IDEAL VERSUS REALITY IN THIRD-PARTY LITIGATION FINANCING

JOANNA M. SHEPHERD[1]

ABSTRACT

Third-party financing of commercial litigation has grown considerably in the United States. Many legal scholars assert that third-party financing can reduce barriers to justice that result when risk-averse, financially constrained plaintiffs are pitted against risk-neutral, well-financed defendants. However, as I discuss in this article, third-party investors have little incentive to finance cases where plaintiffs face significant barriers to justice. In contrast, investors face the highest potential returns in the types of cases where the underlying substantive law creates risk and cost imbalances that advantage, not disadvantage, plaintiffs. Indeed, data from the investment decisions of the largest third-party financiers of U.S. litigation demonstrate that investors are financing many cases where the existing law favors plaintiffs. As a result, rather than improving access to justice, third-party financing is increasing inefficiency and threatening both the compensatory and deterrent functions of the legal system.

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1. INTRODUCTION

Third-party financing of commercial litigation has grown considerably in the United States in recent years. In these investment schemes, risk-tolerant investors have the opportunity to gamble on the outcome of commercial lawsuits. Many supporters assert that third-party financing can level the playing field between risk-averse, financially constrained plaintiffs and risk-neutral, well-financed defendants. However, as I discuss in this article, the largest third-party investors in U.S. litigation are generally not financing the types of cases where plaintiffs face significant barriers to justice. In contrast, they are investing in cases where the underlying substantive law creates cost and risk imbalances that generally favor plaintiffs. As a result, rather than improving access to justice, third-party financing is increasing inefficiency and threatening both the compensatory and deterrent functions of the legal system.

Third-party litigation financing is not an entirely new phenomenon in the United States; indeed certain forms have been in practice since the 1980s.[2] The cash-advance industry offers pre-settlement funding agreements that are loans of a few thousand dollars to personal injury victims while their lawsuits are pending.[3] In another form of third-party litigation financing, the syndicated lawsuit, plaintiffs directly solicit individual lenders to invest in claims and share proportionally in the recovery.[4] Both of these forms are nonrecourse loans because the plaintiff need only pay back the loan if the lawsuit succeeds.

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[2] Jason Lyon, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 574 (2010).

[3] Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns* RAND CORPORATION, at 12 (2010) *available at* http://www.rand.org/pubs/occasional_papers/OP306.html ("two industry leaders estimate the average sizes of their cash advances to be $1,750 and $4,500").

[4] Susan Lorde Martin, *Syndicated Lawsuits: Illegal Champerty or New Business Opportunity?*,

However, in recent years, a new breed of third-party litigation financing has evolved in the United States. Large litigation finance corporations now exist that provide capital in exchange for a share of the eventual recovery by a corporate plaintiff. Whereas the cash advance industry makes pre-settlement loans of a few thousand dollars in exchange for a share of recoveries that tend to peak in the low hundred thousands, the new litigation finance corporations routinely loan several million dollars in exchange for shares of recoveries that can be in the billion-dollar range.[5] Currently, six corporations are willing to invest in commercial lawsuits in the United States.[6] However, only two publicly-traded corporations exist primarily to invest in American commercial litigation, Juridica Investments and Burford Capital.[7] Both of these corporations manage investment funds of well over $100 million. Of the remaining four corporations, three are private companies that provide little information about their investments—ARCA Capital, Calunius Capital, and Juris Capital—and one is publicly-traded but invests primarily in litigation outside of the United States—IMF Ltd.[8] A handful of other corporations, investment banks, and hedge funds have recently formed litigation funding divisions to buy interests in commercial lawsuits.[9]

The legal status of third-party litigation finance in the United States is far from clear. For centuries, common law prohibited third-party financing by the doctrines of maintenance and champerty. Maintenance is the provision of support for a lawsuit to which one is not a party and champerty, a form of maintenance, involves acquiring an interest in the recovery from the lawsuit.[10] The current laws

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30 AM. BUS. L.J. 485, 498 (1992); Daniel C. Cox, *Lawsuit Syndication: An Investment Opportunity in Legal Grievances*, 35 ST. LOUIS U. L.J. 153, 154–59 (1990).

[5] Lyon, *supra* note 2 at 578.

[6] Garber, *supra* note 3 at 14-16.

[7] Lyon, *supra* note 5.

[8] Garber, *supra* note 3 at 15-16.

[9] Lyon, *supra* note 5.

[10] *See generally* 14 AM. JUR. 2D *Champerty and Maintenance* §§ 1-20 (1964 & Supp. 1994).

regarding maintenance and champerty vary across jurisdictions: twenty-seven states and the District of Columbia explicitly permit champerty, albeit with varying limitations, and sixteen of these states explicitly cite the investment by contract into a stranger's suit as a permissible form of maintenance.[11] Although no American court has yet considered the legality of third-party finance in commercial litigation, courts have split on whether pre-settlement funding agreements in personal injury litigation are legal and enforceable.[12]

Third-party litigation financing has substantial support from practitioners and legal scholars. The basis of their support is that third-party financing of litigation can reduce barriers to justice that result when risk-averse, financially-constrained plaintiffs are pitted against risk-neutral, well-financed defendants. By relieving a risk-averse plaintiff of much of the litigation risk, third-party financing can offset a risk-neutral defendant's bargaining advantage and level the playing field in negotiations. This would improve plaintiffs' compensation and promote deterrence that is more accurate.

