacted state regulations of third-party litigation funders to protect consumers in the commercial litigation context. Overall, the caps, registration requirements, and expansion of enacted legislation balance efficiency, deterrence, and compensation while still allowing for financially constrained plaintiffs to seek the outside funding they may need to pursue a meritorious claim.

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INTRODUCTION

As Michael Cannata, principal of Patent Monetization Inc., has stated, “[a]s long as the US [litigation] market continues to be one of the world’s largest . . . and the biggest pay-outs are available, this is going to be attractive for [third-party] investment.”¹ The attractiveness of the U.S. litigation market is evident from the amount of money third-party funders are willing to invest in various lawsuits. On average, third-party funders invest between \$2 million and \$15 million in a single complex commercial litigation lawsuit.² This substantial investment is made in the hope of multimillion-dollar payoffs,³ which often occur, resulting in a rate of return of up to 200% on a single lawsuit asset.⁴

¹ Jack Ellis, *Patent Litigation as an Asset Class*, INTELL. ASSET MGMT., Nov.–Dec. 2012, at 43, 46, 49 (internal quotation mark omitted). Patent Monetization Inc. is a private third-party litigation-financing firm. *Id.* at 44.

² See Catherine Ho, *Investment Firms Playing Role in Legal Field*, WASH. POST, Dec. 12, 2011, at A14 (stating that Burford Group, a New York–based third-party funder, routinely invests between \$2 million and \$15 million in any one lawsuit); see also Kevin LaCroix, *Litigation Funding: A U.S. Growth Industry?*, D & O DIARY (Apr. 10, 2012), <http://www.dandodiary.com/2012/04/articles/securities-litigation/litigation-funding-a-us-growth-industry/> (stating that litigation finance company BlackRobe Capital Partners LLC invests between \$2 million and \$8 million in complex commercial litigation cases).

³ William Alden, *Looking to Make a Profit on Lawsuits, Firms Invest in Them*, N.Y. TIMES (Apr. 30, 2012, 6:07 PM), <http://dealbook.nytimes.com/2012/04/30/looking-to-make-a-profit-on-lawsuits-firms-invest-in-them/>.

⁴ See Paul M. Barrett, *Lawsuit Finance Moves Up the Food Chain*, BLOOMBERG BUSINESSWEEK, Jan. 16–22, 2012, at 42, 42 (discussing a case where Burford Capital “invested \$6 million in a breach-of-contract

Third-party litigation companies can keep as much as 40% of the proceeds that result from the underlying litigation asset,⁵ which often causes plaintiffs to receive very little recovery from their claims. One example of disproportionate plaintiff recovery involves DeepNines, a Texas-based security company, which obtained \$8 million in third-party financing to pursue patent infringement litigation against a competitor.⁶ In the end, the parties agreed on a settlement of \$25 million, \$10.1 million of which went to the third-party litigation funder.⁷ Almost the entire remaining damage award went to legal fees, resulting in DeepNines's net recovery of only \$800,000.⁸ The third-party litigation funder ended up with a return of over 126% while the plaintiff received barely 3% of the total recovery.⁹ Overall, third-party litigation funders are focused on where they can get the highest rate of return,¹⁰ with some of the largest third-party litigation funders seeing annual returns of up to 91% on their U.S. litigation investments.¹¹

The growth of third-party litigation finance has most negatively impacted defendants. The huge sums being invested in commercial litigation results in distorted incentives for plaintiffs.¹² As James E. Tyrrell, Jr., regional managing partner at Patton Boggs LLP, has pointed out, “[t]he abundance of funds now available to plaintiffs may have ‘tipped the funding scales’ toward plaintiffs, creating an imbalance of resources,”¹³ which raises some concern about access to justice for defendants. Plaintiffs may be less likely to settle disputes if they can off-load much of the risk that usually accompanies a trial onto third-party

lawsuit between two Arizona real estate developers,” and, once damages were paid out, Burford received “more than \$18 million . . . a 200 percent return”).

⁵ See Ho, *supra* note 2 (discussing practice of Burford Capital).

⁶ Lisa Rickard, *Why Are Hedge Funds Allowed to Invest in Litigation?*, ATLANTIC (July 3, 2012, 1:42 PM), <http://www.theatlantic.com/national/archive/2012/07/why-are-hedge-funds-allowed-to-invest-in-litigation/259345/>.

⁷ *Id.*

⁸ *Id.*

⁹ See *id.*

¹⁰ See Daniel Fisher, *Juridica Chief Used to Argue Lawsuits, Now He Invests in Them*, FORBES (Oct. 12, 2012, 10:07 AM), <http://www.forbes.com/sites/danielfisher/2012/10/12/juridica-chief-used-to-argue-lawsuits-now-he-invests-in-them> (quoting Juridica Investments Ltd. CEO Richard Fields saying, “We’re focused on how to get the biggest IRR [internal rate of return]” (internal quotation marks omitted)).

¹¹ See Alden, *supra* note 3; see also Fisher, *supra* note 10 (stating that Juridica Investments Ltd. claims an 85% rate of return on completed investments).

¹² See Joanna M. Shepherd, *Ideal Versus Reality in Third-Party Litigation Financing*, 8 J.L. ECON. & POL’Y 593, 609 (2012).

¹³ GEOFFREY MCGOVERN ET AL., THIRD-PARTY LITIGATION FUNDING AND CLAIM TRANSFER: TRENDS AND IMPLICATIONS FOR THE CIVIL JUSTICE SYSTEM 9–10 (2010), available at http://www.rand.org/content/dam/rand/pubs/conf_proceedings/2010/RAND_CF272.pdf.

litigation funders.¹⁴ Further, these plaintiffs may bring frivolous lawsuits, resulting in inefficiencies in the legal system and higher costs for both parties.¹⁵ For the plaintiffs, these higher costs are often borne by the third-party litigation funders, but defendants must shoulder the costs themselves. Consequently, litigation costs rise because plaintiffs can prolong litigation due to their extensive third-party backing.¹⁶ Even more significant is that third-party litigation funders do not seem to invest in the types of cases where plaintiffs are in need of access to justice.¹⁷ Instead, these funders invest in the cases that are the most likely to be successful and have the highest potential damage awards, which are primarily patent infringement and antitrust lawsuits.¹⁸

The growth of third-party litigation financing is a threat to the judicial system. This Comment proposes putting caps on the amount a third-party litigation funder can recover, similar to contingency caps for attorneys' fees, which are already in place in some states.¹⁹ By reducing the potential recovery, these caps would decrease the amount a third-party litigation funder is willing to invest in any given lawsuit because the possible return on investment is diminished.²⁰ Overall, this solution would likely decrease settlement amounts,

¹⁴ See Rickard, *supra* note 6 (“[Third-party litigation financing] supporters allege that the practice is risk-free for plaintiffs, since, if they lose, they typically don’t have to repay the investor.”).

¹⁵ See Ellis, *supra* note 1, at 46 (quoting Gary Rubin, who conducted research on behalf of the U.S. Chamber Institute for Legal Reform and found that, when making investment decisions, third-party litigation funders consider many aspects besides just the legal merit: “The legal merit of a lawsuit, however, is only one component of [the investment decision] calculus—the other being the potential amount of recovery. If that potential recovery is sufficiently large, the lawsuit will be attractive as an investment vehicle even if the likelihood of achieving that recovery is small. When the potential recovery is large enough, there will always be willing investors”). David Abrams and Daniel Chen conducted a study of the effect of third-party litigation finance in Australia and found that “litigation funders appear to have an impact on the functioning of courts. States that have a greater litigation funding presence experience a greater backlog in courts, fewer finalizations, and a lower clearance rate. This is also reflected in court expenditures, which increase with greater litigation funding.” David S. Abrams & Daniel L. Chen, *A Market for Justice: A First Look at Third Party Litigation Funding* 1, 31 (Jan. 2012) (unpublished manuscript), available at <https://www.law.upenn.edu/cf/faculty/dabrams/workingpapers/MarketforJustice.pdf>.

¹⁶ See JOHN BEISNER ET AL., *SELLING LAWSUITS, BUYING TROUBLE: THIRD-PARTY LITIGATION FINANCING IN THE UNITED STATES* 6 (2009), available at <http://www.instituteforlegalreform.com/sites/default/files/thirdparty litigation financing.pdf>.

¹⁷ See Shepherd, *supra* note 12, at 609 (“[M]any of the cases financed by the largest third-party investors are the opposite of the types of cases where financing could improve access to justice for vulnerable plaintiffs.”).

¹⁸ Vanessa O’Connell, *Funds Spring Up to Invest in High-Stakes Litigation*, WALL STREET J., Oct. 3, 2011, at B1 (“The funders tend to bet on patent or antitrust cases for the biggest profit . . .”).

¹⁹ See *infra* notes 196–98 and accompanying text (identifying existing state caps on contingency fees).

²⁰ See *infra* Part V.A.

while keeping third-party litigation financing available for needy plaintiffs and increasing judicial efficiency and fairness at the same time.²¹ In addition to the aforementioned caps, this Comment suggests other solutions, such as state or national registration requirements for third-party litigation funders²² and expanding existing state statutory regulations governing the litigation financing industry to apply in the commercial-litigation financing context.²³

This Comment's five parts lend support to these proposals. Part I presents a brief background and overview of the current state of the third-party litigation financing industry (section A), addressing arguments promoting its widespread growth (section B) and the general problems that third-party litigation has been found to create in practice (section C).

Part II examines the historic prohibition on uninterested third-party involvement in litigation through the doctrines of maintenance and champerty (section A), including a brief breakdown of the current treatment of the doctrines in the United States (section B).

Part III addresses the risk imbalances created by the intersection of third-party litigation financing and treble damage litigation where funders tend to invest significant portions of their portfolios. It identifies the risk imbalances caused by treble damage statutes (section A), the attractiveness of treble damage cases for third-party investors (section B), and the consequences of the presence of third-party litigation financing in antitrust and patent infringement litigation (section C).

Part IV addresses current state laws that attempt to regulate third-party litigation financing (section A), ultimately concluding that these regulations do not protect parties in the commercial litigation context (section B).

Part V proposes solutions to regulate the third-party litigation financing industry. These solutions include: (1) capping the recovery of third-party litigation funders (section A), (2) enacting registration requirements for third-party funders (section B), and (3) expanding and applying the enacted state legislation regulating third-party litigation financing to commercial litigation (section C).

²¹ See *infra* Part V.A.

²² See *infra* Part V.B.

²³ See *infra* Part V.C.

I. THE CURRENT STATE OF THIRD-PARTY LITIGATION FINANCING

Third-party litigation financing has grown from an industry that was based primarily around small lawsuit loan agreements into a multimillion-dollar investment vehicle for hedge funds, private equity firms, insurance companies, banks, and high net worth individuals.²⁴ In this Part, section A traces the growth of the third-party litigation financing industry in the United States and also discusses how third-party financing of commercial litigation is different from other types of litigation financing, such as lawsuit loans and presettlement funding. Next, section B discusses the arguments in favor of the continued growth of third-party litigation financing. Finally, the problems that third-party litigation financing causes in practice are addressed in section C, demonstrating that third-party litigation financing results in a distortion of the risk and cost deterrents that prevent many prospective plaintiffs from pursuing litigation.

A. *Background and Overview of Third-Party Litigation Financing*

The basic premise behind third-party litigation financing as addressed in this Comment is that the funders offer a financial advance collateralized with the opportunity for recovery of a portion of any damages resulting from the successful outcome of the financed lawsuit.²⁵ Third-party litigation financing is not a new industry in the United States. Two forms of third-party investment have been in practice since the 1990s: presettlement funding and the syndicated lawsuit.²⁶ Both of these types of financing are rooted in the contingency fee model of litigation financing, where an attorney will advance services (representation in litigating the claim) and other costs associated with adjudicating a claim in exchange for a percentage of the recovery from the lawsuit.²⁷ The presettlement funding industry involves cash advance loans by third-party lending companies to plaintiffs, typically personal injury plaintiffs,

²⁴ See Holly E. Loiseau et al., *Third-Party Financing of Commercial Litigation*, 24 IN-HOUSE LITIGATOR, no. 4, 2010, at 1, 7.

