

## IDEAL VERSUS REALITY IN THIRD-PARTY LITIGATION FINANCING

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### 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, the two largest third-party investors in U.S. litigation are not investing in the types of cases where third-party financing can improve access to justice. Instead, they are distorting justice in the cases they finance by exacerbating existing imbalances in risk preferences and bargaining positions that disfavor defendants. Thus, as currently practiced, third-party financing of U.S. commercial litigation threatens 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, third-party financiers are not investing in the types of cases where third-party financing can improve access to justice. Instead, they are distorting justice in the cases they finance by exacerbating existing imbalances in risk preferences and bargaining positions that disfavor defendants. These distortions reduce social welfare by leading to overcompensation of some plaintiffs and overdeterrence of certain behaviors.

Third-party litigation financing is not an entirely new phenomenon in the United States; indeed certain forms have been in practice since the 1980s.<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> Both of these forms are nonrecourse loans because the plaintiff need only pay back the loan if the lawsuit succeeds.

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

<sup>3</sup> 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](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”).

<sup>4</sup> Susan Lorde Martin, *Syndicated Lawsuits: Illegal Champerty or New Business Opportunity?*, 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).

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.<sup>5</sup> Currently, six corporations are willing to invest in commercial lawsuits in the United States.<sup>6</sup> However, only two publicly-traded corporations exist primarily to invest in American commercial litigation, Juridica Investments and Burford Capital.<sup>7</sup> 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.<sup>8</sup> A handful of other corporations, investment banks, and hedge funds have recently formed litigation funding divisions to buy interests in commercial lawsuits.<sup>9</sup>

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.<sup>10</sup> The current laws regarding maintenance and champerty vary across jurisdictions: twenty-seven

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<sup>5</sup> Lyon, *supra* note 2 at 578.

<sup>6</sup> Garber, *supra* note 3 at 14-16.

<sup>7</sup> Lyon, *supra* note 5.

<sup>8</sup> Garber, *supra* note 3 at 15-16.

<sup>9</sup> Lyon, *supra* note 5.

<sup>10</sup> See generally 14 AM. JUR. 2D *Champerty and Maintenance* §§ 1-20 (1964 & Supp. 1994).

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.<sup>11</sup> 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.<sup>12</sup>

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 actual cases financed by the largest third-party investors are effectively the opposite of the types of cases where third-party financing could improve access to justice—cases with financially-constrained or risk-averse plaintiffs. Instead, Burford Capital and Juridica Investments are financing cases that have risk-averse defendants trying to avoid financial ruin. In fact, it is the relatively strong risk aversion and weak bargaining position of the defendants that makes the expected rates of return on investment in these cases particularly attractive.

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<sup>11</sup> Garber, *supra* note 3 at 14-16.

<sup>12</sup> *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).

For example, both corporations have invested in patent infringement cases and price-fixing cases, and Burford Capital has invested in at least one large class action as well. 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 risks that defendants face in these cases result in significant imbalances in risk preferences that weaken the defendants' bargaining positions compared to plaintiffs. This increases the expected return on investment for third-party financiers because risk-averse defendants facing catastrophic trial judgments are eager to settle cases for amounts well above trial expectations. Moreover, in the cases that fail to settle and proceed to trial, potential damages are significant and often trebled, increasing the expected return for third-party investors.

Thus, although third-party litigation financing has the potential to improve access to justice, it is instead worsening existing distortions of justice. 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 justice could improve. Instead, they are investing in cases where third-party financing actually distorts justice by exacerbating existing imbalances in risk preferences

and bargaining position that disfavor the defendants. These distortions reduce social welfare by leading to overcompensation of some plaintiffs and overdeterrence of certain behaviors. I conclude in Section 4.

## 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 result in suboptimal deterrence of wrongful behavior in activities in which low-wealth individuals engage.<sup>13</sup>

Plaintiffs' risk aversion is another barrier to justice in many situations. Risk-averse plaintiffs may not pursue meritorious claims even when they can afford the legal fees.<sup>14</sup> The uncertain nature of legal proceedings and damage awards reduces the expected value of legal claims to risk-averse plaintiffs. If the

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<sup>13</sup> 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).