However, the goal of third-party investors is not to improve access to justice for financially-constrained or risk-averse plaintiffs. Instead, third-party investors aspire only to maximize the returns from their investments in litigation. Moreover, the cases with the largest potential return are often the cases where the existing substantive law advantages, not disadvantages, the plaintiffs. As a result, many of the cases financed by third-party investors are the opposite of the types of cases where financing could improve access to justice for vulnerable

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[11] Garber, *supra* note 3 at 14-16.
[12] *See*, *e.g.*, Saladini v. Righellis, 687 N.E.2d 1224 (Mass. 1997) *and* Osprey v. Cabana, 532 S.E.2d 269 (S.C. 2000) (finding that litigation loans are legal). *But see* Rancman v. Interim Settlement Funding Corp., 789 N.E.2d 217, 219 (Ohio 2003) *and* Odell v. Legal Bucks, L.L.C., 665 S.E.2d 767 (N.C. Ct. App. 2008) (declining to enforce a litigation lending agreement).

plaintiffs. Thus, the reality of third-party financiers' investment strategy directly conflicts with the theoretical ideal of third-party financing.

Illustrating this conflict, Juridica regularly invests in patent infringement cases and price-fixing cases, and Burford Capital invests in multi-party litigation. The underlying substantive law in these types of cases creates cost and risk imbalances that generally favor plaintiffs. In patent infringement cases, defendants face exorbitant costs of defending claims, the possibility of preliminary injunctions, and the risk of significant losses at trial including treble damages, attorneys' fees, and permanent injunctions. Defendants in price-fixing cases also face the risk of exorbitant damages at trial due to the possibility of treble damages, attorneys' fees, joint-and-several liability rules that prohibit proportional liability, rules against contribution, and the potential for tolling of the statute of limitations. In class-actions, defendants face exposure to both catastrophic losses at trial when individual plaintiffs' claims are aggregated and exorbitant litigation expenses that can last for decades. The asymmetric costs and risks that defendants face in these cases result in significant imbalances in risk preferences that weaken the defendants' bargaining positions compared to plaintiffs.

By increasing the supply of funds available in these types of cases, third-party financing exacerbates existing cost and risk imbalances created by the underlying substantive law. Because third-party investors absorb much of the plaintiffs' risk in the cases they finance, they worsen the existing risk imbalances that already favor plaintiffs. Similarly, by financing much of the plaintiffs' litigation costs, third-party investors worsen existing cost imbalances that favor plaintiffs. These imbalances induce defendants to accept even less favorable settlements than they would have without third-party financing. Settlements that are systematically larger than expected trial outcomes or outcomes dictated by the underlying substantive law lead to overcompensation of some plaintiffs and overdeterrence of certain behaviors.

Thus, although third-party litigation finance has the potential to improve access to justice, it is instead increasing inefficiency. In Section 2, I discuss how third-party financing of litigation can correct certain distortions in justice that result when risk-averse, financially-constrained plaintiffs are pitted against risk-neutral, well-financed defendants. However, in Section 3, I explain that third-party financiers are not investing in the types of cases where plaintiffs face significant barriers to justice. Instead, they are investing in cases where the underlying substantive law generally favors plaintiffs. As a result, as I discuss in Section 4, rather than improving access to justice, third-party financing is increasing inefficiency and threatening both the compensatory and deterrent functions of the legal system. I conclude in Section 5.

2. THE IDEAL OF THIRD-PARTY FINANCING OF LITIGATION

Third-party litigation financing has numerous supporters among legal scholars. The basis of their support is the assumption that third-party financing removes barriers to justice resulting from plaintiffs' financial constraints and risk aversion. As a result, the supporters contend that third-party litigation financing will improve the efficiency of the legal system by increasing both the compensation of deserving plaintiffs and the deterrence of wrongful conduct.

Cost barriers represent a major barrier to justice in the U.S. legal system. Because litigation is costly, many plaintiffs with limited financial resources cannot afford to bring legal claims. When deserving plaintiffs do not bring they go uncompensated. Moreover, because the cost barriers result in undercompensation, they lower the expected cost of engaging in activities that pose a risk to low-wealth individuals. As a result, the cost barriers will results in suboptimal deterrence of wrongful behavior in activities in which low-wealth individuals engage.[13]

Plaintiffs' risk aversion is another barrier to justice in many situations. Risk-averse plaintiffs may not purse meritorious claims even when they can afford the legal fees.[14] The uncertain nature of legal proceedings and damage awards reduces the expected value of legal claims to risk-averse plaintiffs. If the expected value of an uncertain claim decreases below the expected cost of bringing the claim, a risk-averse plaintiff will choose not to bring an otherwise meritorious claim. As a result, deserving plaintiffs will go uncompensated and the tort law will not adequately deter wrongful conduct.

Moreover, even when the expected values are high enough to induce risk-averse plaintiffs to pursue uncertain claims, imbalances in risk preferences between plaintiffs and defendants can distort settlement incentives. Risk-averse plaintiffs will be willing to settle legal claims for lower amounts than risk-neutral plaintiffs will because the uncertainty of trial lowers the expected value of legal claims to risk-averse plaintiffs. As a result, risk-averse plaintiffs pitted against risk-neutral defendants will result in settlements that are lower than the mean expected damage awards (which equal the expected value of claims for risk-neutral plaintiffs).[15] Similarly, risk-neutral plaintiffs pitted against risk-averse defendants will result in settlements that are higher than the mean expected damage awards because the uncertainty of trial raises the cost of legal claims to

[13] *See, e.g.* Paul H. Rubin & Joanna Shepherd, *The Demographics of Tort Reform*, 4 REV. OF L. & ECON. 591 (2008) (finding that there is less deterrence of wrongful behavior directed towards lower income groups).
[14] David Abrams & Daniel L. Chen, A Market for Justice: The Effect of Litigation Funding on Legal Outcomes 3 (unpublished manuscript) (on file with author).
[15] *See* Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J. LEGAL STUD. 329, 329, 335-36 (1987); Robert Rhee, *Tort Arbitrage*, 60 FLA. L. REV. 146, 153-55 (2008); Alfred F. Conard, *The Economic Treatment of Automobile Injuries*, 63 MICH. L. REV. 279 (1964).