²⁵ See Andrew Hananel & David Staubitz, Current Development, *The Ethics of Law Loans in the Post-Rancman Era*, 17 GEO. J. LEGAL ETHICS 795, 800 (2004). Hananel and Staubitz refer to this concept as a “law loan.” *Id.* The concept of the “law loan” has since evolved into various complex financial strategies of investing in lawsuits by uninterested third parties, i.e., third-party litigation financing. See Geoffrey J. Lysaught & D. Scott Hazelgrove, *Economic Implications of Third-Party Litigation Financing on the U.S. Civil Justice System*, 8 J.L. ECON. & POL’Y 645, 648 (2012).

²⁶ Jason Lyon, Comment, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 573–74 (2010).

²⁷ *Id.* at 574. The other costs include court costs, discovery costs, etc., which arise from litigating a claim in court.

to cover the costs of litigation while their lawsuits are pending.²⁸ In syndicated lawsuits, plaintiffs solicit individual lenders to invest in litigation; in exchange, the lender will share proportionately in any proceeds resulting from the lawsuit.²⁹ In both of these types of third-party litigation financing, the plaintiff will only have to repay the lender if the financed litigation is successful.³⁰

Third-party litigation financing has continued to evolve in the United States. The most recent trend with regard to third-party litigation financing involves the formation of large litigation finance corporations that invest in a corporate plaintiff's lawsuit in exchange for a share of the eventual recovery.³¹ Although the practice of large corporations investing in litigation began in Australia and the United Kingdom, it has subsequently moved to the United States, where corporate litigation financing activity has surpassed that of similar activity in other countries.³²

The differences between third-party financing of commercial litigation and other forms of third-party litigation investment, such as lawsuit syndication and presettlement funding, are twofold. The first difference is the manner in which the investors get their return. The second difference is the amount of money the third-party funders typically invest and the potential rewards from investment.

In the lawsuit syndication and presettlement funding context, the investment deal is normally structured as a loan that does not require repayment unless the plaintiff is successful.³³ If the plaintiff recovers damages, the investor gets its loan repaid while also receiving a set percentage of interest

²⁸ See STEVEN GARBER, ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWN, AND UNKNOWN 9 (2010), available at http://www.rand.org/pubs/occasional_papers/OP306.html.

²⁹ See Susan Lorde Martin, *Syndicated Lawsuits: Illegal Champerty or New Business Opportunity?*, 30 AM. BUS. L.J. 485, 498 (1992); Daniel C. Cox, Comment, *Lawsuit Syndication: An Investment Opportunity in Legal Grievances*, 35 ST. LOUIS U. L.J. 153, 154–59 (1990).

³⁰ Shepherd, *supra* note 12, at 593–94 (“Both of these forms of third-party litigation financing are non-recourse loans because the plaintiff need only pay back the loan if the lawsuit succeeds.”).

³¹ *Id.* at 594; see also Rickard, *supra* note 6 (“In essence, [third-party litigation financing] is the practice of hedge funds and other investment firms providing funds to plaintiffs’ lawyers in order to conduct litigation.”).

³² Jennifer Banzaca, *In Turbulent Markets, Hedge Fund Managers Turn to Litigation Funding for Absolute, Uncorrelated Returns*, HEDGE FUND L. REP., June 24, 2009, available at <http://www.juriscapitalcorp.com/images/Hedge%20Fund%20Law%20Report%20Article.pdf>.

³³ Shepherd, *supra* note 12, at 593–94.

based on the principal loan amount.³⁴ By contrast, in commercial-litigation financing, the recovery is not based on the original amount invested. The funder usually gets a lump sum calculated by a flat percentage of the damage award or a set amount of the damage award plus a flat percentage of the remaining recovery.³⁵

The second difference between commercial-litigation financing and other forms of litigation investment is that, in commercial-litigation financing done by litigation finance companies, the funder routinely invests multimillion-dollar sums for a percentage of possible billion-dollar recoveries.³⁶ In comparison, in presettlement funding and lawsuit syndication, the third-party investment is generally in the thousands or tens of thousands of dollars, with typical recoveries reaching into the hundred-thousand-dollar range.³⁷ The investment difference is primarily because presettlement funding and lawsuit syndication are used in consumer civil litigation, whereas commercial-litigation financing involves investment groups that invest in large commercial cases.³⁸

The sheer size of the investment required in third-party financing of commercial litigation has limited the number of financiers in the industry thus far—in the United States there appear to be only six corporations that invest primarily in commercial litigation.³⁹ Of these six corporations, three are publicly traded (Burford Capital, IMF Ltd., and Juridica Investments), and of those three publicly traded companies only Burford Capital and Juridica Investments invest primarily in U.S. litigation.⁴⁰ Both Burford and Juridica are

³⁴ See Cox, *supra* note 29, at 155 (citing *A Scheme to Sell Pieces of an Action*, BUS. WK., May 24, 1976, at 35, 36, which discusses a lawsuit syndication agreement where investors would receive 25% interest on their \$500,000 investment if the underlying lawsuit were successful).

³⁵ See *supra* note 5 and accompanying text; see also Fisher, *supra* note 10 (“In Case 0409-C, Juridica reports, the jury returned a \$50 million verdict, good news for the firm since it only invested \$4.3 million and stands to gain the first \$3 million of any cash settlement plus 49% of the rest.”).

³⁶ Shepherd, *supra* note 12, at 594.

³⁷ Lyon, *supra* note 26, at 578.

³⁸ See Loiseau et al., *supra* note 24, at 7.

³⁹ See GARBER, *supra* note 28, at 14–15 (stating the six corporations are ARCA Capital, Burford Capital, Calunius Capital, IMF Ltd., Juridica Investments, and Juris Capital).

⁴⁰ Lyon, *supra* note 26, at 578. The other three corporations, which are not publicly traded, provide little to no public information about their investment activities and investment strategies. Therefore, most information on the commercial litigation funders in this Comment will come from available information about the publicly traded litigation investment companies.

incorporated and publicly traded in the United Kingdom.⁴¹ Additionally, both companies manage portfolios of over \$200 million of U.S. commercial-litigation investments.⁴² IMF Ltd. is an Australian company that invests primarily in litigation outside the United States, but has created a U.S. venture, Bentham Capital, to directly invest in U.S. litigation.⁴³ In addition to corporations that invest directly in commercial litigation, other corporations, hedge funds, and investment banks give capital to third-party litigation funders to broaden their portfolios and purchase interests in commercial lawsuits.⁴⁴

The third-party litigation funders that invest multimillion-dollar sums in commercial litigation will be the focus of this Comment. The funding by these uninterested third parties is concentrated in particular cases—primarily patent infringement and antitrust cases—to garner the largest potential profit.⁴⁵ These investments create disproportionate risk incentives for plaintiffs and defendants and disadvantage defendants in litigation, causing a multitude of problems that will be discussed throughout this Comment.⁴⁶ Moreover, there are lingering questions as to the validity of these agreements under the doctrines of maintenance and champerty since no third-party litigation financing agreement in a commercial lawsuit has ever been challenged in court.⁴⁷ The next portion of this Comment will discuss in detail why some commentators favor third-party litigation financing, and then move on to address the problems that third-party litigation financing creates in practice.

B. Arguments in Favor of Third-Party Litigation Financing

Many commentators have debated the validity and desirability of third-party litigation financing agreements. Proponents of third-party litigation

⁴¹ *About Juridica*, JURIDICA INVS. LTD., <http://www.juridicainvestments.com/about-juridica.aspx> (last visited Dec. 14, 2013); *Structure*, BURFORD, <http://www.burfordcapital.com/who-we-are/structure/> (last visited Dec. 14, 2013).

⁴² Alden, *supra* note 3.

⁴³ See IMF (AUSTL.) LTD., 2012 ANNUAL REPORT 4 (2012), available at http://www.imf.com.au/docs/default-source/site-documents/imf-10091_ar-2012_v13.pdf. However, no investment information is available for Bentham Capital. According to the Chairman of IMF Ltd.'s review in the 2012 *Annual Report*, Bentham Capital will have invested in three lawsuits by its first anniversary. See *id.*

⁴⁴ See Barrett, *supra* note 4, at 42 (stating Buford Capital has received investments from sources such as “Invesco UK, Reservoir Capital Group, and Scottish Widows Investment Partnership”); Ho, *supra* note 2 (“Burford [Capital] raises capital from hedge funds, private equity funds and other institutional backers, then lends that money to people in cases that appear to have a good chance of reaping major rewards, either through a settlement, judgment or jury verdict.”).

⁴⁵ O’Connell, *supra* note 18.

⁴⁶ See *infra* Part III.

⁴⁷ See O’Connell, *supra* note 18.

financing argue primarily that it provides access to justice for plaintiffs who otherwise could not resolve legal disputes because of the costs of litigation.⁴⁸ Financing agreements that give plaintiffs their day in court are viewed as socially desirable because they allow for third-party litigation financing companies to finance low-income plaintiffs or businesses with insufficient revenues or limited financial resources who could not provide for their own legal claims.⁴⁹ If these types of plaintiffs are unable to bring their meritorious claims due to the cost barriers of litigation, suboptimal deterrence of wrongful behavior may result.⁵⁰ Third-party litigation financing can help provide access to courts for plaintiffs with limited financial resources because it allows the plaintiffs to bring their meritorious claims without having to fund the high cost of litigation themselves, “redistributing the cost burdens of litigation while promoting access to justice.”⁵¹

Another argument in support of third-party litigation financing is that risk averse plaintiffs are often unwilling to pursue legal claims even if they can afford litigation costs because of the indefinite nature of legal outcomes and damage awards, which lowers the expected value of bringing a lawsuit.⁵² When the expected value of a legal claim dips below the expected cost of adjudicating that claim, a plaintiff is unlikely to bring the claim even if it is meritorious, resulting in inadequate deterrence of wrongful conduct.⁵³ Third-party litigation financing, it is argued, can reduce these undesired results of inadequate deterrence by spreading the risk and cost of a lawsuit between multiple parties, thus encouraging plaintiffs to adjudicate their claims.⁵⁴

C. Problems Caused by Third-Party Litigation Financing in Practice

Despite the social benefits that proponents claim third-party litigation financing can create, there are a multitude of problems that result when the use

⁴⁸ See Susan Lorde Martin, *Litigation Financing: Another Subprime Industry That Has a Place in the United States Market*, 53 VILL. L. REV. 83, 114 (2008); Douglas R. Richmond, *Other People's Money: The Ethics of Litigation Funding*, 56 MERCER L. REV. 649, 681 (2005); Lyon, *supra* note 26, at 609.

⁴⁹ Cf. Shepherd, *supra* note 12, at 598 (advocating for contingency fee arrangements).

⁵⁰ See, e.g., Paul H. Rubin & Joanna M. Shepherd, *The Demographics of Tort Reform*, 4 REV. L. & ECON. 591, 595–96 (2008) (finding that there is less deterrence of wrongful behavior directed toward lower income groups that usually cannot afford the costs of litigation). The types of activities can range from a wrong to an individual plaintiff to wrongs perpetrated against corporate defendants who may not be in the financial position necessary to fund their own litigation.

⁵¹ Lyon, *supra* note 26, at 609.

⁵² Abrams & Chen, *supra* note 15, at 3.

⁵³ See Shepherd, *supra* note 12, at 598–99.