<sup>14</sup> David Abrams & Daniel L. Chen, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes* 3 (unpublished manuscript) (on file with author).

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).<sup>15</sup> 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 risk-averse defendants. Such settlements that systematically differ from trial expectations threaten the substantive law regime because the compensatory and tort law does not achieve its deterrent goals when defendants pay damages that differ from what the substantive law obligates them to pay.<sup>16</sup>

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-

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<sup>15</sup> 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).

<sup>16</sup> Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367 (2009).

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.<sup>17</sup>

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

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<sup>17</sup> 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 (“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.”).

more” to resolve.<sup>18</sup> 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.<sup>19</sup> 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.<sup>20</sup> Third-parties that finance much of the 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 both result in improved compensation and more accurate deterrence of wrongful behavior.

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

<sup>19</sup> 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>.

<sup>20</sup> 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](http://www.law.northwestern.edu/searlecenter/papers/Schanzenbach_Agency%20Costs.pdf).

### 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 financing realizes its potential 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, nor should that be the mission of a publicly-traded company. 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 financiers actually invest in may diverge from the types of cases that financiers would invest in if improving access to justice were their mission.

One particular category of cases where third-party financing could improve access to justice is personal injury lawsuits. In these cases, individual plaintiffs often lack sufficient resources to finance cases and plaintiffs are typically much more risk-averse than defendants are. These imbalances in financial resources and risk preferences create an imbalance in bargaining power, and ultimately, to plaintiffs either failing to bring meritorious claims or accepting settlements that are significantly less than the mean expected jury award.<sup>21</sup> As a result, third-party financing could reduce many of the barriers to justice in personal-injury cases.

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<sup>21</sup> 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).

Indeed, Jon Molot, Managing Director and Chairman of the Investment Committee at Burford Capital, recently recognized that “Personal injury lawsuits typically pit cash-strapped, one-time plaintiffs against larger entities, very often repeat players such as insurance companies or product manufacturers.”<sup>22</sup> As a result, he indicated that third-party financing “would not only promote more accurate deterrence – by ensuring that defendants pay amounts closer to the mean expected damages award – but also improve plaintiffs’ compensation.”<sup>23</sup>

However, neither of the two largest third-party investors in litigation, Juridica Investments and Burford Capital, finance personal-injury claims. Juridica has declared that it “does not invest in personal injury, product liability, [or] mass tort” claims.<sup>24</sup> Similarly, Burford Capital has indicated that “The Company’s focus will be largely, if not entirely, on larger commercial matters . . . the Company does not intend to invest in litigation brought by individuals.”<sup>25</sup>

Instead, the only third-party financing in personal injury cases is from cash-advance firms. These firms offer personal injury victims nonrecourse loans of a few thousand dollars<sup>26</sup> while their personal injury lawsuits are pending. These “cash advances” are loans because the firms charge a fixed interest rate on the funds received, typically 3-5% per month, or higher.<sup>27</sup> However, they are nonrecourse loans because the plaintiff need only pay back the advance if the lawsuit succeeds. Despite the potential benefit of third-party financing in

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<sup>22</sup> Molot, *supra* note 16 at 18.

<sup>23</sup> Molot, *supra* note 16 at 21.

<sup>24</sup> *Our Policy Statement*, JURIDICA INV. LTD., <http://www.juridicainvestments.com/about-juridica/our-public-policy-statement.aspx>.

<sup>25</sup> *Objectives and Policies*, BURFORD CAPITAL, available at <http://www.burfordcapital.com/objectivesandpolicies.html>.

<sup>26</sup> Garber, *supra* note 3; (“two industry leaders estimate the average sizes of their cash advances to be \$1,750 and \$4,500”).