risk-averse defendants. Such settlements that systematically differ from trial expectations threaten the substantive law regime because tort law does not achieve its compensatory and deterrent goals when defendants pay damages that differ from what the substantive law obligates them to pay.[16]

Fortunately, legal arrangements have evolved which reduce the financial and risk barriers to justice and enable plaintiffs to pursue litigation that they would otherwise not pursue. For example, when attorneys take low-wealth plaintiffs' cases on contingency, they are removing cost barriers that could otherwise restrict low-wealth plaintiffs' access to justice. Similarly, contingency-fee attorneys that can diversify the risk inherent in litigation across many lawsuits will be less risk-averse than many individual plaintiffs will. As a result, contingency-fee arrangements enable risk-averse plaintiffs to bring cases that they would otherwise not bring, or reject low settlements that they would otherwise accept.

However, there are some situations when contingency-fee arrangements are not sufficient to provide access to justice for all deserving plaintiffs. For example, contingency-fee attorneys are often unwilling to represent low-wealth plaintiffs because the expected contingency fees do not cover the costs of litigating the cases. Oftentimes, the expected compensatory awards for low-wealth plaintiffs are low due to the low economic damages arising from modest incomes. As a result, the expected contingency fees will be too low to induce attorneys to take such cases on contingency.[17]

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[16] Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367 (2009).

[17] Troy L. Cady, *Note, Disadvantaging the Disadvantaged: The Discriminatory Effects of Punitive Damage Caps*, 25 HOFSTRA L. REV. 1005 (1997) ("Lawyers will become increasingly unwilling to represent plaintiffs in lawsuits that have little or no prospect of yielding adequate compensation for the large amount of time and money invested."); Rachel Zimmerman & Joseph T. Hallinan, As Malpractice Caps Spread, Lawyers Turn Away Some Cases, Wall St. J., Oct. 8, 2004, at A1

In other cases, litigation is so costly and risky that even attorneys that can spread risk and costs across numerous cases are unwilling to accept the cases on contingency. For example, major long term cases, such as large class actions, often have costs that run "into the millions of dollars" and often take "a decade or more" to resolve.[18] Although some of these cases are taken by large, well-capitalized law firms or consortiums of attorneys from different firms in order to spread the cost and risk of the cases, there is a limit to the amount of diversification that individual firms can achieve.[19] As a result, some plaintiffs will not bring meritorious cases, which results in undercompensation and underdeterrence.

In the situations when contingency fee arrangements fail to provide access to justice, third-party financing can allow the pursuit of meritorious claims that would plaintiffs would not otherwise file.[20] Third-parties that finance much of the

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("Caps on damages for pain and suffering ... [are] turning out to have the unpublicized effect of creating two tiers of malpractice victims... Lawyers are turning away cases involving victims that don't represent big economic losses - most notably retired people, children and housewives...."); Catherine M. Sharkey, *Unintended Consequences of Medical Malpractice Damage Caps*, 80 N.Y.U. L. REV. 391 (2005) (showing that awards for overall damages have stayed the same while economic damages have increased possibly because plaintiffs' lawyers have screened out women, minorities, and children who are less likely to receive high economic damages); Stephen Daniels & Joanne Martin, *The Texas Two-Step: Evidence on the Link Between Damage Caps and Access to the Civil Justice System*, 55 DEPAUL L. REV. 635, 661 (2006) (from an interview with a personal injury lawyers in Texas: tort reform has "essentially closed the courthouse door to the negligence that would kill a child, a housewife or an elderly person. [The reason is that] there are no medical expenses, no loss of earning capacity.").

[18] Sarah Northway, *Non-Traditional Class Action Financing and Traditional Rules of Ethics: Time for a Compromise*, 14 GEO. J. LEGAL ETHICS, 241, 247 (2000).

[19] Paul H. Rubin, *On the Efficiency of Increasing Litigation*, presented at the Third Party Financing of Litigation Roundtable, Searle Ctr., Northwestern Univ. Law Sch. (Sept. 2009), at 5-6, *available at* http://www.law.northwestern.edu/searlecenter/uploads/Rubin-ThirdPartyFinancingLitigation.pdf.

[20] For a discussion of whether third-party financing improves justice even in cases brought on contingency, see Max Schanzenbach & David Dana, *How would Third-Party Financing of Litigation Change the Face of American Tort Litigation? The Role of Agency Costs in the Attorney-Client Relationship"*, presented at the Third Party Financing of Litigation Roundtable, Searle Ctr., Northwestern Univ. Law Sch. (Sept. 2009), *available at* http://www.law.northwestern.edu/searlecenter/papers/Schanzenbach_Agency%20Costs.pdf.

expense of litigation reduce cost barriers to justice that financially-constrained plaintiffs may otherwise face. Third-parties that diversify their investment portfolio across numerous lawsuits can spread the risk of unfavorable judgments and allow plaintiffs to take a more risk-neutral approach to litigation decisions. This will reduce the occasions where plaintiffs' risk aversion leads them to accept settlements below the expected value. Thus, third-party litigation financing can result in both improved compensation and more accurate deterrence of wrongful behavior.

3. The Reality of Third-Party Financing of Litigation

Although third-party financing of litigation has the potential to improve access to justice, whether this goal is attained depends on the types of cases third-party investors choose to finance. If third-party financiers invest in cases brought by low-wealth plaintiffs, then the financing may remove cost barriers to justice. Similarly, if they invest in cases brought by risk-averse plaintiffs against risk-neutral defendants, then the financing may reduce distortions in justice resulting from imbalances in risk preferences.