⁵⁴ *Id.* at 599.

of third-party financing becomes widespread. The first problem caused by the growth of lawsuit financing is that it results in more litigation.⁵⁵ This problem is created because lawsuits that would not normally be pursued due to the prohibitive costs and risks are now being filed because the costs and risks are shared with third-party funders.⁵⁶ A 2012 study of third-party litigation financing in Australia demonstrated that increased court congestion results from the development of third-party litigation financing.⁵⁷ The Australian study found that in jurisdictions where a large third-party litigation firm operated, the lawsuits were more drawn out, creating backlogs in the courts' ability to hear cases.⁵⁸ This increase in the number and length of lawsuits may ultimately result in an increase in the amount of court expenditures by both parties in jurisdictions where third-party litigation financing is legal.⁵⁹

A second problem caused by third-party litigation financing is that it encourages parties to file frivolous claims.⁶⁰ Third-party financing permits plaintiffs to off-load risk onto third-party funders, which could allow plaintiffs to test nonmeritorious claims.⁶¹ Further, because third-party litigation financing companies are broadly invested in multiple claims and well capitalized in those investments, they can more easily shoulder the risk of a nonmeritorious claim because that risk can be spread over the broader portfolio of lawsuit investment.⁶² The study of third-party litigation investment in Australia found that over time there was a growing spread between maximum profits and maximum losses, making longer cases riskier.⁶³ Despite this, there is still a high likelihood that third-party litigation funders are investing in the pursuit of nonmeritorious claims because the risk can be spread out among multiple investors.⁶⁴

⁵⁵ Paul H. Rubin, *Third-Party Financing of Litigation*, 38 N. KY. L. REV. 673, 677 (2011).

⁵⁶ *See id.*

⁵⁷ Abrams & Chen, *supra* note 15, at 31.

⁵⁸ *See id.* at 26, 31.

⁵⁹ *Id.* at 31.

⁶⁰ BEISNER ET AL., *supra* note 16, at 5.

⁶¹ *See id.* at 6 (“[T]hird-party funding companies are able to mitigate their downside risk in two ways: they can spread the risk of any particular case over their entire portfolio of cases, and they can spread the risk among their investors.”).

⁶² *See id.*

⁶³ *See* Abrams & Chen, *supra* note 15, at 15.

⁶⁴ *See id.* at 5–6. The third-party litigation financing industry in Australia is much more developed than its U.S. counterpart, and as a result, there are more investors for which to spread the risk and thus an increase in the volume of frivolous or questionable claims. *See* U.S. CHAMBER INST. FOR LEGAL REFORM, THIRD PARTY FINANCING: ETHICAL & LEGAL RAMIFICATIONS IN COLLECTIVE ACTIONS 10–11 (2009), available at <http://www.instituteforlegalreform.com/sites/default/files/images2/stories/documents/pdf/research/thirdpartyfi>

A third problem with third-party litigation financing is that it removes plaintiffs' incentives to settle, prolonging litigation and increasing the value of settlements.⁶⁵ Litigants will likely reject any settlement that is below the amount suggested by a third-party financing arrangement because they must recover enough money from a settlement in order to ensure recovery for both the third-party funder and themselves.⁶⁶ For example, if a funder invests \$2 million in a litigation claim in exchange for 40% of any recovery, the funder will set a settlement floor of at least \$5 million.⁶⁷ It is likely a funder would require the settlement to be greater than \$5 million so that it could generate some sort of return on the investment.⁶⁸ As a result, this creates a disincentive for the litigant to accept what would otherwise be a fair settlement agreement had there not been the presence of a third-party litigation funder.⁶⁹

The problems caused by third-party litigation financing in practice are threefold: it (1) increases the amount of litigation, (2) causes the filing of more frivolous lawsuits, and (3) results in larger average settlement amounts. These problems are only magnified considering the types of cases that third-party litigation funders in the United States are apt to invest in.⁷⁰ Third-party litigation funders absorb plaintiffs' risks by investing significant amounts in lawsuits and then diversify their own downside risk by having a large portfolio of investments.⁷¹ The result is a distortion of both the risk and cost barriers to litigation.

nancingeurope.pdf. Investment in frivolous lawsuits could also become a problem in the United States if the third-party litigation financing industry continues to grow unrestrained.

⁶⁵ BEISNER ET AL., *supra* note 16, at 6.

⁶⁶ *See* Rancman v. Interim Settlement Funding Corp., 99 Ohio St. 3d 121, 2003-Ohio-2721, 789 N.E.2d 217, at ¶¶ 15–17 (noting that the amount the plaintiff-appellant owed to litigation financiers was an “absolute disincentive” to settle at a lesser amount); *see also* Loiseau et al., *supra* note 24, at 8 (“Once a plaintiff has commenced a lawsuit with the backing of an investor, critics contend that plaintiffs will be more likely to demand a higher settlement than they might otherwise be willing to accept because they have to pay a percentage of the recovery to the investor.”).

⁶⁷ *See* Loiseau et al., *supra* note 24, at 8 (“[I]nvestors may demand that the plaintiffs they support only accept above a certain threshold in any settlement such that the investor’s costs are covered.”). If the funder received 40% of \$5 million, it would recover \$2 million, allowing it to break even.

⁶⁸ *See id.*

⁶⁹ *See* BEISNER ET AL., *supra* note 16, at 6.

⁷⁰ *See infra* Part III.

⁷¹ *See* BEISNER ET AL., *supra* note 16, at 6.

II. MAINTENANCE AND CHAMPERTY

Two historic legal barriers to third-party litigation financing agreements are the common-law doctrines of maintenance and champerty, which forbid outside involvement in litigation.⁷² The doctrines of maintenance and champerty are applicable in some jurisdictions in the United States, but they are useless or completely outlawed in others.⁷³ The variation in treatment of the doctrines has resulted in the inconsistent presence of third-party litigation financing in different states.⁷⁴ This Part addresses the historical context in which maintenance and champerty arose (section A) and then examines the federal treatment of the doctrines (section B) and three different state approaches to enforcing the doctrines (section B.1). This Part then moves on to discuss the issues that are caused by the differing treatments of maintenance and champerty in various jurisdictions and the disproportionate effect these differing treatments have on third-party litigation financing investment (section B.2). Ultimately this Part concludes that the doctrines of maintenance and champerty should be replaced with new mechanisms to regulate third-party litigation financing because the unequal treatment of the doctrines by differing jurisdictions has created funding havens that result in judicial inequality for defendants.

A. *Historical Treatment of Maintenance and Champerty*

Historically, third-party litigation financing was prohibited by the common-law doctrines of maintenance and champerty. Maintenance is defined as “the action of wrongfully aiding and abetting litigation; *spec.* sustentation of a suit or suitor at law by a party who has no interest in the proceedings.”⁷⁵ Champerty is a particular type of maintenance⁷⁶ and is defined as an “agreement to divide litigation proceeds between the owner of the litigated claim and a party unrelated to the lawsuit who supports or helps enforce the

⁷² Lyon, *supra* note 26, at 579.

⁷³ See Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1289–90 (2011); Lyon, *supra* note 26, at 583 (stating that “thirty-two states and the District of Columbia still retain either statutes or intact precedents prohibiting champerty”).

⁷⁴ See Banzaca, *supra* note 32 (suggesting that third-party litigation funders attempt to avoid investing in lawsuits in states where there are strict maintenance and champerty laws on the books).

⁷⁵ Lyon, *supra* note 26, at 579 (quoting OXFORD ENGLISH DICTIONARY 226 (2d ed. 1989)) (internal quotation mark omitted).

⁷⁶ 14 AM. JUR. 2D *Champerty, Maintenance, and Barratry* § 1 (2009). See generally *id.* §§ 1–15 (discussing champerty and maintenance more expansively).

claim.”⁷⁷ More critically, the doctrine of champerty outlaws “an 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.”⁷⁸ These doctrines “were developed at common law to prevent officious intermeddlers from stirring up strife and contention by vexatious and speculative litigation which would disturb the peace of society, lead to corrupt practices, and prevent the remedial process of law.”⁷⁹

Maintenance and champerty have their foundations in the common law and were introduced during the Medieval period in England.⁸⁰ In medieval England, litigation was viewed as, “at best[,] a necessary evil,” and the prevailing view was that litigation was something that should be avoided at all costs.⁸¹ It was seen as quarrelsome and unchristian⁸² and was primarily brought to challenge the right or title to land.⁸³ Litigants would sue for property rights, which they usually did not possess, and seek aid from third parties who had the legal or financial ability to overwhelm courts.⁸⁴ These litigants backed by third parties were often able to obtain a successful verdict, allowing them to gain title to land in which they did not possess any preexisting rights.⁸⁵ In exchange for support, the litigant would deed a portion of the disputed land to the third party, increasing the third party’s power under the English feudal system.⁸⁶ As a result of these distortions of justice, legislatures responded by prohibiting uninterested third parties from participating in litigation through the doctrines of maintenance and champerty.⁸⁷

⁷⁷ BLACK’S LAW DICTIONARY 262 (9th ed. 2009).

⁷⁸ Steinitz, *supra* note 73, at 1286–87 (quoting BLACK’S LAW DICTIONARY 262 (9th ed. 2009)).

⁷⁹ 14 AM. JUR. 2D *Champerty, Maintenance, and Barratry* § 1 (2009).

⁸⁰ See Max Radin, *Maintenance by Champerty*, 24 CALIF. L. REV. 48, 65 (1935).

⁸¹ *Id.* at 68.

⁸² *Id.* at 58.

⁸³ See Steinitz, *supra* note 73, at 1287.

⁸⁴ See *id.*

⁸⁵ See *id.* (“[S]mall men’ transferred their rights of action in property disputes to ‘great men’ in order to get the great men’s support at law. Because the legal establishment was weak at the time, the great men could overwhelm the court, thus enabling the little man to get his land claim and the great men to get their share. In other words, *champerty* was a means by which great men increased their power at the expense of the courts of justice.” (quoting William R. Long, *Champerty and Contingent Fees III*, DR. BILL LONG.COM (Dec. 14, 2005), <http://www.drbilllong.com/LegalHistoryII/ChampertyIII.html>)).

⁸⁶ See Radin, *supra* note 80, at 60–61.

⁸⁷ See Steinitz, *supra* note 73, at 1287.

B. *Maintenance and Champerty in the United States*

Due to the English common law system, the legal concepts of maintenance and champerty made their way into American jurisprudence.⁸⁸ During the middle of the nineteenth century, the validity of the doctrines were called into question in the United States.⁸⁹ Many in the legal community did not think that maintenance and champerty were helpful in preventing frivolous lawsuits and believed that the doctrines were inhibiting access to justice.⁹⁰ Despite this criticism, maintenance and champerty remained in effect to bar lawyers from soliciting business, to stop uninterested third parties from paying for litigation, and to prevent lawyers from entering into contingency fee arrangements with clients.⁹¹

More probing of maintenance and champerty arose during the middle of the twentieth century because of the existing social struggle for civil rights.⁹² Litigation was seen as an avenue to advance social change.⁹³ Critics pointed to the necessity of relaxed restrictions, arguing these doctrines were invoked to disadvantage some of the American populace.⁹⁴ As a result, the Supreme Court relaxed the doctrines of maintenance and champerty as they applied to

⁸⁸ Lyon, *supra* note 26, at 581.

⁸⁹ See Radin, *supra* note 80, at 68, 70.

⁹⁰ See *id.* The New York Code of Civil Procedure of 1848 allowed the assignment of civil actions, which “gave the assignee,—the indubitably champertous assignee,—a recognition and a standing.” *Id.* at 68. Radin then goes on to argue that “[t]here is no necessary and inevitable connection between improper litigation, hard bargains[,] and solicitation on the one hand and the acquisition by a third party of an interest in a litigated case, on the other,” and that the laws of champerty and maintenance are not useful in the American legal system. *Id.* at 72.

