Litigation Finance: A Market Solution to a Procedural Problem

JONATHAN T. MOLOT*

In a system dominated by settlement, scholars, lawyers, and judges who want to promote accuracy in litigation strive to promote accurate settlements. This effort typically relies on judicial intervention in pretrial practice, or on extrajudicial substitutes, to educate parties on the merits of their positions and induce them to settle for amounts that reflect those merits. The goal is to make pretrial resolutions look more like adjudicated resolutions, albeit with less expense.

These reform efforts largely fail to address a major force that can skew settlements away from the merits: imbalances in risk preferences. Settlements are a product not only of the parties’ expectations for trial but also of their tolerance for risk. In deciding whether to settle or proceed to trial, parties must compare a given settlement amount with a range of possible trial outcomes, the precise distribution of which is uncertain. When parties choose between a certain outcome and an uncertain outcome, their choice will be affected by their risk preferences. And where one party is a repeat player and the other is a one-time participant, they will have very different risk tolerances—the one-time, risk-averse participant will be more fearful of proceeding to trial, more eager to settle, and in a weaker bargaining position.

When imbalances in risk preferences skew settlements away from the merits, this is just as much a market failure as a failure of procedure. Unlike the efficient markets we rely on to price all sorts of assets and liabilities, the market for litigation claims is uniquely limited to just two participants. The plaintiff can sell only to the defendant and the defendant can deal only with the plaintiff. For this reason, imbalances in risk preferences can lead to the mispricing of lawsuits.

If we want the settlement process to value lawsuits accurately, perhaps we should do the opposite of what scholars have done in the past. We should consider making settlements look less like adjudications and more like market transactions. If a party to a lawsuit is poorly equipped to bear litigation risk and fearful of being coerced into an unfair settlement, we would not rely on judicial intervention to save him. Rather, we would empower the party to help himself via a market transaction. If the weaker party could off-load risk via the market to someone better able to bear it, he might be able to counter the stronger party’s bargaining advantage. Indeed, by enlisting the help of a third party that holds a diverse portfolio of litigation risk and is better able to bear such risk, the weaker party could bolster his negotiating position and secure a settlement that reflects the merits of the lawsuit rather than the bargaining positions of the parties.

* Professor of Law, Georgetown University Law Center. © 2010, Jonathan T. Molot. My thanks to Brad Clark, Sam Issacharoff, Geoff Miller, Henry Monaghan, Richard Nagareda, Robert Rhee, Tony Sebok, Jon Siegel, and Roger Trangsrud, and to participants in conferences at RAND/UCLA and Northwestern’s Searle Center. Since writing this Article, the author has helped to found the Burford Group, investment advisor to Burford Capital Limited, a publicly traded commercial dispute financier.
This Article compares traditional approaches to promoting accuracy with an alternative, market-based approach. It considers the nascent litigation markets that exist in this country and abroad, and the obstacles that have prevented their maturation into a viable solution. Finally, the Article considers reforms to foster a more robust litigation market. The goal is to shed new light on a litigation finance industry long viewed by the legal profession and the academy with disdain. The Article recasts litigation finance as a potential engine for good—a force that may promote accuracy in adjudication where conventional reform efforts have failed.

**Table of Contents**

INTRODUCTION .......................................... 67

I. TRADITIONAL EFFORTS TO PROMOTE MERITS-BASED RESOLUTIONS ... 75
   A. THE PROBLEM: THREE FORCES THAT MAY LEAD SETTLEMENTS TO STRAY FROM THE MERITS ........................................ 75
   B. THE TRADITIONAL SOLUTIONS: STRATEGIES EMPLOYED TO MAKE PRETRIAL RESOLUTIONS LOOK MORE LIKE ADJUDICATIONS ...... 77
      1. Formal Judicial Intervention ........................................ 77
      2. Informal Judicial Intervention ...................................... 78
      3. Extrajudicial Alternative Dispute Resolution .................... 80
   C. SHORTCOMINGS OF THE TRADITIONAL, ADJUDICATION-FOCUSED APPROACHES ......................................................... 81