However, the goal of third-party financiers is not to improve access to justice. Although improving justice may be a positive side effect of third-party financing, the financiers are ultimately investing in commercial litigation to maximize the expected returns on their investments. As a result, the types of cases that third-party investors finance often diverge from the types of cases where third-party financing can improve access to justice.

Emphasizing the return-maximizing goal over the justice-improving goal, Chris Bogart, CEO of Burford Capital, explains, "We're fundamentally a capital provider. We take a share of the ultimate recovery, having taken the risk of funding the case. Forget this being about the law or litigation - we're providing risk funding for an investment in the same way as in any other sector of the market. If the investment pays off we make a return on the capital we're investing."[21]

Similarly, Timothy Scranton, Director of Juridica Capital Management, a subsidiary of Juridica Investment that identifies potential investments, explains that Juridica's focus on U.S. litigation is purely profit driven: "Why is the U.S. legal industry so large and attractive to claim investors? Some of the influences include the role of the jury trial in civil cases and the substantial awards that plaintiffs can recover. In some cases, special damages, such as treble and punitive damages, make claims a potentially profitable asset. Likewise, special litigation regimes (such as class actions) allow the aggregation of potentially thousands of low-value claims and present another opportunity to create value."[22]

Unfortunately, third-party financiers seeking to maximize investment returns have little incentive to finance cases where plaintiffs face significant barriers to justice. In contrast, investors face the highest potential returns in the types of cases where the underlying substantive law creates risk and cost imbalances that favor plaintiffs. In these cases, defendants often agree to inefficiently large settlements to avoid the risk of disastrous losses at trial.

Indeed, data from the investment decisions of one of the largest third-party financiers of U.S. litigation demonstrates that investors are financing many cases where the existing law favors plaintiffs. Juridica currently has $134 million

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[21] Matt Byrne, *World's largest dispute financier' targets US litigation market uptick*, THE LAWYER (Nov. 29, 2010), http://www.thelawyer.com/%E2%80%98world%E2%80%99s-largest-dispute-financier%E2%80%99-targets-us-litigation-market-uptick/1006248.article.

[22] Geoffrey McGovern, Neil Rickman, Joseph W. Doherty, Fred Kipperman, Jamie Morikawa & Kate Giglio, *Third-Party Litigation Funding and Claim Transfer: Trends and Implications for the Civil Justice System*, RAND CORPORATION at 11 (2010) *available at* http://www.rand.org/pubs/conf_proceedings/CF272 (summarizing remarks of Timothy D. Scrantom).

invested in 25 cases.[23] Over 60 percent of this total is invested in antitrust price-fixing cases, while another 28 percent is invested in patent infringement cases.[24] The remaining 12 percent of the total is invested in various statutory claims, property damage claims, contract claims, and arbitration.[25]

Although Burford has not reported the exact allocation of its investment capital, CEO Bogart has said, "Burford's focus will be on cases with big potential rewards. These could include patent thefts, antitrust proceedings or corporate torts."[26] Burford has also invested in a multi-party lawsuit brought by 30,000 plaintiffs in Ecuador who accuse Texaco, bought by Chevron in 2001, of damaging the forest and their health.[27]

Although data on investment in U.S. litigation is currently only available for Juridica Investments, the investment strategies are likely similar for other third-party financiers of commercial litigation. Third-party financiers have little incentive to invest in cases where plaintiffs face significant barriers to justice. In contrast, as I discuss in the next section, investors face the highest potential returns in the types of cases where the underlying substantive law creates risk and cost imbalances that advantage, not disadvantage, plaintiffs.

A. PATENT INFRINGEMENT LITIGATION

The U.S. patent system was created to encourage innovation by granting property rights in intellectual property. These property rights are protected

[23] *The Fund* (May 6, 2011), JURIDICA, *available at* http://www.juridicainvestments.com/about-juridica/the-fund.aspx.
[24] *Id.*
[25] *Id.*
[26] Jason Douglas, DOW JONES NEWSWIRES, *UPDATE: Burford Capital Raises GBP80 Million In 5th AIM Float Of '09*, Dow (Oct. 16, 2009), *available at* http://www.advfn.com/news_UPDATE-Burford-Capital-Raises-GBP80-Million-In-5th-AIM-Float-Of-09_39926053.html.
[27] Braden Reddall, *Chevron-Ecuador case only at beginning of the end*, REUTERS, (Feb. 15, 2011) *available at* http://www.reuters.com/article/2011/02/15/us-ecuador-chevron-analysis-idUSTRE71D7IJ20110215.

through patent infringement litigation. However, characteristics of patent infringement litigation and much of the applicable substantive law creates cost and risk imbalances that favor plaintiffs. These imbalances strengthen the bargaining power of plaintiffs relative to defendants, resulting in settlements that often diverge from expected trial outcomes. As a result, legal scholars argue that many patent infringement cases are opportunistic, initiated not to protect property rights but to bully quick settlement agreements out of defendants.[28] Below, I briefly discuss the characteristics of patent infringement suits that can lead to cost and risk imbalances.

First, defending patent infringement claims is very costly. For patent suits with $1 million at risk, the median estimated total litigation cost was $650,000 in 2005; for suits with $1-$25 million at risk, the median estimated total litigation cost was $2 million; for suits with more than $25 million at risk, the median estimated total litigation cost is $4.5 million.[29] These costs are typically unequally borne by defendants. Defendants usually have higher discovery burdens than plaintiffs; plaintiffs often have few documents beyond the patent and prosecution history.[30] Moreover, patents are presumptively valid as a matter of law, which requires the defendant to prove that the patent is invalid by a standard of clear and convincing evidence, whereas the plaintiff must only prove infringement by a standard of preponderance of the evidence.[31]