⁹¹ See *NAACP v. Button*, 371 U.S. 415, 423 & n.7 (1963) (plurality opinion); see also Lyon, *supra* note 26, at 582.

⁹² See Lyon, *supra* note 26, at 582.

⁹³ See generally Stephen C. Yeazell, Brown, *the Civil Rights Movement, and the Silent Litigation Revolution*, 57 VAND. L. REV. 1975, 2000–03 (2004) (explaining that the culture of the civil rights movement valued civil litigation as an “instrument of social change”).

⁹⁴ See Comment, *The South’s Amended Barratry Laws: An Attempt to End Group Pressure Through the Courts*, 72 YALE L.J. 1613, 1613 (1963).

In the middle 1950’s seven southern states suddenly discovered a need to reinvigorate and extend existing champerty, maintenance and solicitation rules. The flurry of legislation came on the heels of the Supreme Court’s decision in *Brown v. Board of Education* in which five civil rights organizations appeared as amicus curiae. The two events were not unconnected. The action of the legislatures was a vigorous political response to the success of these organizations before the courts.

Id. (footnotes omitted). The civil rights organizations had financed some of the litigation, and in turn, the state legislatures wanted to block this support of civil rights litigation by using the doctrines of maintenance and champerty. See *id.* at 1615–22.

nonprofit organizations.⁹⁵ In *NAACP v. Button*, the Supreme Court held that an organization's solicitation of prospective litigants for the purpose of furthering civil-rights objectives comes within the First Amendment right "to engage in association for the advancement of beliefs and ideas."⁹⁶ This holding applied to nonprofit organizations where "litigation is not a technique of resolving private differences," but "a form of political expression" and "political association."⁹⁷ The Court found that the solicitation of prospective litigants is entitled to First Amendment protection and that the "government may regulate in the area only with narrow specificity."⁹⁸ However, the holding in *Button* did not eliminate the doctrines of maintenance and champerty.⁹⁹ The Court subsequently upheld the rights of states to regulate conduct under the doctrines in *Ohralik v. Ohio State Bar Association*.¹⁰⁰ The Court held that conduct as it relates to third-party participation in lawsuits "is subject to regulation in furtherance of important state interests."¹⁰¹

1. States' Treatment of Maintenance and Champerty

The Court's holding in *Ohralik* has resulted in significant variation in states' treatment of the law regulating third-party conduct under maintenance and champerty. Currently twenty-seven states and the District of Columbia explicitly permit champerty.¹⁰² Sixteen of the twenty-seven states that permit champerty mention investment in a stranger's lawsuit by contract as an accepted form of maintenance.¹⁰³

The varying treatment of maintenance and champerty is demonstrated through the judicial application of the doctrines. For example, the South Carolina Supreme Court considered the issue of champerty in *Osprey, Inc. v. Cabana Ltd. Partnership*.¹⁰⁴ The issue in the case pertained to a contract for an interest in a lawsuit, where the party that purchased the interest was considered

⁹⁵ See *Button*, 371 U.S. at 428–29 (plurality opinion).

⁹⁶ *Id.* at 430 (quoting *NAACP v. Alabama ex rel. Patterson*, 357 U.S. 449, 460 (1958)) (internal quotation marks omitted).

⁹⁷ *Id.* at 429, 431.

⁹⁸ See *id.* at 433.

⁹⁹ See Lyon, *supra* note 26, at 588–89.

¹⁰⁰ See 436 U.S. 447, 459 (1978).

¹⁰¹ See *id.*

¹⁰² GARBER, *supra* note 28, at 18.

¹⁰³ See *id.* ("Of the twenty-eight states [including Washington, D.C.] that permit maintenance in some form, sixteen explicitly permit maintenance for profit." (quoting Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 107 (2011)) (internal quotation mark omitted)).

¹⁰⁴ 532 S.E.2d 269 (S.C. 2000).

by the court to be an uninterested third party.¹⁰⁵ The lawsuit in question was settled, and the party that purchased an interest in the lawsuit sued to enforce its rights under the contract.¹⁰⁶ The party who originally sold the interest in its lawsuit moved to dismiss the case on the grounds that the agreement was champertous and unenforceable on its face.¹⁰⁷ The court held that the doctrine of champerty was abolished as a defense to the enforcement of an agreement because “it no longer is required to prevent the evils traditionally associated with the doctrine as it developed in medieval times.”¹⁰⁸ The court was “convinced that other well-developed principles of law can more effectively accomplish the goals of preventing speculation in groundless lawsuits and the filing of frivolous suits than dated notions of champerty.”¹⁰⁹

Similarly, the Supreme Judicial Court of Massachusetts abolished the use of maintenance and champerty in the case of *Saladini v. Righellis*.¹¹⁰ In that case, Saladini agreed to advance funds to Righellis to pursue litigation in exchange for part of the recovery.¹¹¹ Righellis eventually settled the dispute but did not split the recovery with Saladini.¹¹² Saladini sued for the contracted amount of the recovery that she was due,¹¹³ and the court ruled in her favor, stating that it was “no longer . . . persuaded that the champerty doctrine is needed to protect against the evils once feared: speculation in lawsuits, the bringing of frivolous lawsuits, or financial overreaching by a party of superior bargaining position.”¹¹⁴

In contrast, the Minnesota Court of Appeals in *Johnson v. Wright* invalidated a litigation loan agreement where the lender was an uninterested third party and had contracted to recover a portion of the lawsuit proceeds.¹¹⁵ The court held that “an agreement in which [a funder] ha[s] no interest

¹⁰⁵ See *id.* at 271.

¹⁰⁶ *Id.* at 271–72.

¹⁰⁷ *Id.* at 272.

¹⁰⁸ *Id.* at 279.

¹⁰⁹ *Id.* at 277. The court’s examples of other principles of law that would replace champerty in addressing speculation in groundless and frivolous litigation include the South Carolina Rules of Professional Conduct, which provide for sanctions against attorneys who bring frivolous litigation, and the contract doctrines of “unconscionability, duress, and good faith [which] establish standards of fair dealing between opposing parties.” *Id.*

¹¹⁰ 687 N.E.2d 1224, 1224 (Mass. 1997).

¹¹¹ *Id.* at 1224–25.

¹¹² *Id.* at 1225.

¹¹³ *Id.*

¹¹⁴ *Id.* at 1224, 1226.

¹¹⁵ 682 N.W.2d 671, 674 (Minn. Ct. App. 2004).

otherwise, and when he is in no way related to the party he aids, is champertous and void as against public policy.”¹¹⁶ The court in *Johnson* expressly declined to follow *Saladini* and *Osprey*, opining that there was no reason “to abandon the champerty doctrine simply because a few states have chosen to do so.”¹¹⁷ Minnesota is not the only state that continues to uphold champerty and maintenance laws; Indiana and Pennsylvania also continue to recognize champerty and maintenance as a defense that invalidates financing agreements between litigants and uninterested third parties.¹¹⁸

A third approach taken by states that have addressed champerty and maintenance strikes a middle ground. The doctrines are not abolished, but they are applied very reluctantly. In New York, champerty laws prohibit a party from acquiring an interest in any legal claim “with the intent and for the purpose of bringing an action or proceeding thereon.”¹¹⁹ The New York Court of Appeals has stated, “in order to constitute champertous conduct in the acquisition of rights . . . , the foundational intent to sue on that claim must at least have been the primary purpose for, if not the sole motivation behind, entering into the transaction.”¹²⁰ This means that unless the facts of the case overwhelmingly evidence that the acquisition of rights to a claim was for the purpose of bringing a lawsuit for profit, champerty will not be recognized in New York.¹²¹

2. *Issues with the Variation in States’ Treatment of Maintenance and Champerty*

Despite the split among courts on the doctrines of maintenance, champerty, and the permissibility of litigation financing agreements, no court has

¹¹⁶ *Id.* at 678.

¹¹⁷ *Id.* at 679–80.

¹¹⁸ *See, e.g.,* *Midtown Chiropractic v. Ill. Farmers Ins. Co.*, 847 N.E.2d 942, 947 (Ind. 2006) (disallowing the “assignment of proceeds from a personal injury claim” because the assignment was champertous); *Fleetwood Area Sch. Dist. v. Berks Cnty. Bd. of Assessment Appeals*, 821 A.2d 1268, 1273 (Pa. Commw. Ct. 2003) (“[T]he activity of champerty has long been considered repugnant to public policy against profiteering and speculating in litigation” Moreover, . . . the doctrine of champerty continues to be viable in this Commonwealth and can be raised as a defense.” (citation omitted) (quoting *Clark v. Cambria Cnty. Bd. of Assessment Appeals*, 747 A.2d 1242, 1245–46 (Pa. Commw. Ct. 2000))).

¹¹⁹ N.Y. JUD. LAW § 489 (McKinney 2005).

¹²⁰ *Bluebird Partners, v. First Fid. Bank, N.A.*, 731 N.E.2d 581, 587 (N.Y. 2000).

¹²¹ *See id.* at 586–88 (indicating that the doctrine of champerty could be used to invalidate a litigation financing agreement where the sole purpose of the third-party funding is to enable the plaintiff to pursue the cause of action).

considered the legality of third-party financing of commercial litigation.¹²² Third-party litigation funders consider the existing maintenance and champerty laws when looking for investments and avoid jurisdictions with strict maintenance and champerty rulings on the books.¹²³ Some commentators argue that, in the American legal system, litigation should be encouraged and barriers to litigation should be removed, rendering maintenance and champerty obsolete.¹²⁴ The varying treatment of maintenance and champerty makes states that have eliminated the doctrines susceptible to lawsuits funded by uninterested third-parties.¹²⁵ If all states do not reject maintenance and champerty, inequality in the ability for potential plaintiffs to get third-party financing may result.

Overall, there appears to be a trend toward removing maintenance and champerty as barriers to third-party litigation financing.¹²⁶ Because maintenance and champerty are, by and large, no longer useful apparatuses for regulating third-party financing due to the imbalanced administration of the doctrines from jurisdiction to jurisdiction, they should be completely eliminated. A new solution regulating third-party litigation financing needs to replace these outdated doctrines to level the playing field for defendants while still protecting plaintiffs from predatory litigation funders.

III. THE RISK IMBALANCES CREATED BY THE INTERACTION OF THIRD-PARTY LITIGATION FINANCING AND TREBLE DAMAGES

Third-party funders have invested much of their litigation portfolios in cases that include the possibility of recovering treble damages.¹²⁷ The enormous recoveries that result from treble damages create significant risk imbalances between plaintiffs and defendants.¹²⁸ Plaintiffs are given a relative bargaining advantage over defendants because of asymmetric litigation costs

¹²² Shepherd, *supra* note 12, at 594–95.

¹²³ Banzaca, *supra* note 32.

¹²⁴ Lyon, *supra* note 26, at 589.

¹²⁵ See Banzaca, *supra* note 32. Discussing champerty and how it effects the company's investment decisions, Juridica CEO Richard Fields said, "There are a few states where it's crystal clear that [champerty is] not a problem, like New Jersey. Most states have cases on the books and in some states it's more of a risk than others. There are only a few states where champerty gives a defendant a defense." *Id.* (internal quotation mark omitted).

¹²⁶ See Lyon, *supra* note 26, at 588 ("A series of Supreme Court cases in the 1960s, '70s and '80s that struck down state regulation of various aspects of the legal industry enshrined in American jurisprudence the shift in popular attitudes about litigation.").

¹²⁷ See *infra* Part III.B.