II. AN ALTERNATIVE APPROACH: MAKE PRETRIAL RESOLUTIONS LOOK LESS LIKE ADJUDICATIONS AND MORE LIKE MARKET TRANSACTIONS .. 82
   A. UNDERSTANDING THE PROBLEM OF SKEWED SETTLEMENTS AS A MARKET FAILURE SUSCEPTIBLE TO A MARKET SOLUTION ........... 83
   B. EXISTING LITIGATION MARKETS AND OBSTACLES TO THEIR MATURATION ......................................................... 90
      1. A Long-Standing, Albeit Limited, Market: The Contingent Fee System .......................................................... 90
      2. Emerging Markets in Litigation Risk ................................. 92
         a. The Cash Advance Industry for Personal Injury Victims ................. 93
INTRODUCTION

The success of any substantive law regime—whether common law or statutory—necessarily depends upon the quality of the corresponding procedural regime. If litigation cannot be counted on to apply law accurately to the relevant facts, then it does not matter how carefully we craft substantive law rules.1 Substantive law goals, such as deterrence, compensation, and retributive justice, cannot be achieved if defendants end up paying amounts different from what substantive law obligates them to pay, or if plaintiffs end up receiving amounts different from what substantive law entitles them to receive.2 A principal goal of civil procedure—indeed, the principal goal—is the accurate application of law to fact.

However, in a world dominated by settlement—and a system in which the

---

2. See, e.g., Steven Shavell, The Fundamental Divergence Between the Private and the Social Motive To Use the Legal System, 26 J. LEGAL STUD. 575, 577–79 (1997) (explaining that differences between private and social costs and benefits provide separate incentives to use the legal system, and therefore, private incentives may result in socially excessive suits, or vice versa).
vast majority of lawsuits settle—accurate adjudication alone is insufficient. If we want to promote the accurate application of law to fact, we need to ensure not only that adjudicated cases are resolved accurately, but also that settlements are based on trial expectations. If parties settle based on something other than the merits, then the system will fail. If a defendant gets off too easily by convincing a plaintiff to accept an unduly low settlement or a plaintiff extracts an unduly high settlement from a defendant, then it does not matter how accurately the case would have been resolved had it proceeded to trial. Litigation should be tailored not only to adjudicate cases accurately, but also to promote settlements that reflect the merits of lawsuits.

Civil procedure scholars have long recognized that defendants may pay more in settlement than they expect to pay in judgments, and plaintiffs may accept less, because doing so will save them litigation expenses. Indeed, because litigation expenses are an important driver of settlement amounts, and civil procedure rules can affect the costliness as well as the accuracy of adjudication, scholars have worked to streamline the process and reduce expenses. They often focus as much upon the efficiency of the litigation process as its accuracy in their quest to make sure that defendants do not pay too much and plaintiffs do not receive too little.

But there is another, potentially more important, driver of settlement levels that has been less of a focus in civil procedure scholarship. Settlements are a product not only of the parties’ litigation expenses and expectations for trial, but

---


8. There are a few notable exceptions that address unequal bargaining power. See, e.g., Marc Galanter, Why the “Haves” Come Out Ahead: Speculations on the Limits of Legal Change, 9 Law & Soc’y Rev. 95, 95–124, 125 fig. 3 (1974) (modeling a legal system possessing general features similar to that of the United States, and identifying advantages produced by the system for participants that are, for example, wealthy, experienced, and repeat); David Rosenberg, Class Actions for Mass Torts: Doing Individual Justice by Collective Means, 62 Ind. L.J. 561, 564 (1987) [hereinafter Rosenberg, Class Actions]; David Rosenberg, Essay, Mass Tort Class Actions: What Defendants Have and Plaintiffs Don’t, 37 Harv. J. on Legis. 393, 395 (2000); see also In Litigation: Do the “Haves” Still Come Out Ahead? (Herbert M. Kritzer & Susan S. Silbey eds., 2003) (reproducing Marc Galanter’s original work, see Galanter, supra, and ten additional scholarly articles evaluating and drawing from Galanter’s article). For an exploration of what is meant by procedural “equality” or “inequality,” see William B. Rubenstein, The Concept of Equality in Civil Procedure, 23 Cardozo L. Rev. 1865, 1867–70 (2002).
also, of their respective risk preferences. In deciding whether to settle or proceed to trial, parties must compare a given settlement amount with a range of possible trial outcomes, the precise distribution of which is uncertain. When parties are choosing between a certain outcome and an uncertain outcome, their choice will be affected by their risk preferences.