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[28] *See, e.g.* Michael J. Meurer, *Controlling Opportunistic and Anti-Competitive Intellectual Property Litigation*, 44 B.C. L. REV 509 (2003).
[29] AM. INTELL. PROP. LAW ASS'N (AIPLA), REPORT OF THE ECONOMIC SURVEY 22-23 (2005); James Bessen & Michael J. Meurer, *Lessons for Patent Policy from Empirical Research on Patent Litigation*, 9 LEWIS & CLARK L. REV. 1, 2 (2005).
[30] Christopher 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).
[31] *See, e.g. id.* at 437; SRAM Corp. v. AD-II Eng'g, Inc., 465 F.3d 1351, 1357 (Fed. Cir. 2006) (explaining that the presumption of invalidity "can be overcome only through facts supported by clear and convincing evidence"); Cross Med. Prods., Inc. v. Medtronic Sofamor Danek, Inc., 424 F.3d 1293, 1310 (Fed. Cir. 2005) ("To prove direct infringement, the plaintiff must establish by a

Second, plaintiffs can obtain preliminary injunctions against the defendants' accused infringing products. Despite the restrictive standard that generally applies to preliminary injunctions, they are relatively common in patent infringement cases.[32] Preliminary injunctions on major product lines for the duration of litigation can impose significant financial burdens on defendant firms. There is no analogous financial risk for many plaintiffs in patent infringement cases.

Third, the defendants' potential losses at trial are significant. If found infringing, then the defendant may have to pay an established or reasonable royalty to the plaintiff.[33] If the defendant has substantial past sales and established profits, this royalty can be substantial. Moreover, if found willfully infringing, the defendant may have to pay treble damages and attorneys' fees.[34] In addition, the court may issue a permanent injunction to stop all future sales of the allegedly infringing product.[35] The uncertainty inherent in patent infringement cases increases the risk of these potential losses, even for defendants that believe the evidence shows they are not infringing.[36]

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preponderance of the evidence that one or more claims of the patent read on the accused device literally or under the doctrine of equivalents."); Warner-Lambert Co. v. Teva Pharm. USA, Inc., 418 F.3d 1326, 1341 n.15 (Fed. Cir. 2005) (stating that preponderance of the evidence "simply requires proving that infringement was more likely than not to have occurred.").

[32] *See* Jean O. Lanjouw & Josh Lerner, *Tilting the Table? The Predatory Use of Preliminary Injunctions*, 44 J.L. & ECON. 573, 595 (2001)*;* John G. Mills, *The Developing Standard for Irreparable Harm in Preliminary Injunctions to Prevent Patent Infringement*, 81 J. PAT. & TRADEMARK OFF. SOC'Y 51, 55-56 (1999).

[33] *See, e.g.* J.P. Mello, *Technology Licensing and Patent Trolls*, 12 B.U. J. SCI. & TECH. L. 388, 392-393 (2006).

[34] 35 U.S.C. § 284 (1999) (A "court may increase the damages up to three times the amount found or assessed."); 35 U.S.C. § 285 (1952) ("The court in exceptional cases may award reasonable attorney fees to the prevailing party.").

[35] *See, e.g.* Mello, *supra* note 42 at 393.

[36] Michael J. Meurer, *Controlling Opportunistic and Anti-Competitive Intellectual Property Litigation*, 44 B.C. L. REV. 509, 512-513 (2003).

The asymmetric costs of litigation, the risk of preliminary injunctions, and the potential losses at trial result in significant cost and risk imbalances in patent infringement cases. These imbalances weaken the defendants' bargaining position compared to plaintiffs, and often result in defendants settling claims at levels above which the substantive law would otherwise obligate.

Juridica has allocated 28 percent of its $134 million investment fund to patent infringement cases.[37] Similarly, the CEO of Burford Capital has indicated that they may also focus investment in patent infringement cases.[38]

Moreover, recognizing the significant profit potential in patent infringement litigation, Juridica has recently branched out to add direct investment in patents to its investment portfolio—a job description commonly referred to as a "patent troll":

> During 2008, we identified multiple opportunities to acquire patents outright for litigation. It also became evident that the cost of patent litigation was often significantly higher than the purchase price of a patent or portfolio of related patents. In addition, we identified multiple law firms that are willing to take the best of these cases on pure contingency fee basis and carry risk of the litigation, occasionally including the cost of experts and third party disbursements. We also identified market participants that have been successful in monetising patents by settlement prior to litigation through licensing programs. We organised Turtle Bay Technologies Limited ("TBT") in December of 2008 as a wholly owned subsidiary of JCML to take advantage of these market characteristics. TBT gives JIL an opportunity to fund the purchase price of patent assets

[37] *Id.*
[38] Douglas, *supra* note 35.

for significantly less than the cost of litigation and to retain a much larger equity stake in the outcome of litigation or settlement activities for less money. In addition, by purchasing patents outright or the majority equity stake in a patent and using law firms that assist in settlement or prosecute litigation on a pure contingency fee basis, these particular investments have a much lower risk profile. In 2009, we expect to make further investments in patents through TBT. These investments will be structured so that 100% of investment returns are paid to JIL under a funding agreement.[39]

"Patent troll", a pejorative term, was originally coined to describe "somebody who tries to make a lot of money off a patent that they are not practicing and have no intention of practicing and in most cases never practiced."[40]

Litigation brought by patent trolls suffers from all of the previously-mentioned problems that weaken defendants' bargaining position relative to plaintiffs in patent infringement cases—asymmetric costs of litigation, the risk of preliminary injunctions, and the potential for substantial losses at trial. However, patent troll litigation exacerbates the imbalance in bargaining positions because the patent troll is immune from counterclaims that can level the playing field in patent infringement cases. In some patent infringement cases between two similarly-situated competitors, the plaintiff faces the risk that the defendant will file a counterclaim, asserting that the plaintiff is infringing on a patent held by the defendant.[41] The threat of this counterclaim serves to reduce the imbalance in risk