<sup>27</sup> Molot, *supra* note 16 at 24. Similarly, in a recent CNN interview, the president of one cash-advance company indicated that 2-4% monthly interest rates are typical. *Campbell Brown Program*, (CNN television broadcast Feb. 18, 2010).

personal-injury cases, there appear to be serious problems with the current cash-advance industry. Many critics claim that the high interest rates take advantage of the less fortunate and distort the incentives to accept reasonable settlements.<sup>28</sup> Thus, they do little to ensure that plaintiffs receive what they are entitled to under substantive law.<sup>29</sup>

Instead of aspiring to improve access to justice for financially-constrained or risk-averse plaintiffs, third-party litigation financiers aspire only to maximize the return from their investments in litigation. As a result, the reality of third-party financiers' investment strategy often conflicts with the ideal of third-party financing.

Emphasizing the profit-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."<sup>30</sup>

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

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<sup>28</sup> Molot, *supra* note 16 at 24. Garber, *supra* note 3 at 24.

<sup>29</sup> *Id.* At 24

<sup>30</sup> 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>.

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.”<sup>31</sup>

The profit-maximizing goal is also evident in the types of cases Burford Capital and Juridica Investments choose to finance. Juridica currently has \$134 million invested in 25 cases.<sup>32</sup> Juridica invested over 60 percent of the total in antitrust price-fixing cases, while they invested another 28 percent in patent infringement cases.<sup>33</sup> Juridica divided the remaining 12 percent of the total investment between various statutory claims, property damage claims, contract claims, and arbitration.<sup>34</sup>

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.”<sup>35</sup> Burford has also invested in a class action lawsuit brought by 30,000 plaintiffs in Ecuador who accuse Texaco, bought by Chevron in 2001, of damaging the forest and their health.<sup>36</sup>

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<sup>31</sup> 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](http://www.rand.org/pubs/conf_proceedings/CF272) (summarizing remarks of Timothy D. Scramton).

<sup>32</sup> *The Fund* (May 6, 2011), JURIDICA, available at <http://www.juridicainvestments.com/about-juridica/the-fund.aspx>.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> Jason Douglas, DOW JONES NEWSWIRE, *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](http://www.advfn.com/news_UPDATE-Burford-Capital-Raises-GBP80-Million-In-5th-AIM-Float-Of-09_39926053.html).

<sup>36</sup> 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>.

Although my discussion focuses on Juridica Investments and Burford Capital because they are the only publicly-traded corporations that invest primarily in U.S. litigation, the investment strategies are likely similar for other third-party financiers of commercial litigation. The types of cases that these third-party investors are choosing to finance are not the types generally thought to have substantial cost barriers or risk barriers to justice, as least on the plaintiffs' side. Instead, as I discuss in the next section, these cases often have defendants that are more risk averse than plaintiffs. As a result, the plaintiffs' strong bargaining position allows them to extract large settlements out of defendants, even for weak legal claims.

#### 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 through patent infringement litigation. However, specific characteristics of patent infringement cases pose significant risks on defendants and create a substantial imbalance in the risk preferences of plaintiffs and defendants. This imbalance raises the bargaining power of plaintiffs compared to defendants, creating legal outcomes that differ from the outcomes obligated by the substantive law. 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.<sup>37</sup> Below, I briefly discuss the characteristics of patent infringement suits that can lead to an imbalance in risk preferences between plaintiffs and defendants.

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<sup>37</sup> See, e.g. Michael J. Meurer, *Controlling Opportunistic and Anti-Competitive Intellectual Property Litigation*, 44 B.C. L. REV 509 (2003).

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.<sup>38</sup> 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.<sup>39</sup> 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.<sup>40</sup>

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.<sup>41</sup> Preliminary injunctions on major product lines for the duration of litigation can impose significant financial burdens on defendant firms.

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<sup>38</sup> 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).

<sup>39</sup> 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).

<sup>40</sup> 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 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.").

<sup>41</sup> 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).