¹²⁸ See Shepherd, *supra* note 12, at 603–07.

that result from the existence of these risk imbalances.¹²⁹ The disadvantages defendants face are only exacerbated when third-party litigation financing comes into the fold.¹³⁰ This Part explains the risk imbalances that exist as a result of treble damage statutes (section A), the attractiveness of cases with potential treble damages to third-party investors (section B), and the large litigation advantages that result for plaintiffs when treble damages and third-party financing intertwine (section C).

A. Existing Risk Imbalances Caused by Treble Damage Statutes

Treble damages are a signature of American law and are statutorily imposed in many types of cases, most notably patent infringement¹³¹ and antitrust actions.¹³² The existence of these types of damages has resulted in a majority of commercial third-party litigation investment being channeled into patent infringement and antitrust litigation.¹³³ Treble damages means that “any verdict rendered . . . upon which a judgment will be entered by the court, will be multiplied by three.”¹³⁴ The statutory structure of treble damages was created to deter potential wrongdoers, provide incentives for plaintiffs to bring lawsuits, and fully compensate the victims of the conduct associated with the treble damage statutes.¹³⁵ The effectiveness of treble damages has been the subject of much debate.¹³⁶ Despite this debate, treble damage statutes often cause plaintiffs to recover substantial damages.¹³⁷

¹²⁹ See *infra* Part III.A.

¹³⁰ See *infra* Part III.A.

¹³¹ 35 U.S.C. § 284 (2006 & Supp. V 2011) (“Upon finding for the claimant . . . the court may increase the damages up to three times the amount found or assessed.”).

¹³² 15 U.S.C. § 15(a) (2012) (“[A]ny person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws . . . shall recover threefold the damages by him sustained . . .”).

¹³³ See O’Connell, *supra* note 18.

¹³⁴ Lowry v. Tile, Mantel & Grate Ass’n of Cal., 106 F. 38, 46 (C.C.N.D. Cal. 1900), *aff’d sub nom.* W.W. Montague & Co. v. Lowry, 115 F. 27 (9th Cir. 1902), *aff’d*, 193 U.S. 38 (1904).

¹³⁵ Leon B. Greenfield & David F. Olsky, *Treble Damages: To What Purpose and to What Effect?*, WILMERHALE 5 (Feb. 2, 2007), http://www.wilmerhale.com/files/Publication/dc8754ff-a713-459e-80aa-f8e5cf50cf12/Presentation/PublicationAttachment/98011e52-2e46-41c1-ae26-019292035734/Treble%20Damages%20Article_%20BIICL%20conference.pdf (discussing the reasons for treble damages).

¹³⁶ See, e.g., William Breit & Kenneth G. Elzinga, *Private Antitrust Enforcement: The New Learning*, 28 J.L. & ECON. 405, 430–35 (1985) (discussing various critiques of treble damages); Robert H. Lande, *Are Antitrust “Treble” Damages Really Single Damages?*, 54 OHIO ST. L.J. 115, 118–19 (1993) (“[W]hen viewed correctly, [treble] antitrust damages awards are approximately equal to, or less than, the actual damages caused by antitrust violations.”); Michael J. Meurer, *Controlling Opportunistic and Anti-competitive Intellectual Property Litigation*, 44 B.C. L. REV. 509, 539 (2003) (“Trebled antitrust damages are a potent deterrent of anticompetitive activity, but in practice antitrust does little to control socially harmful IP litigation because its reach is very limited; it does not apply to opportunistic litigation and applies only to a subset of anticompetitive litigation.”); Steven C. Salop & Lawrence J. White, *Economic Analysis of Private Antitrust*

Patent infringement lawsuits can result in treble damages,¹³⁸ and the costs of litigation for these types of cases can be significant. In 2011, in patent infringement cases with \$1 million to \$25 million at risk, the average cost of litigation for each party was \$2.5 million, while the average litigation cost for each party in cases with more than \$25 million at risk was \$5 million.¹³⁹ Defendants are disadvantaged in these cases because they bear a higher burden of proof than plaintiffs. Defendants must prove that a patent is invalid by clear and convincing evidence, while plaintiffs only have to show that the defendant infringed on the patent by a preponderance of the evidence.¹⁴⁰ “Discovery burdens are [also] unequal and mostly one-sided in favor of the patent troll who commonly has few documents beyond the patent and prosecution history.”¹⁴¹ Furthermore, if the defendant is found to have willfully infringed on a patent, the defendant may have to pay treble damages and attorneys’ fees.¹⁴² This cost can be substantial: the median damage award for patent infringement lawsuits in 2012 was \$9.5 million, with multiple juries awarding damages of over \$1 billion.¹⁴³ The low burden of proof and large damage awards result in a bargaining advantage for plaintiffs and gives plaintiffs an

Litigation, 74 GEO. L.J. 1001, 1051 (1986) (arguing that eliminating treble damages for antitrust violations would increase such violations).

¹³⁷ See Shepherd, *supra* note 12, at 605 (discussing that if a defendant is found liable of price fixing, “damages often exceed \$1 billion”).

¹³⁸ 35 U.S.C. § 284 (2006 & Supp. V 2011).

¹³⁹ AM. INTELLECTUAL PROP. LAW ASS’N, REPORT OF THE ECONOMIC SURVEY 2011, at 35 (2011).

¹⁴⁰ See *Advanced Cardiovascular Sys., Inc. v. Scimed Life Sys., Inc.*, 261 F.3d 1329, 1336 (Fed. Cir. 2001) (“[T]he plaintiff must establish by a preponderance of the evidence that the accused device infringes one or more claims of the patent either literally or under the doctrine of equivalents.”); *U.S. Surgical Corp. v. Ethicon, Inc.*, 103 F.3d 1554, 1563 (Fed. Cir. 1997) (“[I]nvalidity must be proved by clear and convincing evidence.”).

¹⁴¹ Christopher A. Harkins, *Fending Off Paper Patents and Patent Trolls: A Novel “Cold Fusion” Defense Because Changing Times Demand It*, 17 ALB. L.J. SCI. & TECH. 407, 443 (2007).

¹⁴² 35 U.S.C. § 284 (“[A] court may increase the damages up to three times the amount found or assessed.”); 35 U.S.C. § 285 (2006) (“The court in exceptional cases may award reasonable attorney fees to the prevailing party.”); see also *I4I Ltd. P’ship v. Microsoft Corp.*, 598 F.3d 831, 858 (Fed. Cir. 2010) (discussing a court’s discretion to award treble damages upon a finding of willful infringement), *aff’d*, 131 S. Ct. 2238 (2011); *Epcon Gas Sys., Inc. v. Bauer Compressors, Inc.*, 279 F.3d 1022, 1034 (Fed. Cir. 2002) (discussing how a court may award reasonable attorneys’ fees in exceptional cases, such as where there is a showing of willful infringement).

¹⁴³ CHRIS BARRY ET AL., PRICEWATERHOUSECOOPERS, 2013 PATENT LITIGATION STUDY: BIG CASES MAKE HEADLINES, WHILE PATENT CASES PROLIFERATE 3, 7–8 (2013), available at http://www.pwc.com/en_US/us/forensic-services/publications/assets/2013-patent-litigation-study.pdf (“But [in 2012] alone, three cases, tried before juries in separate districts, resulted in awards of \$1 billion or greater: *Monsanto v. DuPont*, *Apple v. Samsung*, and *Carnegie Mellon University v. Marvell*.”). However, “[t]he largest historical awards have rarely been upheld”: “by mid-2013, two of the three blockbusters from 2012 were significantly reduced or settled, with the other still pending appeals.” *Id.* at 8.

incentive to bring lawsuits regardless of their merit.¹⁴⁴ In contrast, the defendant is faced with spending enormous amounts of money to undertake any portion of the litigation process, even if the defendant does not think it is infringing on the patent.¹⁴⁵ This bargaining advantage can force defendants to agree to larger settlements than they would have accepted without the threat of treble damages and high litigation costs.¹⁴⁶

Similarly in antitrust cases, plaintiffs have a bargaining advantage over defendants. Damages are automatically trebled in these cases,¹⁴⁷ resulting in large damage awards often exceeding \$1 billion.¹⁴⁸ Additionally, defendants can face joint and several liability with no right to contribution from co-conspirators if the plaintiff is successful.¹⁴⁹ A successful plaintiff is also entitled to recover reasonable attorneys' fees from the defendant.¹⁵⁰ These factors further increase the potential damage award and give plaintiffs an incredible bargaining advantage in settlement negotiations.¹⁵¹ Just like in patent infringement lawsuits, an unsuccessful plaintiff only has to pay its cost of litigation while an unsuccessful defendant has to pay treble damages, attorneys' fees for both sides, and possibly the damages of its co-conspirators due to joint and several liability.¹⁵² Also similar to patent infringement cases, this bargaining advantage for plaintiffs can force defendants into settling claims for much more than a usual market would bear had there not been the

¹⁴⁴ See Meurer, *supra* note 136, at 512–15.

¹⁴⁵ See *id.*

¹⁴⁶ See *id.* at 512–16.

¹⁴⁷ 15 U.S.C. § 15(a) (2012).

¹⁴⁸ See Shepherd, *supra* note 12, at 605 (citing *Antitrust Damage Allocation: Hearings Before the Subcomm. on Monopolies & Commercial Law of the H. Comm. on the Judiciary*, 97th Cong. 141 (1983) (prepared statement of Robert P. Taylor, Attorney, Pillsbury, Madison & Sutro); *In re Visa Check/MasterMoney Antitrust Litig.*, 297 F. Supp. 2d 503, 506–07 (E.D.N.Y. 2003) (approving a settlement in excess of \$3 billion), *aff'd sub nom. Wal-Mart Stores, Inc. v. Visa U.S.A., Inc.*, 396 F.3d 96 (2d Cir. 2005)).

¹⁴⁹ See *id.* at 606 (“As a result, a liable conspirator who has paid the trebled value of the entire cartel’s total overcharges cannot sue its co-conspirators to pay their fair share.”); Greenfield & Olsky, *supra* note 135, at 2–3 (discussing antitrust treble damages).

¹⁵⁰ 15 U.S.C. § 15(a).

¹⁵¹ Shepherd, *supra* note 12, at 607.

¹⁵² See *id.* at 605; see also JURIDICA INVS. LTD., ANNUAL REPORT & ACCOUNTS 2008, at 9 (2008), available at http://www.juridicainvestments.com/~media/Files/J/Juridica/pdfs/2008_Annual_Report.pdf (“Antitrust litigation is brought in the US under the Sherman Act or the Clayton Act and carries the possibility of statutory treble damages for the defendants. . . . The price-fixing cases are particularly attractive investment opportunities for JIL as they are perceived to have a low risk profile and high potential damages. Civil litigation in this arena often, but not always, follows either criminal prosecution by the US Department of Justice or early settlement by a cartel member in exchange for giving evidence against co-conspirators. These events help to establish liability. The multi-defendant nature of these cases increases the likelihood of pre-trial settlements.”).

threat of treble damages, litigation costs, and joint and several liability, leading to inefficient litigation outcomes.¹⁵³

B. Attractiveness of Statutory Treble Damage Cases for Third-Party Investors

The large damage awards available because of treble damage statutes in patent infringement and antitrust cases have enticed third-party litigation funders to devote substantial portions of their investment portfolio to these types of lawsuits.¹⁵⁴ For example, sixteen of the twenty-three lawsuits Juridica Investments has invested in as of June 30, 2012 were antitrust or patent infringement cases.¹⁵⁵ The investment in these twenty-three lawsuits totaled \$157.1 million.¹⁵⁶ In total, 85% of Juridica's litigation investment funds were committed to antitrust and patent infringement lawsuits, with \$96.9 million committed to six antitrust cases and \$37.3 million committed to ten patent infringement cases.¹⁵⁷

Burford Capital, another third-party litigation funder, might also have a substantial commitment to patent infringement and antitrust lawsuits.¹⁵⁸ Although Burford Capital does not specifically report what lawsuits it is currently invested in, it has stated that it plans to invest in “cases with big potential rewards. These could include patent thefts, antitrust proceedings or corporate torts”¹⁵⁹

C. Consequences of Third-Party Litigation Financing and Treble Damage Awards

Overall, the laws underlying patent infringement and antitrust litigation—chiefly treble damages statutes—create a risk imbalance that favors plaintiffs. Defendants are pressured to overpay in settlement agreements because they

¹⁵³ See Shepherd, *supra* note 12, at 607.