Consider, for example, the settlement dynamics in a personal injury lawsuit that pits a one-time personal injury plaintiff against a large, repeat-player defendant, like an insurance company. The repeat player in this process will approach settlement by looking at the range of possible trial outcomes and calculating an expected value for the suit that is the average of all those possible trial outcomes. The range of possible trial outcomes typically will include large numbers of modest jury awards and defense verdicts because, a great many times, personal injury plaintiffs collect relatively small amounts or nothing at all. But the range also will include a smaller number of very large jury awards—those few (albeit prominent) cases where plaintiffs win punitive damages awards or where juries award extraordinarily large compensatory damages based on their sympathy for the plaintiff or anger towards the defendant. The “expected value” of any given lawsuit to a repeat-player defendant will be the weighted average of all these possible jury awards. If a repeat-player defendant can settle for less than the mean expected award, it is better off settling than going to trial. If, on the other hand, it would cost more than the mean damages award to settle, then the defendant would be better off proceeding to trial. So long as the repeat-player defendant holds a sufficiently diverse portfolio of cases—and no single case would be large enough to harm its financial condition—the defendant would be indifferent between settling at the mean and proceeding to trial (putting aside, for now, the saved litigation expenses).

A one-time plaintiff, in contrast, would be less likely to focus on the mean damages award and more likely to focus on a lower number that reflects the typical (perhaps the median or mode) damages award. The plaintiff would ask his or her lawyer “what do most people in my situation get at trial?” And the lawyer would have to report on the large number of plaintiffs who receive modest damages awards or nothing at all. The lawyer might say: “Some get more and some get less—indeed, many get nothing—but I would say $50,000 is probably the most typical damages award for a plaintiff in your situation.” The plaintiff might then ask: “But what about the plaintiff I read about in the newspaper who collected millions of dollars?” The lawyer would respond: “You might get lucky and collect that much too, but the odds are very much against it.” If the plaintiff were offered a $50,000 settlement in line with the typical

---

9. The plaintiff typically will be represented by a repeat-player contingent fee attorney, the effects of which are discussed below. See infra notes 62–63 and accompanying text.
10. See infra notes 58–59 and accompanying text.
11. See id.
12. The actual discount off of the mean would be a product of the unique risk preferences of the individual plaintiff. See infra note 56 and accompanying text.
expected damages award, the question for the plaintiff would be whether he is willing to risk that $50,000 for the chance of winning millions. Even if the mean expected damages award is higher than $50,000—say it is $75,000 or even $100,000 or $150,000 when one averages in the remote possibility of a blockbuster multi-million dollar award—the plaintiff will have a hard time rejecting a $50,000 settlement and proceeding to trial. Whereas a repeat-player defendant may be indifferent as between settling at the mean and going to trial, the plaintiff with only one chance at trial cannot expect the trial to produce the mean damages award. He will not likely give up $50,000 to buy a lottery ticket for a chance at winning millions, even if the odds of winning millions might be good enough to make that lottery ticket an attractive bet to someone who is risk neutral. The plaintiff with just one chance at a trial must look at what the typical plaintiff gets, rather than at the (higher) numerical average that an insurance company would pay out if it took every case to trial.

Where a lawsuit pits a one-time plaintiff against a repeat-player defendant, we would thus expect the imbalance in the parties’ risk preferences to favor the defendant and produce settlements below the mean damages award. In some categories of litigation, however, the imbalance in risk preferences may work in completely the opposite direction—strongly favoring plaintiffs rather than defendants. Consider, for example, a consumer class action lawsuit. From the plaintiffs’ perspective, the amount at stake for each individual class member may be too small for any one of them to care. The potential fee for the lead plaintiffs’ attorney would, of course, be much larger, but the suit may represent just one of many that the plaintiffs’ law firm has in its portfolio and the fees may, in any event, be spread over a group of firms working together. From the defendant’s perspective, in contrast, the potential damages may be large enough relative to the company’s balance sheet that the defendant 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. The precise extent to which class certification imposes settlement pressures, and just how often it may lead settlements to stray from the merits, has been the subject of vigorous debate. But there can be little doubt that risk imbalances in this context are markedly different from those in the personal

13. See Rhee, supra note 4, at 145–46, 153–54; Marc J. Shukaitis, A Market in Personal Injury Tort Claims, 16 J. LEGAL STUD. 329, 335–36 (1987). Moreover, a personal injury victim may have strong reasons, beyond just the time value of money, for wanting cash now rather than later. See infra note 54.