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.<sup>42</sup> 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.<sup>43</sup> In addition, the court may issue a permanent injunction to stop all future sales of the allegedly infringing product.<sup>44</sup> 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.<sup>45</sup>

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

Thus, patent infringement cases are not generally the types of cases where third-party litigation financing can improve access to justice. Nevertheless, Juridica has allocated 28 percent of its \$134 million investment fund to patent infringement cases.<sup>46</sup> Although exact data is unavailable on Burford's investment

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<sup>42</sup> See, e.g. J.P. Mello, *Technology Licensing and Patent Trolls*, 12 B.U. J. SCI. & TECH. L. 388, 392-393 (2006).

<sup>43</sup> 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.").

<sup>44</sup> See, e.g. Mello, *supra* note 42 at 393.

<sup>45</sup> Michael J. Meurer, *Controlling Opportunistic and Anti-Competitive Intellectual Property Litigation*, 44 B.C. L. REV. 509, 512-513 (2003).

<sup>46</sup> *Id.*

fund, the CEO has indicated that Burford will also focus its investment in patent infringement cases.<sup>47</sup>

Moreover, in its 2008 Annual Report, Juridica revealed that it has 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 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

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<sup>47</sup> Douglas, *supra* note 35.

so that 100% of investment returns are paid to JIL under a funding agreement.<sup>48</sup>

“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.”<sup>49</sup>

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.<sup>50</sup> The threat of this counterclaim serves to reduce the imbalance in risk 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.<sup>51</sup> As a result, patent trolls are often successful in bullying a quick settlement from an otherwise innocent defendant.<sup>52</sup>

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<sup>48</sup> *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](http://www.juridicainvestments.com/~media/Files/J/Juridica/pdfs/2008_Annual_Report.pdf).

<sup>49</sup> Lisa Lerer, *Mind Games*, IP LAW & BUSINESS, May 2006, at 5, available at <http://www.intven.com/docs/02505060001IntVen.pdf>.

<sup>50</sup> See Patent Reform Act of 2005, H.R. 2795, 109th Cong. (2005).

<sup>51</sup> Mello, *supra* note 42 at 394-395.

<sup>52</sup> Harkins, *supra* note 39 at 448.

## B. PRICE-FIXING CASES

Defendants in price-fixing cases also face many risks that create imbalances in risk aversion and bargaining power. As a result, defendants often agree to unfavorable settlement offers 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.<sup>53</sup> Moreover, under section four of the Clayton Act, the court automatically trebles judgments in price-fixing cases.<sup>54</sup> Such exorbitant damage awards have the potential to cripple many firms.<sup>55</sup> In addition, victorious plaintiffs in price-fixing cases are entitled to recover reasonable attorneys' fees from liable defendants.<sup>56</sup> In contrast, absent a finding of misconduct on the part of the plaintiff,<sup>57</sup> successful defendants in price-fixing cases are not entitled to attorneys' fees.

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<sup>53</sup> 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).

<sup>54</sup> 15 U.S.C. § 15(a) (2006).

<sup>55</sup> 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)

<sup>56</sup> 15 U.S.C. § 15 (1982).

<sup>57</sup> 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).

Second, defendants in price-fixing cases are jointly and severally liable to plaintiffs.<sup>58</sup> Thus, each price-fixing firm is potentially liable for the overcharges on all of 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.<sup>59</sup>

To make matters worse, a liable defendant in a price-fixing case has no right to contribution from its co-conspirators.<sup>60</sup> 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.

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

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<sup>58</sup> *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)).

<sup>59</sup> Christopher R. Leslie, *Judgment-Sharing Agreements*, 58 DUKE L.J. 747, 752 (2009).

<sup>60</sup> *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))).

damages.<sup>61</sup> As a result, the remaining defendants risk being liable for the trebled-damage component of the settling defendant's overcharges.<sup>62</sup>

Third, the statute of limitations may toll upon a finding of fraudulent concealment on the part of the defendant.<sup>63</sup> As a result, damages may go back much farther than antitrust law's four-year statute of limitation would otherwise imply.<sup>64</sup> 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 bargaining power in settlement negotiations. The resulting imbalances in the risk aversion and bargaining power between plaintiffs and defendants has the potential to greatly distort justice as defendants agree to unfavorable settlement terms in order to avoid the risk of catastrophic judgments.