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[39] *Limited Annual Report & Accounts 2008*, JURIDICA INVESTMENTS at 10 (2008), *available at* http://www.juridicainvestments.com/~/media/Files/J/Juridica/pdfs/2008_Annual_Report.pdf.
[40] Lisa Lerer, *Mind Games*, IP LAW & BUSINESS, May 2006, at 5, *available at* http://www.intven.com/docs/02505060001IntVen.pdf.
[41] *See* Patent Reform Act of 2005, H.R. 2795, 109th Cong. (2005).

aversion between plaintiffs and defendants. In contrast, because patent trolls do not manufacture any products, the defendant cannot counterclaim to reduce the imbalance in risk aversion and bargaining position.[42] As a result, patent trolls are often successful in bullying a quick settlement from an otherwise innocent defendant.[43]

B. PRICE-FIXING CASES

The underlying substantive law also imposes asymmetric costs and risks on defendants in price-fixing cases. As a result, defendants often agree to unfavorable settlement terms to avoid the risk of disastrous losses.

First, the potential damages defendants face if found liable of price fixing are substantial. Measured by the entire cartel's overcharge, damages often exceed $1 billion.[44] Moreover, under section four of the Clayton Act, the court automatically trebles judgments in price-fixing cases.[45] Such exorbitant damage awards have the potential to cripple many firms.[46] In addition, victorious plaintiffs in price-fixing cases are entitled to recover reasonable attorneys' fees from liable defendants.[47] In contrast, absent a finding of misconduct on the part of the

[42] Mello, *supra* note 42 at 394-395.
[43] Harkins, *supra* note 39 at 448.
[44] *See Antitrust Damage Allocation: Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 97th Cong., 141 (1981-82) (prepared statement of Robert P. Taylor, Attorney, Pillsbury, Madison & Sutro); *In re* Visa Check/Mastermoney Antitrust Litig., 297 F. Supp. 2d 503, 507 (E.D.N.Y. 2003) ($3.4 billion settlement).
[45] 15 U.S.C. § 15(a) (2006).
[46] *See* Edward D. Cavanagh, *Contribution, Claim Reduction, and Individual Treble Damage Responsibility: Which Path to Reform of Antitrust Remedies?*, 40 VAND. L. REV. 1277, 1283 (1987)
[47] 15 U.S.C. § 15 (1982).

plaintiff,[48] successful defendants in price-fixing cases are not entitled to attorneys' fees.

Second, defendants in price-fixing cases are jointly and severally liable to plaintiffs.[49] Thus, each price-fixing firm is potentially liable for the overcharges on all if its co-conspirators' sales. Moreover, because plaintiffs may sue one, some, or all of the alleged price-fixing firms, the court may saddle one firm with the entire damage award. As a result, a deep-pocket defendant who was only marginally involved in the price-fixing conspiracy or reaped only minor benefits can be accountable for the trebled value of the cartel's total overcharges.[50]

To make matters worse, a liable defendant in a price-fixing case has no right to contribution from its co-conspirators.[51] 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. This serves to magnify the potential damage exposure of an individual defendant in a price-fixing case.

[48] Sanctions imposed pursuant to Federal Rule of Civil Procedure 11 for filing frivolous claims frequently involve the award of attorneys' fees to the prevailing defendant. *See* Oliveri v. Thompson, 803 F.2d 1265, 1271 (2d Cir. 1986) (stating that "sanctions for misconduct and abuse of the legal system seem to be inevitably interwoven with the problems of shifting the burden of attorneys' fees, which have become the primary cost factor in litigation"). Attorneys' fees also may be shifted pursuant to 28 U.S.C. § 1927 if an attorney multiplies the proceedings "unreasonably and vexatiously." Finally, courts may shift fees pursuant to the court's inherent equitable power if plaintiff files or maintains the action in bad faith. Roadway Express, Inc. v. Piper, 447 U.S. 752, 765-66 (1980).

[49] Perma Life Mufflers, Inc. v. Int'l Parts Corp., 392 U.S. 134, 144 (1968) (White, J., concurring) ("Damages normally may be had from either or both defendants without regard to their relative responsibility for originating the combination or their different roles in effectuating its ends."); Wilson P. Abraham Constr. Corp. v. Tex. Indus., Inc., 604 F.2d 897, 904 n.15 (5th Cir. 1979), *aff'd sub nom.* Texas Indus., Inc. v. Radcliff Materials, Inc., 451 U.S. 630 (1981); Wainwright v. Kraftco Corp., 58 F.R.D. 9, 11 (N.D. Ga. 1973) ("It is well settled that an antitrust action is a tort action and that in multi-defendant antitrust actions the co-conspirator joint tortfeasors are jointly and severally liable for the entire amount of damages caused by their acts." (citations omitted)).

[50] Christopher R. Leslie, *Judgment-Sharing Agreements*, 58 DUKE L.J. 747, 752 (2009).

[51] United States v. Atl. Research Corp., 127 S. Ct. 2331, 2337-38 (2007) ("Contribution is defined as the "tortfeasor's right to collect from others responsible for the same tort after the tortfeasor has paid more than his or her proportionate share, the shares being determined as a percentage of fault.'" (quoting Black's Law Dictionary 353 (8th ed. 1999))).

Moreover, even when plaintiffs sue several of the alleged co-conspirators, an early settlement from one firm leaves the remaining defendants at risk of paying a portion of the damages inflicted by the settling party. Although the remaining defendants receive a credit for any settlement, the settlement is subtracted from the treble damages award, rather than the amount of actual damages.[52] As a result, the remaining defendants risk liability for the trebled-damage component of the settling defendant's overcharges.[53]

Third, the statute of limitations may toll upon a finding of fraudulent concealment on the part of the defendant.[54] As a result, damages may go back much farther than antitrust law's four-year statute of limitation would otherwise imply.[55] Once again, this serves to increase the risk of a substantial damage award if a defendant proceeds to trial.