injury suit, often working in this context to the disadvantage of defendants. Moreover, this is not the only setting in which imbalances in risk preferences may disfavor defendants. Consider a lawsuit against a company that is the subject of a merger or acquisition, a private equity investment, or a debt refinancing. If a potential acquirer, investor, or other capital provider is uncomfortable assuming litigation risk as part of the proposed deal, the defendant may need to settle the lawsuit quickly in order to eliminate the risk and remove an obstacle to obtaining the capital it is trying to raise.\textsuperscript{16} The defendant that needs certainty in order to save a business transaction may be induced to settle a lawsuit for much more than it is worth. In such a case, the risk aversion of the defendant’s capital providers, and the dynamics of the pending deal, may drive settlement amounts as much as the underlying merits of the suit.

In the personal injury suit, the consumer class action, the lawsuit that interferes with a deal, and many other settings, the ultimate amount paid by defendants and received by plaintiffs will depend not only on the facts of the case and the relevant substantive law rules, but also on the parties’ risk preferences. Particularly where one party is a repeat player and the other is a one-time participant, it is unrealistic to expect that defendants will pay or plaintiffs will receive what they are supposed to under substantive law alone. Try as we may to craft a tort law regime that promotes ideal levels of deterrence or compensation, to craft contract law doctrines that pay expectancy damages and allow efficient breaches, or to draft civil rights legislation or consumer protection statutes that achieve legislative goals, in reality, our legal system is unlikely to strike the same balances and achieve the precise objectives that substantive lawmakers envision. If we want to advance substantive law goals, we must find a way to ensure that settlements are driven as much as possible by the merits and as little as possible by imbalances in risk preferences.

There are essentially two ways we could approach this problem. The first is to try to structure civil procedure so that the merits loom larger in settlement. Settlements will always be based both on the merits and on parties’ risk preferences. If judges are able to intervene early on in a predictable manner that promotes settlements based on the merits, this might reduce the relative importance of risk preferences in the settlement process.\textsuperscript{17} Scholars have considered, for example, greater use of the summary judgment procedure to favor strong claims and defenses and weed out weaker ones.\textsuperscript{18} Scholars have also looked at informal judicial promotion of settlement and at extrajudicial substitutes as alternative ways to promote fair, accurate settlements.\textsuperscript{19} This sort of civil pro-

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{17} See, e.g., Miller, \textit{supra} note 5, at 27.
\item \textsuperscript{18} See infra section I.B.1.
\item \textsuperscript{19} See infra section I.B.2.
\end{itemize}
\end{footnotesize}
procedure scholarship—which includes some of my own work—seeks to reduce
the influence of factors outside the merits by increasing the importance of the
merits. The goal of procedural reform, in this body of scholarship, is to make
settlements look more like adjudications.

But there is a second way to offset the imbalances in risk preferences that
might otherwise threaten to overpower the merits in settlement negotiations.
Instead of making settlements look more like adjudications, we might try to
make them look less like adjudications. A litigation settlement occupies a tenu-
ous middle ground between an adjudication and a market transaction. Indeed,
the law of preclusion recognizes the settlement’s hybrid nature—reflecting the
reality that a settlement is both the conclusion of a lawsuit and a business deal
between the parties. To the extent that a litigation settlement represents a
market transaction, and not just the conclusion of a lawsuit, one may blame
inaccurate litigation settlements not only on our system of civil procedure, but
also on the limited market alternatives available to plaintiffs and defendants.
Indeed, the mispricing of litigation settlements is just as much a market failure
as it is a judicial failure.

A lawsuit represents an asset for the plaintiff and a liability for the defendant,
and in this respect, litigation settlements resemble other market transactions.
But unlike the efficient markets that we routinely rely on to price all sorts of
assets and liabilities accurately, the market for litigation claims is uniquely
limited to just two participants. The plaintiff can sell only to the defendant and
the defendant can deal only with the plaintiff. It is mainly for this reason that
imbalances in risk preferences can result in the dramatic mispricing of lawsuits.
A risk-averse, one-time plaintiff may dispose of a claim for too little because he
is forced to sell to a repeat-player, risk-neutral defendant that is in a much
stronger bargaining position. Likewise, a plaintiff may be able to extract too
much in settlement from a risk-averse, one-time defendant because the two
parties are forced to deal with one another. If, however, the more risk-averse
party had a market alternative to settling with the less risk-averse party, then the
more risk-averse party might not be coerced into settling. The risk-averse party