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<sup>61</sup> *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).

<sup>62</sup> 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.").

<sup>63</sup> 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.").

<sup>64</sup> 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

Thus, price-fixing cases are not generally the types of cases where third-party financing can improve the efficiency of the legal system by removing barriers to justice. Nevertheless, Juridica has allocated over 60 percent of its investment fund to price-fixing cases,<sup>65</sup> and Burford has indicated that it plans to focus its investment in these cases.<sup>66</sup>

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.<sup>67</sup>

### C. CLASS-ACTIONS

Third-party financing in class actions may increase access to justice if the cases are too costly or risky for contingency-fee attorneys or consortiums of attorneys to take the cases otherwise. However, class actions also have the

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<sup>65</sup> *The Fund* (May 6, 2011), JURIDICA, available at <http://www.juridicainvestments.com/about-juridica/the-fund.aspx>.

<sup>66</sup> Douglas, *supra* note 35.

<sup>67</sup> *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](http://www.juridicainvestments.com/~media/Files/J/Juridica/pdfs/2008_Annual_Report.pdf).

potential to create an even stronger imbalance between plaintiffs' and defendants' bargaining position than either patent infringement or price-fixing cases. Because class-action suits expose defendants to potentially ruinous judgments at trial and endless litigation, defendants are under enormous pressure to settle cases with even weak claims.

By aggregating the claims of numerous plaintiffs, a class action exposes corporate defendants to enormous losses a trial. Even *de minimis* individual damage claims multiply at the class level into massive sums of money.<sup>68</sup> Whereas individual trials rarely pose a solvency threat, a class action with even a remote risk of financial ruin triggers defendants' risk-aversion and motivates them to settle claims for more than their expected value.<sup>69</sup>

Moreover, corporate defendants fear debilitating and expensive litigation defending against even weak class action suits. Defending against class action suits can easily cost tens-of-millions of dollars *annually*, and the suits can drag on for decades.<sup>70</sup> To avoid the "gargantuan scale" of discovery and endless litigation, defendants often choose to settle early to avoid the exorbitant costs.<sup>71</sup>

Thus, many defendants have no choice but to settle to avoid company-threatening trial verdicts and preserve economic value for innocent shareholders.<sup>72</sup> The imbalance in plaintiffs' and defendants' bargaining positions has been discussed widely by legal scholars and jurists. Judge Friendly, the revered Second Circuit jurist, claimed that class actions are "blackmail" because the

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<sup>68</sup> See HENRY J. FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 120 (1973).

<sup>69</sup> Charles Silver, "We're Scared to Death": *Class Certification and Blackmail*, 78 N.Y.U. L. REV. 1357, 1370 (2003).

<sup>70</sup> Mark Herrmann, *From Saccharin to Breast Implants: Mass Torts, Then and Now*, 26 LITIG. 50, 52 (1999).

<sup>71</sup> Silver, *supra* note 69 at 1362.

<sup>72</sup> *Id.*

defendants' only choice is to settle or face economic ruin.<sup>73</sup> 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.”<sup>74</sup> 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.”<sup>75</sup>

The resulting imbalance in risk aversion and bargaining positions may greatly distort justice as defendants settle claims for more than their expected value. These overpayments result in overdeterrence while often doing little to compensate victims; many class action cases result in millions of dollars of attorneys' fees, but only small amounts of compensation for plaintiffs.<sup>76</sup>

Indeed, Richard Fields, Chief Executive of Juridica Capital Management Limited, has recognized that “financiers involved in class action funding are often attempting to create a ‘perfect storm’ of class action or tort litigation to force settlement by defendants unwilling to risk a large judgment, even in a baseless case.”<sup>77</sup> As a result, Juridica has refused to invest in class action lawsuits.

Similarly, Jon Molot, Managing Director and Chairman of the Investment Committee at Burford Capital, recently recognized that in class actions, “the

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<sup>73</sup> Friendly, *supra* note 68.