¹⁵⁴ See O'Connell, *supra* note 18; see also Fisher, *supra* note 10 (“[Juridica CEO Richard] Fields’[s] ideal case is where the damages are large and quantifiable, and the law favors the plaintiff, such as antitrust lawsuits where there is no real dispute that the defendant companies engaged in some sort of concerted effort to fix prices.”).

¹⁵⁵ *Assets Under Management*, JURIDICA INVS. LTD., <http://www.juridicainvestments.com/investor-relations/financialdata-and-tools/assets-under-management.aspx> (last visited Dec. 14, 2013).

¹⁵⁶ *Id.*

¹⁵⁷ See *id.*

¹⁵⁸ See Jason Douglas, *UPDATE: Burford Capital Raises GBP80 Million in 5th AIM Float of '09*, DOW JONES BUSINESS NEWS, Oct. 16, 2009, available at http://www.advfn.com/news_UPDATE-Burford-Capital-Raises-GBP80-Million-In-5t_39926046.html.

¹⁵⁹ *Id.*

otherwise face the prospect of paying treble damages to a successful plaintiff.¹⁶⁰ Third-party litigation funders intensify this risk imbalance by absorbing a majority of the plaintiff's risk exposure by funding most of the litigation costs.¹⁶¹ Third-party litigation financing encourages plaintiffs to bring lawsuits that have exorbitant potential damage awards.¹⁶² Third-party litigation funders are also protected from downside risk because they can mitigate potential losses in any one case by spreading out risk over a number of cases in their portfolios.¹⁶³

The existence of a third-party funder in a lawsuit may cause the defendant to accept an even less favorable settlement¹⁶⁴ because the defendant knows it faces the prospect of fighting an opposing party with extremely deep pockets. According to Joanna Shepherd, Associate Professor at Emory University School of Law, “[s]ettlements that are systematically larger than expected trial outcomes otherwise dictated by the substantive law lead to overcompensation of some plaintiffs and over-deterrence of certain behaviors.”¹⁶⁵ This over-deterrence leads to inefficient behavior¹⁶⁶ that could ultimately manifest in a social cost to the population at large by stifling competition and innovation by parties who fear potentially costly patent infringement or antitrust litigation. Third-party litigation funders only aggravate the possible social costs by giving plaintiffs the means to bring these lawsuits and increasing the volume of litigation as a result.¹⁶⁷

The intermingling of third-party litigation financing and treble damages is a dangerous combination for defendants. This Comment's solution looks to avoid these inefficient outcomes and balance the litigation scales between the opposing parties.

IV. STATES' ATTEMPTS TO REGULATE THIRD-PARTY LITIGATION FINANCING

As third-party litigation financing has grown in the United States, a few states have attempted to regulate the industry to provide protection to those receiving third-party funding. This Part discusses what regulations states have

¹⁶⁰ See *supra* Part III.A.

¹⁶¹ Shepherd, *supra* note 12, at 595–96.

¹⁶² See Rubin, *supra* note 55, at 677, 684–85.

¹⁶³ See *id.* at 677; see also BEISNER ET AL., *supra* note 16, at 6.

¹⁶⁴ See Shepherd, *supra* note 12, at 609.

¹⁶⁵ *Id.* at 610.

¹⁶⁶ See *id.*

¹⁶⁷ See Rubin, *supra* note 55, at 677–78.

enacted and are attempting to enact to police the third-party litigation financing industry (section A). This Part further addresses how these state laws fail to adequately regulate third-party litigation financing in commercial litigation because they focus on third-party litigation financing to individuals (section B).

A. *Current Status of State Laws Regulating Third-Party Litigation Financing*

Maine, Nebraska, and Ohio¹⁶⁸ have passed laws that attempt to put restrictions on third-party litigation funders.¹⁶⁹ The enacted statutes are framed mostly to protect individual plaintiffs and apply primarily to the financing of noncommercial civil litigation.¹⁷⁰ These statutes provide for certain clauses and language to be set forth in third-party litigation financing contracts with plaintiffs.¹⁷¹ The three states that have enacted legislation have required clauses that include (1) language that allows a plaintiff who signs a third-party litigation financing contract to cancel that contract within five days of receiving the financing if the plaintiff returns the funds, (2) language that instructs the plaintiff to consult an attorney, (3) itemized one-time fees charged by the funder, (4) the annual percentage rate of return that the funder will receive on the investment, and (5) the total dollar amount to be repaid by the plaintiff to the funder after the conclusion of the litigation.¹⁷² The Maine and Nebraska statutes further require third-party litigation funders to register with the state, which includes a fee, as well as to maintain a surety bond or line of credit with the state in order to ensure the funders' financial viability.¹⁷³ The Nebraska statute prohibits referral relationships between attorneys and funders to avoid conflicts of interest for attorneys who are representing clients who

¹⁶⁸ When the Ohio statute was enacted in 2008, it revived third-party lending in the state after the Ohio Supreme Court rendered third-party financing agreements unenforceable in *Rancman v. Interim Settlement Funding Corp.*, 99 Ohio St. 3d 121, 2003-Ohio-2721, 789 N.E.2d 217, at ¶¶ 15–17. See Ben Hallman & Caitlin Ginley, *States Are Battleground in Drive to Regulate Lawsuit Funding*, CENTER FOR PUB. INTEGRITY, <http://www.publicintegrity.org/2011/02/02/2160/states-are-battleground-drive-regulate-lawsuit-funding> (last updated May 6, 2013, 4:16 PM).

¹⁶⁹ Maine Consumer Credit Code Legal Funding Practices, ME. REV. STAT. ANN. tit. 9-A, §§ 12-101 to -107 (2009); Nonrecourse Civil Litigation Act, NEB. REV. STAT. ANN. §§ 25-3301 to -3309 (West Supp. 2010); OHIO REV. CODE ANN. § 1349.55 (West Supp. 2013); see Lyon, *supra* note 26, at 575.

¹⁷⁰ Lyon, *supra* note 26, at 575 (“[T]hese statutes appear to apply primarily to loans in personal injury, rather than commercial, suits.”).

¹⁷¹ See ME. REV. STAT. ANN. tit. 9-A, § 12-104(2)–(7); NEB. REV. STAT. ANN. § 25-3303(1); OHIO REV. CODE ANN. § 1349.55(B)(1)–(6).

¹⁷² See ME. REV. STAT. ANN. tit. 9-A, § 12-104(2)–(3), (6); NEB. REV. STAT. ANN. § 25-3303(1)(a)–(b), (e); OHIO REV. CODE ANN. § 1349.55(B)(1)–(2), (5).

¹⁷³ See ME. REV. STAT. ANN. tit. 9-A, § 12-106; NEB. REV. STAT. ANN. § 25-3307.

may need to seek third-party litigation financing.¹⁷⁴ The Nebraska statute also prohibits third-party funders from accessing any information that would normally be privileged under the attorney–client relationship or making any decisions regarding the underlying civil action.¹⁷⁵ The enacted state statutes seek to minimize the ethical issues that have caused the propriety of third-party litigation financing contracts to be questioned¹⁷⁶ and attempt to make third-party litigation financing a more regulated and less issue-ridden industry.

Illinois, Kentucky, New York, and Texas have all tried to pass third-party financing laws similar to those that are in effect in Maine, Nebraska, and Ohio.¹⁷⁷ Some states’ efforts to enact these laws have been met with resistance from lobbyists for third-party litigation funders who do not want lawsuit funding to be controlled.¹⁷⁸ As a result Illinois, Kentucky, New York, and Texas have been unable to enact laws regulating third-party litigation financing.¹⁷⁹

B. Downfalls of the Enacted Legislation Regulating Third-Party Litigation Financing

The success of the laws enacted by Maine, Nebraska, and Ohio is questionable at best.¹⁸⁰ The enacted statutes and proposed bills are seen by many to only exacerbate a growing problem in which third-party litigation funders are now given a license to engage in deceptive and unfair business practices to seek high returns.¹⁸¹ The statutes and bills have been criticized for

¹⁷⁴ See NEB. REV. STAT. ANN. § 25-3304(1), (2).

¹⁷⁵ See *id.* § 25-3306.

¹⁷⁶ See GARBER, *supra* note 28, at 18–19 (citing various papers that critique third-party litigation financing for causing conflicts of interest between attorneys and their clients).

¹⁷⁷ See H.B. 412, 2011 Gen. Assemb., Reg. Sess. (Ky. 2011); see Hallman & Ginley, *supra* note 167 (discussing legislation in Illinois, New York, and Texas).

¹⁷⁸ See Hallman & Ginley, *supra* note 168.

¹⁷⁹ See *id.*; HB 412, KY. LEGISLATURE, <http://www.lrc.ky.gov/record/11rs/HB412.htm> (last visited Dec. 14, 2013) (providing legislative history of the Kentucky bill).

¹⁸⁰ Cf. Binyamin Applebaum, *Lawsuit Loans Add New Risk for the Injured*, N.Y. TIMES, Jan. 17, 2011, at A1 (“To fortify its position, the industry has started volunteering to be regulated—but on its own terms. The companies, and lawyers who support the industry, have lobbied state legislatures to establish rules like licensing and disclosure requirements, but also to make clear that some rules, like price caps, do not apply. Maine and Ohio passed the first such laws in 2008, followed by Nebraska . . .”).

¹⁸¹ See, e.g., Editorial, *Lawsuit Loan Sharks*, CHI. TRIB., Dec. 24, 2010, § 1, at 16 (suggesting that a proposed Illinois bill regulating third-party litigation financing, similar to those enacted in other states such as Maine, Nebraska, and Ohio, that provides consumer protection and requires certain disclosures in third-party funding contracts, “would give legal certainty to an abusive practice and put it under a light regulatory scheme where it can flourish—spawning lawsuits galore”).

failing to regulate third-party litigation financing because they only require third-party funders to (1) use boilerplate contract language and (2) obtain a state license to conduct their activities, making the funders appear legitimate.¹⁸²

Another inherent flaw in the enacted third-party litigation financing regulation is that there is no limit on the percentage of a judgment or settlement a funder can receive, nor is there a limit on the interest rate that the funder can charge on the invested funds.¹⁸³ This only encourages predatory business practices, as funders can contract for minimum recovery amounts in the millions and charge exorbitant interest rates on top of that.¹⁸⁴ The proposed legislation also fails to provide interest rate or judgment percentage recovery protections for consumers.¹⁸⁵ As a result, third-party litigation funders have an incentive to engage in misleading business tactics because they can charge extremely high interest rates on their investments, require a large percentage of the recovery from a successful underlying lawsuit to be paid to them, or both.¹⁸⁶ This creates large profits for investors but provides little protection for consumers.¹⁸⁷ There are also no legislative measures aimed at protecting defendants.¹⁸⁸ Overall, although the attempts by states to police the third-party litigation finance industry are a good starting point for regulation, they have had no significant effect on the majority of cases involving third-party litigation funders or the inefficiencies they cause.¹⁸⁹

¹⁸² See *id.*

¹⁸³ See Maine Consumer Credit Code Legal Funding Practices, ME. REV. STAT. ANN. tit. 9-A, §§ 12-101 to -107 (2009); Nonrecourse Civil Litigation Act, NEB. REV. STAT. ANN. §§ 25-3301 to -3309 (West Supp. 2010); OHIO REV. CODE ANN. § 1349.55 (West Supp. 2013); see also Applebaum, *supra* note 180 (“[Third-party litigation funding companies], and lawyers who support the industry, have lobbied state legislatures to establish rules like licensing and disclosure requirements, but also to make clear that some rules, like price caps, do not apply.”).