The combination of these factors in price-fixing cases creates potentially staggering exposure for defendants, and, in turn, gives plaintiffs significant

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[52] Burlington Indus. v. Milliken & Co., 690 F.2d 380, 391 (4th Cir. 1982); Flintkote Co. v. Lysfjord, 246 F.2d 368, 398 (9th Cir. 1957); A.B.A. ANTITRUST SECTION, MONOGRAPH NO. 11, CONTRIBUTION AND CLAIM REDUCTION IN ANTITRUST LITIGATION 5 (1986); *see also* Donald J. Polden & E. Thomas Sullivan, *Contribution and Claim Reduction in Antitrust Litigation: A Legislative Analysis*, 20 HARV. J. ON LEGIS. 397, 402-03 (1983) (discussing Burlington Industries).

[53] *See* A.B.A. ANTITRUST SECTION, MONOGRAPH NO. 13, TREBLE-DAMAGES REMEDY 15 (1986) ("Settling defendants rarely pay treble the overcharge resulting from their sales. Therefore, settlements have the potential of leaving the last co-conspirator in a suit liable for damages enormously greater than the overcharge caused by its sales pursuant to the conspiracy."); Paula A. Hutchinson, Note, *A Case Against Contribution in Antitrust*, 58 TEX. L. REV. 961, 980 (1980) ("The nonsettling defendants bear the risk that the plaintiff will settle with another defendant for less than the amount of damages directly attributable to it.").

[54] *See* 15 U.S.C. § 15b; *see also, e.g., In re* Vitamins Antitrust Litig., No. MISC 99-197(TFH), 2000 WL 1475705, at *2-3 (D.D.C. May 9, 2000) (explaining that the plaintiffs' case survived a motion to dismiss in which fraudulent concealment tolled the statute of limitations, extending the period for which recovery was available); *In re* Catfish Antitrust Litig., 826 F. Supp. 1019, 1029 (N.D. Miss. 1993) ("Fraudulent concealment tolls the Clayton Act's statute of limitations.").

[55] 15 U.S.C. § 16(a) (1982). The normal statute of limitations in private actions is four years. 15 U.S.C. § 15(b). Nevertheless, the statute for private actions is tolled during the pendency of a government action, and to bring a suit, private plaintiffs must file within one year following the termination of a prior government proceeding

bargaining power in settlement negotiations. The resulting cost and risk imbalances have the potential to lead to inefficient case outcomes as defendants agree to unfavorable settlement terms in order to avoid the risk of catastrophic judgments.

Juridica has allocated over 60 percent of its investment fund to price-fixing cases,[56] and Burford has indicated that it plans to focus its investment in these cases.[57] In fact, in its 2008 Annual Report, Juridica recognized that many of the factors in price-fixing cases that create imbalances in risk aversion and bargaining power make these cases particularly attractive investment possibilities:

> 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.[58]

C. MULTI-PARTY LITIGATION

Third-party financing in multi-party litigation may increase access to justice if the cases are too costly or risky for contingency-fee attorneys or

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[56] *The Fund* (May 6, 2011), JURIDICA, *available at* http://www.juridicainvestments.com/about-juridica/the-fund.aspx.
[57] Douglas, *supra* note 35.
[58] *Limited Annual Report & Accounts 2008,* JURIDICA INVESTMENTS at 9 (2008), *available at* http://www.juridicainvestments.com/~/media/Files/J/Juridica/pdfs/2008_Annual_Report.pdf.

consortiums of attorneys to otherwise take the cases. However, multi-party cases such as class actions or mass tort litigation also have the potential to create an even stronger imbalance between plaintiffs and defendants than either patent infringement or price-fixing cases. Because these multi-party cases expose defendants to endless litigation and potentially ruinous judgments at trial, defendants are under enormous pressure to accept inefficient settlements that do not reflect the merits of the case or the obligations dictated by the substantive law.

By aggregating the claims of numerous plaintiffs, multi-party cases expose corporate defendants to enormous losses a trial. Even *de minimis* individual damage claims multiply at the class level into massive sums of money.[59] Whereas individual trials rarely pose a solvency threat, a multi-party claim with even a remote risk of financial ruin triggers defendants' risk-aversion and motivates them to settle claims for more than their expected value. [60]

Moreover, corporate defendants fear debilitating and expensive litigation defending against even weak multi-party suits. Defending against these suits can easily cost tens-of-millions of dollars *annually*¸ and the suits can drag on for decades.[61] To avoid the "gargantuan scale" of discovery and endless litigation, defendants often choose to settle early to avoid the exorbitant costs. [62]

Thus, many defendants have no choice but to settle to avoid company-threatening trial verdicts and preserve economic value for innocent shareholders.[63] Legal scholars and jurists have recognized that the cost and risk imbalances in multi-party litigation often lead to inefficient outcomes. Judge Friendly, the

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[59] *See* HENRY J. FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 120 (1973).
[60] Charles Silver, "*We're Scared to Death": Class Certification and Blackmail*, 78 N.Y.U. L. REV. 1357, 1370 (2003).
[61] Mark Herrmann, *From Saccharin to Breast Implants: Mass Torts, Then and Now*, 26 LITIG. 50, 52 (1999).
[62] Silver, *supra* note 69 at 1362.
[63] *Id.*

revered Second Circuit jurist, claimed that class actions are "blackmail" because the defendants' only choice is to settle or face economic ruin.[64] Judge Posner has recognized the "the sheer magnitude of the risk" facing class-action defendants and argues that defendants are "forced by fear of the risk of bankruptcy to settle even if they have no legal liability."[65] Similarly, Judge Easterbrook claims that class-action settlements "reflect the risk of a catastrophic judgment as much as, if not more than, the actual merit of the claims."[66]

In fact, it is the defendants' vulnerable position in multi-party litigation that makes these cases particularly attractive to third-party financiers. The potential return on investment is high in cases where defendants are under enormous pressure to settle cases in order to avoid endless litigation and potentially ruinous judgments at trial. Although, Juridica has refused to invest in class action lawsuits, Burford has recently invested millions in a large multi-party case.[67] Other third-party financiers also have strong incentives to invest in these cases where defendants are particularly vulnerable.