<sup>74</sup> *In re Rhone-Poulenc Rorer Inc.*, 51 F.3d 1293, 1299 (7th Cir. 1995).

<sup>75</sup> *In re Bridgestone/Firestone, Inc.*, 288 F.3d 1012, 1016 (7th Cir. 2002).

<sup>76</sup> 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](http://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.

<sup>77</sup> Press Release, Juridica, Juridica opposes funding of class actions (Dec. 10, 2009) available at <http://www.juridicainvestments.com/media-centre/press-releases/2009/~media/Files/J/Juridica/pdfs/pr-10-12-09.pdf>.

potential damages may be large enough relative to the company's balance sheet that defendants simply cannot afford to lose. The defendant may be forced to settle, even if it believes that the risk of losing at trial is remote, so as to avoid the remote risk of a devastating adverse judgment.... there can be little doubt that risk imbalances in this context are markedly different from those in the personal injury suit, often working in this context to the disadvantage of defendants.”<sup>78</sup>

However, despite recognizing that third-party financing will likely distort justice in class actions, Burford has recently invested millions in a large class action case.<sup>79</sup>

#### D. CONSEQUENCES OF THIRD-PARTY FINANCING

The cases that Burford and Juridica are financing—patent infringement cases, price-fixing cases, and class actions—generally have risk-averse defendants trying to avoid financial ruin. In fact, it is the relatively strong risk aversion and weak bargaining position of the defendants 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.

Unfortunately, the actual cases financed by these third-party investors are effectively the opposite of the types of cases where third-party financing could improve access to justice—cases with financially constrained or risk-averse plaintiffs. Thus, rather than leveling the playing field between risk-averse

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<sup>78</sup> Molot, *supra* note 16 at 4-5.

<sup>79</sup> Reddall, *supra* note 35.

plaintiffs and risk-neutral defendants as supporters had hoped, third-party financing only exacerbates imbalances in risk preferences and bargaining positions. Because third-party investors absorb much of the plaintiffs' risk in the cases they finance, they worsen the existing imbalances in risk preferences that already disfavor defendants. This further weakens the defendants' bargaining position compared to the relatively risk-neutral plaintiff, inducing defendants to accept even less favorable settlements than they would have without third-party financing. 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."<sup>80</sup>

Thus, instead of removing barriers to justice, third-party financing is further distorting justice in many cases. These distortions reduce social welfare by leading 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.<sup>81</sup> An increase in litigation magnifies the underlying nature of the legal system.<sup>82</sup> Thus, an increase in litigation among the types of cases where imbalances in risk

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<sup>80</sup> McGovern, Rickman, Doherty, Kipperman, Morikawa & Giglio, *supra* note 31 at 9. (summarizing remarks of James E. Tyrrell)

<sup>81</sup> Paul H. Rubin, *supra* note 19.

<sup>82</sup> 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>

preferences and bargaining position lead to distortions in justice will magnify these distortions, further pushing the legal system toward inefficiency.

#### 4. 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 field in negotiations. This would improve plaintiffs' compensation and promote deterrence that is more accurate.

However, the cases with the largest profit potential for third-party investors are exactly the opposite of the kinds of cases where third-party financing can improve access to justice. The cases with the highest expected return on investment are cases where plaintiffs have a stronger bargaining position and can extort significant settlements out of risk-averse defendants. Unfortunately, the two largest third-party investors in U.S. litigation, Burford Capital and Juridica Investments, have largely focused their investments in cases with these general characteristics—patent infringement cases, price-fixing cases, and class actions.

Not only are third-party financiers not investing in the types of cases where justice could be improved, they are actually worsening justice in the types of cases they are choosing to finance. By absorbing much of the plaintiffs' litigation risk and steering significant resources into the litigation, third-party financing exacerbates existing imbalances in risk preferences and bargaining position that disfavor the defendants. This intensifies the settlement pressure on defendants, causing them to agree to unfavorable 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 worsening existing distortions of justice. These distortions reduce social welfare by leading to overcompensation of some plaintiffs and overdeterrence of certain behaviors. 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.