¹⁸⁴ See, e.g., Fisher, *supra* note 10 (“In Case 0409-C, Juridica reports, the jury returned a \$50 million verdict, good news for the firm since it only invested \$4.3 million and stands to gain the first \$3 million of any cash settlement plus 49% of the rest.”).

¹⁸⁵ See Hallman & Ginley, *supra* note 168 (stating that the focus of the industry and its allies has been to develop legislation that would “block caps on the interest rates the lenders can charge”); see also John O’Brien, *Ky. Lawsuit Lending Bill Irks Business Group*, LEGAL NEWSLINE (Feb. 25, 2011, 1:19 PM), <http://legalnewsline.com/news/231400-ky-lawsuit-lending-bill-irks-business-group> (noting that Bryan Sunderland, vice president of public affairs of the Kentucky Chamber of Commerce, stated that the proposed Kentucky bill did “nothing to cap the interest rates charged to customers”).

¹⁸⁶ See O’Brien, *supra* note 185.

¹⁸⁷ See *id.* (“Companies must charge these exorbitant rates to ensure a healthy profit, all the while consumers suffer.” (internal quotation marks omitted)).

¹⁸⁸ See *supra* note 170 and accompanying text.

¹⁸⁹ See *supra* Part III.B.

Current legislation regulating the third-party litigation finance industry is inadequate. This legislation needs to be expanded in order to make a significant difference in leveling the litigation playing field and protecting consumers. First, the regulatory scheme for third-party litigation financing must protect all parties who receive financing, regardless of whether they are commercial or individual plaintiffs. Second, safeguards must be added to protect defendants from the inefficiencies that result from third-party litigation financing.¹⁹⁰ Part V of this Comment will provide possible solutions to regulate the third-party litigation finance industry and address the effects of these proposed solutions.

V. PROPOSALS TO REGULATE THIRD-PARTY LITIGATION FINANCING

As discussed in Part IV, a few states have attempted to regulate the third-party litigation financing industry, but overall there is no comprehensive legal precedent for regulation.¹⁹¹ The states that have attempted to regulate third-party litigation financing have done so to protect consumers, but because these laws do not address commercial litigation,¹⁹² they have done little to regulate or affect the overall industry.¹⁹³ Historically, maintenance and champerty prohibited uninterested third parties from involving themselves in litigation, but, due to the doctrines' imbalanced application from one jurisdiction to the next, they are no longer enough to regulate third-party litigation financing.¹⁹⁴ A new comprehensive regulatory scheme needs to be adopted in order to balance the scales of justice between plaintiffs and defendants, especially in cases where third parties fund commercial litigation. This Part argues that this regulatory scheme should include (1) instituting caps on the recovery that financiers can receive (section A); (2) enacting registration and licensing requirements for third-party litigation funders (section B); and (3) extending the Maine, Nebraska, and Ohio framework to create two sets of regulations to govern all forms of third-party litigation financing (section C).

¹⁹⁰ See *supra* Part III.C (discussing the consequences of third-party litigation financing for defendants).

¹⁹¹ BEISNER ET AL., *supra* note 16, at 4.

¹⁹² Lyon, *supra* note 26, at 575.

¹⁹³ See BEISNER ET AL., *supra* note 16, at 3–4.

¹⁹⁴ See *supra* Part II.B.2 (discussing the problems with variation in jurisdictions' treatment of maintenance and champerty).

A. *Limiting the Recovery of Third-Party Litigation Funders*

To help rectify the inequities caused by third-party litigation financing, this section proposes two initial steps. First, with respect to third-party litigation financing agreements, the outdated and mostly meaningless doctrines of maintenance and champerty need to be abolished nationwide in order to allow for a new regulatory scheme to be enacted on a broad scale. Second, a strict cap on the percentage of a settlement or judgment that a third-party funder is allowed to receive needs to be enacted. Imposing caps would still allow for third-party financing investment, which increases access to justice,¹⁹⁵ but would reduce the possible return that a third-party funder could generate from financing litigation. These caps could be similar to caps that are imposed on contingency fee arrangements between plaintiffs and attorneys that are in effect in a few states, including California,¹⁹⁶ Connecticut,¹⁹⁷ and Florida.¹⁹⁸

A contingency fee arrangement is an alternative financing method for clients and attorneys where an attorney is entitled to share in a portion of the recovery from a successful lawsuit instead of collecting an hourly fee throughout the litigation.¹⁹⁹ The statutory caps limit the percentage of a judgment or settlement an attorney hired on a contingency fee basis can

¹⁹⁵ See Lyon, *supra* note 26, at 609.

¹⁹⁶ CAL. BUS. & PROF. CODE § 6146 (West 2003). California law limits attorneys' recovery under contingency fee arrangements to

- (1) Forty percent of the first fifty thousand dollars (\$50,000) recovered.
- (2) Thirty-three and one-third percent of the next fifty thousand dollars (\$50,000) recovered.
- (3) Twenty-five percent of the next five hundred thousand dollars (\$500,000) recovered.
- (4) Fifteen percent of any amount on which the recovery exceeds six hundred thousand dollars (\$600,000).

Id.

¹⁹⁷ CONN. GEN. STAT. ANN. § 52-251c (West 2013). Connecticut law limits attorneys' recovery under contingency fee arrangements to

- (1) Thirty-three and one-third per cent of the first three hundred thousand dollars; (2) twenty-five per cent of the next three hundred thousand dollars; (3) twenty per cent of the next three hundred thousand dollars; (4) fifteen per cent of the next three hundred thousand dollars; and (5) ten per cent of any amount which exceeds one million two hundred thousand dollars.

Id. § 52-251c(b).

¹⁹⁸ R. REGULATING FLA. BAR 4-1.5(f)(4)(B)(i) (limiting attorneys' recovery under contingency fee arrangements in tort litigation to different percentages based on whether the claim is settled before an answer is filed by the defendant, goes to a final judgment, or there is a trial solely to decide damages).

¹⁹⁹ See Richard M. Birnholz, Comment, *The Validity and Propriety of Contingent Fee Controls*, 37 UCLA L. REV. 949, 953 (1990).

receive.²⁰⁰ Overall contingency fee caps have increased access to justice²⁰¹ and deterred frivolous lawsuits by incentivizing attorneys to take on cases in which recovery (and payment to the attorney) is more likely.²⁰² These caps attempt to decrease the attorney's share of the compensation²⁰³ and have been found to cause attorneys to engage in more risk neutral behavior.²⁰⁴ This risk neutral behavior may result in attorneys taking fewer contingency fee cases because they may be unwilling to take cases where the expected outcome is not extremely favorable.²⁰⁵ Further, contingency fee caps have been found to lower the average settlement amount for two reasons: (1) attorneys invest less in these cases due to their limited recovery, and (2) there is less pressure on plaintiffs to seek higher settlements in order to ensure their recovery is advantageous to both the contingency fee attorney and the plaintiff.²⁰⁶

If statutory caps similar to those in existence for contingency fee attorneys were introduced for recoveries by third-party litigation financiers, the same overall effects would likely result. By limiting the contractual percentage of any potential recovery a third-party funder could receive, these caps would reduce the potential return on investment for funders. For example, applying the Connecticut contingency fee caps²⁰⁷ to the \$25 million settlement in the DeepNines case,²⁰⁸ the third-party funder would only have recovered \$2.66

²⁰⁰ See CAL. BUS. & PROF. CODE § 6146(a); CONN. GEN. STAT. ANN. § 52-251c(b); R. REGULATING FLA. BAR 4-1.5(f)(4)(B)(i).

²⁰¹ See Lester Brickman, *Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?*, 37 UCLA L. REV. 29, 38 (1989); see also Birnholz, *supra* note 199, at 953 (stating that contingency fee arrangements “make[] it possible for the poorest litigants to obtain legal representation”).

²⁰² Birnholz, *supra* note 199, at 978.

²⁰³ See *id.*

²⁰⁴ Michael Cristoforo, Note, *Medical-Malpractice Contingency-Fee Caps: A Big Victory for Florida's Voters and Tort Reformers? Maybe Not.*, 62 U. MIAMI L. REV. 913, 923–24 (2008).

²⁰⁵ See *id.* Cristoforo argues that contingency fee caps “reduce[] the opportunity for the attorney to diversify risk and consequently, cause[] the attorney to be less risk-seeking or neutral” because the lawyer receives a lower overall recovery from judgments. *Id.* at 924. Attorneys are then less able to take on cases that do not have a high probability of a beneficial outcome because the losses that might result from an unfavorable outcome cannot be made up in higher returns from the cases with probable beneficial outcomes. See *id.*

²⁰⁶ See *Litigation Abuse Reform Act of 1986: Hearing on S. 2038 and S. 2046 Before the S. Comm. on the Judiciary*, 99th Cong. 271 (1987) (statement of Patricia M. Danzon, Consultant, Institute for Civil Justice, The Rand Corporation) (concluding that, in one study, placing limits on the percentage recovery of contingency fee attorneys had the effect of lowering the average settlement by nine percent); Birnholz, *supra* note 199, at 978 (“If the attorney's percentage is smaller, a plaintiff will obtain the same net recovery from a lower overall settlement amount. . . . [This] eases the burdens on the court system by lessening the number of cases that must be tried.”).

²⁰⁷ CONN. GEN. STAT. ANN. § 52-251c(b) (West 2013).

²⁰⁸ See *supra* notes 6–9 and accompanying text.

million²⁰⁹ instead of the \$10.1 million it actually received from the settlement.²¹⁰ This would have allowed the plaintiff DeepNines to recover \$8.24 million after legal fees and payment to the third-party funder instead of the mere \$800,000 it actually recovered.²¹¹ The third-party funder in DeepNines invested \$8 million in the case and got a 126% return on its investment,²¹² but if these caps were in effect, the funder would have had to invest much less in order to see a positive return. These caps would effectively reduce the amount funders would be willing to invest because the potential recovery would be limited.

Additionally, third-party litigation funders would not be able to diversify risk as easily by taking on a multitude of cases because recovery would be limited in successful cases, making them less able to shoulder losses in riskier cases. Funders, in order to ensure high returns, could only take on the cases most likely to be successful and would have to limit their investment in these cases in order to reach their investment-return targets. This would also result in a reduction in the amount of litigation. Funders would no longer invest in riskier cases, and the cost and risk of pursuing these claims would likely bar many potential plaintiffs from filing lawsuits without third-party backing. Some commentators argue that limiting the recovery of third-party litigation funders could prevent them from investing in the riskiest and most extreme cases—the cases where plaintiffs have the least access to justice.²¹³ However, this argument fails because third-party litigation funders currently do not invest in these risky cases, as would be socially desirable; instead they invest in lawsuits that have the highest potential of success.²¹⁴

²⁰⁹ Based on the Connecticut cap, the third-party funder in the DeepNines case would receive 33⅓% of the first \$300,000 (\$100,000), 25% of the next \$300,000 (\$75,000), 20% of the next \$300,000 (\$60,000), 15% of the next \$300,000 (\$45,000), and then 10% of the remaining \$23.8 million (\$2.38 million), for a total of \$2.66 million. See CONN. GEN. STAT. ANN. § 52-251c(b).

²¹⁰ Rickard, *supra* note 6.