Unfortunately, inefficient settlement outcomes result in overdeterrence while often doing little to compensate victims; many multi-party cases result in millions of dollars of attorneys' fees, but only small amounts of compensation for plaintiffs.[68]

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[64] Friendly, *supra* note 68.
[65] *In re* Rhone-Poulenc Rorer Inc., 51 F.3d 1293, 1299 (7th Cir. 1995).
[66] *In re* Bridgestone/Firestone, Inc., 288 F.3d 1012, 1016 (7th Cir. 2002).
[67] Reddall, *supra* note 35.
[68] Deborah R. Hensler et al., *Class Action Dilemmas: Pursuing Public Goals for Private Gain*, RAND INSTITUTE FOR CIVIL JUSTICE at 83 (2000), *available at* www.rand.org/publications/MR/MR969; To some observers, it seems inappropriate in most, if not all, circumstances for the plaintiff attorneys to pocket more in fees than the class members receive in the aggregate. Moreover, when--as in the case in small damage class actions--the attorneys pocket much more than any one individual class member receives because of the suit, many feel that it is a clear indication that something has gone awry in the process.

4. Consequences of Third-Party Financing

The underlying substantive law in patent infringement and price-fixing cases and the practical reality of multi-party litigation create cost and risk imbalances that generally favor plaintiffs. In fact, it is the relatively strong bargaining position of plaintiffs that makes these cases particularly attractive from a third-party investors' perspective. Risk-averse defendants facing catastrophic trial judgments are eager to settle cases for amounts well above the expected damages at trial, increasing both the certainty and magnitude of third-party investors' returns. Moreover, even if cases fail to settle and proceed to trial, potential damages are significant and often trebled, increasing the expected return for third-party investors. As a result, many 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.

By increasing the supply of funds available in these types of cases, third-party financing exacerbates existing cost and risk imbalances created by the underlying substantive law. Because third-party investors absorb much of the plaintiffs' risk in the cases they finance, they worsen the existing risk imbalances that already favor plaintiffs. Similarly, by financing much of the plaintiffs' litigation costs, third-party investors worsen existing cost imbalances that favor plaintiffs. These imbalances induce defendants to accept even less favorable settlements than they would have without third-party financing, leading to more inefficient outcomes. As James E. Tyrrell, Regional Managing Partner of Patton Boggs LLP and outside counsel to Burford Capital, has pointed out, the "abundance of funds now available to plaintiffs may have 'tipped the funding scales' toward plaintiffs, creating an imbalance of resources" creating "some concern about access to justice" for defendants.[69]

Thus, instead of improving access to justice, third-party financing has the potential to lead to inefficient outcomes in many cases. Settlements that are systematically larger than expected trial outcomes otherwise dictated by the substantive law lead to overcompensation of some plaintiffs and overdeterrence of certain behaviors. Although overcompensation of a particular plaintiff is merely a distributional effect, prolonged overcompensation leads to overdeterrence—wasteful, inefficient defensive actions by potential defendants that fail to provide significant social benefits. Moreover, these welfare losses will be intensified if, as many scholars argue, third-party financing increases litigation.[70] An increase in litigation magnifies the underlying nature of the legal system.[71] Thus, an increase in litigation among the types of cases where cost and risk imbalances lead to inefficient case outcomes will magnify these inefficiencies.

5. CONCLUSION

Legal scholars have recognized that third-party financing of litigation can correct certain distortions in justice that result when risk-averse, financially constrained plaintiffs are pitted against risk-neutral, well-financed defendants. By relieving a risk-averse plaintiff of much of the litigation risk, third-party financing can offset a risk-neutral defendant's bargaining advantage and level the playing

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[69] McGovern, Rickman, Doherty, Kipperman, Morikawa & Giglio, *supra* note 31 at 9. (summarizing remarks of James E. Tyrrell)
[70] Paul H. Rubin, *supra* note 19.
[71] Jeremy Kidd & Todd Zywicki, Does Increased Litigation Increase Justice in a Second-Best World? (February 15, 2011). THE AMERICAN ILLNESS, Frank Buckley, ed., Yale University Press, Forthcoming; George Mason Law & Economics Research Paper No. 11-09. Available at SSRN: http://ssrn.com/abstract=1762160

field in negotiations. This would improve plaintiffs' compensation and promote more accurate deterrence.

However, third-party investors have little incentive to finance cases where plaintiffs face significant barriers to justice. In contrast, investors face the highest potential returns in the types of cases where the underlying substantive law creates risk and cost imbalances that advantage, not disadvantage, plaintiffs. Indeed, the largest third-party financiers of U.S. litigation are currently financing many cases where the existing law favors plaintiffs—patent infringement cases, price-fixing cases, and class actions.

Moreover, by absorbing much of the plaintiffs' litigation risk and steering significant resources into the litigation, third-party financing exacerbates existing cost and risk imbalances that favor plaintiffs. This intensifies the settlement pressure on defendants, causing them to agree to inefficient settlements that do not reflect the merits of the case or the obligations of the substantive law.

Thus, although third-party litigation financing has the potential to improve access to justice, it is instead leading to inefficient case outcomes. Unless steps are taken to change the nature of third-party financing, it will continue to threaten the compensatory and deterrent goals of our legal system.