²¹¹ See *id.* This number is calculated by assuming the \$10.1 million recovered by the third-party litigation funder in the case would be reduced to \$2.66 million, the maximum recovery under the cap. The remaining \$7.44 million of that recovery that originally went to the third-party litigation funder would then be added to the plaintiff's original \$800,000 recovery in the case. See *id.* The portion of the \$25 million settlement not accounted for in this calculation had to be paid out in legal fees. See *id.*

²¹² See *id.*

²¹³ See, for example, Lyon, *supra* note 26, at 591–92, which argues that third-party funding will create a social good because “even if third-party funding is likely to produce more litigation, it is equally likely to . . . provide greater access to justice, which is a net benefit to society.”

²¹⁴ See Banzaca, *supra* note 32 (paraphrasing an interview with Kenneth W. Bradt, CEO of litigation financing firm CaseFunding/Attorney Financial Services, who stated that his firm “only funds cases that have a high likelihood of an appreciable award or settlement”); see also Abrams & Chen, *supra* note 15, at 14–15 (“Firms fund cases where the risk is small and where they estimate the probability of winning a successful

Similarly, neither of the two main criticisms of attorney contingency fee caps raises concerns in the third-party litigation financing context. First, contingency fee caps have been criticized for reducing the quality of legal services provided to clients because attorneys have no incentive to work hard when they cannot receive high contingency fee recoveries.²¹⁵ This criticism does not apply in the third-party litigation financing context because an attorney is not subject to third-party financing caps; therefore an attorney's incentive to render quality legal services is not reduced because the attorney is paid an hourly fee. Second, contingency fee caps have been criticized for restricting access to the legal system.²¹⁶ This criticism also seems inapplicable to third-party litigation financing because a majority of third-party litigation funders' investments are in patent infringement and antitrust lawsuits where access to justice is not a major issue.²¹⁷

In summary, introducing caps on the percentage of a judgment or settlement a third-party litigation funder can receive would reduce the inefficiencies that are created by third-party litigation financing. Plaintiffs would likely receive less funding from third-party funders, and cost barriers would prevent a considerable number of nonmeritorious lawsuits from being brought in the first place. This decrease in investment would reduce the risk imbalances that third-party funders create by providing endless financing to plaintiffs who might receive large damage awards. The pressure on plaintiffs to settle for large dollar amounts in order to ensure they are duly compensated would decrease because funders would have less invested in the underlying lawsuit. The overall result would be a more balanced litigation landscape where plaintiffs could receive third-party financing if needed, but the bargaining advantage in favor of plaintiffs would be drastically reduced.

judgment or settlement to be large. . . . [They] prefer cases that are likely to settle quickly since the longer and more complex a matter is, the greater their risk.”).

²¹⁵ Cristoforo, *supra* note 204, at 921, 925–26; *see also* Stephen J. Cotten & Rudy Santore, *Contingent Fee Caps, Screening, and the Quality of Legal Services*, 32 INT'L REV. L. & ECON. 317, 326 (2012) (“[E]ven seemingly innocuous restrictions on contingent fees, such as non-binding caps, can have significant behavioral effects. More importantly, these behavioral effects can decrease the quality of legal services and reduce client welfare.”); Eric Helland & Alexander Tabarok, *Contingency Fees, Settlement Delay, and Low-Quality Litigation: Empirical Evidence from Two Datasets*, 19 J.L. ECON. & ORG. 517, 540 (2003) (concluding that “when contingency fees are limited . . . a reduction in legal-quality” results).

²¹⁶ Cristoforo, *supra* note 204, at 921–23 (“[Contingency fee caps] only restrict access to the legal system for claimants with low-damage claims and for those with more risk involved in their claims.”); James K. Carroll et al., ABA, Report on Contingent Fees in Medical Malpractice Litigation 11 (Sept. 20, 2004) (draft report), available at <http://apps.americanbar.org/tips/contingent/MedMalReport092004DCW2.pdf>.

²¹⁷ *See* Shepherd, *supra* note 12, at 601.

B. *Enacting Registration Requirements for Third-Party Litigation Funders*

In addition to recovery caps, this Comment proposes that all third-party litigation funders must register and be licensed by a public regulatory agency.²¹⁸ This registration process would allow the regulatory agency to monitor the activity of third-party litigation funders and make sure that recovery caps are being honored. If any litigation funder is found in violation of the regulations, that funder would lose its license and no longer be able to legally invest in litigation claims.

By having each third-party litigation funder register, the public regulatory agency could create a database containing information about every third-party litigation funder, including its typical deal structure—the usual percentage of recovery the funder requires and any threshold recovery amount that must first go to the funder. This would provide plaintiffs seeking financing with data about potential funders. The licensing and registration requirement would also discourage deceptive funding practices and predatory funders²¹⁹ because this type of behavior would cause a third-party litigation funder to lose its license.

To succeed, this registration and licensing requirement would need to be a nationwide or collaborative effort by all states in order to create a substantially similar information disclosure procedure for third-party funders.²²⁰ If different states enact their own disclosure standards, there would be information asymmetry between the states, and third-party litigation financiers might only do business in states with more relaxed requirements that allow them to more easily take advantage of potential plaintiffs.²²¹ A nationwide or collaborative system would address these concerns and provide a more uniform disclosure standard nationwide.

²¹⁸ See generally Martin, *supra* note 48, at 115 (arguing for a licensing system for third-party litigation funders, and suggesting that “[t]he licensing system currently being created by the [National Association of Securities Dealers] for the [Conference of State Bank Supervisors] for the mortgage industry could serve as a model”).

²¹⁹ *Id.*

²²⁰ See *id.* at 97–98, 115 (suggesting a collaborative state effort to regulate the third-party litigation financing industry, much like the one in place to regulate the subprime mortgage industry).

²²¹ See, e.g., Julia H. McLaughlin, *Litigation Funding: Charting a Legal and Ethical Course*, 31 VT. L. REV. 615, 647–49 (2007) (discussing how different states’ treatment of ethical issues involved in third-party funding of individual consumer lawsuits has caused varying standards of acceptability for these types of agreements); Lyon, *supra* note 26, at 575 (“Laws governing third-party finance agreements appear to vary significantly from state to state.”).

C. *Extending Already-Enacted State Legislation Regulating Third-Party Litigation Financing*

The legislation that is in effect in Maine, Nebraska, and Ohio provides a great foundation to craft expansive legislation that would govern all types of third-party litigation investment.²²² Currently, these state requirements do not seem to be mandatory in commercial-litigation financing agreements.²²³ The state regulations are framed in the context of ethics and consumer protection²²⁴ and do not address the risk imbalances caused by third-party litigation financing addressed throughout this Comment.²²⁵ Broad regulations for third-party financing of commercial litigation based on existing state laws, as well as a separate set of standards for third-party financing of individual consumer lawsuits, should be enacted to protect overall consumer interests. These regulations should include (1) requirements that particular contractual language be included in agreements, (2) basic ethical standards to govern the agreements, and (3) information disclosure requirements for funders to create uniformity in litigation financing transactions within each subset of third-party litigation financing—consumer and commercial. These regulations would help plaintiffs seeking financing to choose the best litigation financing arrangement for them, because the regulations would require all funding contracts to disclose and explain relevant information and substantive contract terms.²²⁶

Incorporating other policies that are present in the enacted legislation into the new broadly applicable rules would provide further consumer protections. Beneficial consumer protections that should be enacted on a broad scale include (1) requiring the funder to maintain a surety bond or line of credit to ensure the financial viability of the financier; (2) prohibiting third-party funders' access to privileged information; and (3) barring third-party funders' ability to make any decisions regarding the underlying civil action.²²⁷ Making these regulations applicable in both the commercial- and consumer-litigation contexts would protect all plaintiffs utilizing third-party litigation financing.

²²² Maine Consumer Credit Code Legal Funding Practices, ME. REV. STAT. ANN. tit. 9-A, §§ 12-101 to -107 (2009); Nonrecourse Civil Litigation Act, NEB. REV. STAT. ANN. §§ 25-3301 to -3309 (West Supp. 2010); OHIO REV. CODE ANN. § 1349.55 (West Supp. 2013).

²²³ See Lyon, *supra* note 26, at 575.

²²⁴ See Loiseau et al., *supra* note 24, at 9.

²²⁵ See *supra* Part III (discussing the risk imbalances between plaintiffs and defendants).

²²⁶ See Martin, *supra* note 48, at 115–16 (“[Litigation] funding contracts should have to use plain, ordinary language with topics clearly divided and captioned.”).

²²⁷ See NEB. REV. STAT. ANN. §§ 25-3303(1)(c), -3306, -3307(2); OHIO REV. CODE ANN. § 1349.55(B)(3) (barring third-party funders from making litigation decisions).

The suggested requirements would demand compliance with uniform standards of disclosure and consumer dealing, while solving possible conflicts of interest issues.²²⁸ Combining these expanded regulations with the other suggestions in this Comment would achieve the goal of balancing the scales of justice for both plaintiffs and defendants by allowing plaintiffs to seek financing if necessary, but stop the use of this third-party investment to financially overwhelm defendants.

CONCLUSION

Third-party litigation financing in its purest form is designed to provide access to justice to those who have meritorious claims, but cannot afford to bring litigation on their own.²²⁹ In reality, third-party litigation financing has resulted in large investment firms financing commercial litigation and has created risk imbalances that favor plaintiffs. Plaintiffs can use the resources of deep-pocketed third-party litigation funders to pursue litigation they might not have been able to bring otherwise. These cases usually have required statutory damages that result in exorbitant damage awards or force defendants into inefficient settlements as a result of these distorted risk incentives.²³⁰

As third-party litigation financing becomes more prevalent in the United States, these inefficiencies will only be intensified if the status quo remains, resulting in the degradation of equity in the legal system. In order to rebalance the scales of justice between plaintiffs and defendants, third-party litigation financing must be overhauled in order to avoid inefficient outcomes and abuse of the legal system. Adapting the concept of contingency fee caps to third-party litigation financing and using the framework of enacted third-party litigation financing legislation in Maine, Nebraska, and Ohio, this Comment has argued for (1) instituting caps on the recovery that financiers can receive; (2) enacting registration and licensing requirements for third-party litigation funders; and (3) extending the Maine, Nebraska, and Ohio framework to create

²²⁸ These regulations could be similar to those for the Association of Litigation Funders in the United Kingdom, which has a code of conduct for its member funders that suggests capital requirements and restrictions on control of the lawsuit by the funder. *Key Aspects*, ASS'N LITIG. FUNDERS, <http://associationoflitigationfunders.com/code-of-conduct/key-aspects/> (last visited Oct. 28, 2013). This could be helpful in crafting binding legislation for litigation funders in the United States. The Association of Litigation Funders is a trade group and therefore has no authority or mechanism to bind funders to, or enforce, its code of conduct. *See Mission/Role*, ASS'N LITIG. FUNDERS, <http://associationoflitigationfunders.com/about-us/mission-role/> (last visited Oct. 28, 2013). The U.S. legislation would need to be binding on all funders.

²²⁹ *See* Shepherd, *supra* note 12, 596–97.

²³⁰ *See supra* Part III.

two sets of regulations to govern both commercial and consumer third-party litigation financing.

If adopted, the proposals in this Comment would limit third-party litigation funders' investment in litigation by reducing their returns, thereby reinstating many of the cost and risk deterrents plaintiffs face when filing a lawsuit.²³¹ The proposals would also create uniform disclosure standards to allow consumers to be informed about taking on third-party investment,²³² as well as extend consumer protections to apply in both the consumer and the commercial third-party litigation financing contexts.²³³

Overall, third-party litigation financing in the United States needs to be repaired in order to rebalance the scales of justice between plaintiffs and defendants and restore fairness in the American legal system.

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²³¹ See *supra* Part V.A.

²³² See *supra* Part V.B.

²³³ See *supra* Part V.C.

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