(2003) [hereinafter Molot, Old Judicial Role]; Jonathan T. Molot, How Changes in the Legal Profession

21. See infra section II.A.

22. See Robert Cooter, Towards a Market in Unmatured Tort Claims, 75 VA. L. REV. 383, 396
(1989).

23. See, e.g., Geoffrey P. Miller, Commentary, On the Costs of Civil Justice, 80 TEX. L. REV. 2115,
2115 (2002); Robert H. Mnookin & Robert B. Wilson, Rational Bargaining and Market Efficiency:
Understanding Pennzoil v. Texaco, 75 VA. L. REV. 295, 295 (1989); Robert J. Rhee, The Effect of Risk
on Legal Valuation, 78 U. COLO. L. REV. 193, 229 (2007) [hereinafter Rhee, Effect of Risk]; Rhee, supra
(advocating for a broader understanding of adjudication as a means to enforce “the values embodied in
authoritative texts such as the Constitution and statutes,” rather than merely a tool to end disputes).

24. See Cooter, supra note 22, at 397; Miller, supra note 23, at 2115.
with a market alternative would not likely settle for an amount at odds with the merits.

If we want the settlement process to value lawsuits accurately, perhaps we should do the exact opposite of what scholars (including myself) have done in the past. We should consider making settlements look less like adjudications and more like market transactions. If a party to a lawsuit is poorly equipped to bear litigation risk and fearful of being coerced into an unfair settlement, we would not rely on judicial intervention to save him. Rather, we would empower that party to help himself via a market transaction. If the weaker party had the ability to off-load litigation risk via the market to someone better able to bear it, he might be able to counter the stronger party’s bargaining advantage. Indeed, by enlisting the help of a third party that holds a diverse portfolio of litigation risk and is better able to bear the risk, the weaker party could bolster its negotiating position and secure a settlement that reflects the merits of the lawsuit rather than the relative bargaining positions of the parties.25

This Article explores the two paths that civil procedure scholars might take in their efforts to promote accuracy in adjudication. One path seeks to make settlement look more like adjudication, principally by relying on judicial intervention, or extrajudicial substitutes, in pretrial practice. The other path seeks to make settlement look more like a market transaction by removing obstacles to the sale of legal claims and transfer of legal risks.26 Although the paths are not mutually exclusive, and we probably should pursue both, I suggest that the overlooked, market-based approach may ultimately be the more promising one.

The Article is organized as follows. Part I explores conventional efforts to promote fair settlements, most of which rely upon judicial intervention in pretrial practice, or on extrajudicial substitutes, to make settlements look more like adjudications. Part I also outlines the shortcomings of these conventional approaches and highlights the need to explore alternatives. Part II discusses an alternative, market-based approach that would empower parties to help themselves—by off-loading some risk to a third party better able to bear it, thereby improving the litigant’s bargaining position vis-à-vis the opponent. Part II then evaluates the nascent markets in legal claims that already exist in this country and abroad, and the obstacles that have prevented these markets from maturing into a meaningful solution to the problem of inaccurate settlements. Finally, Part III considers proposals for reform that would remove these obstacles. Part III explores the costs and benefits of a market solution, and some potential compromises that might help facilitate a robust market in litigation claims without unduly sacrificing other, non-market values.

The goal is neither to offer a definitive proposal for reform nor to define a

---

25. Moreover, the investment of additional resources might actually improve the plaintiffs’ litigating position and increase the recovery over what it would have been had the plaintiff proceeded to trial.

26. The choice between an adjudication-oriented approach and a market-oriented approach may be seen as a manifestation of a broader choice that regulators face in a variety of contexts between command-and-control regulation and market-oriented solutions.
single, overarching market solution. The problems raised by a market approach are too complex to attempt anything so ambitious here. Moreover, to understand the potential good that litigation finance can achieve, it is important to distinguish different categories of litigation and different kinds of market mechanisms. A personal injury victim and a small, start-up software company may both feel ill equipped to go up against a large, repeat-player corporate defendant, but the needs of those two plaintiffs and the market mechanisms available to them will differ significantly. A personal injury plaintiff with a meritorious claim will have no problem finding a contingent fee attorney willing to absorb the risk of losing the case and being out litigation expenses. In contrast, a software company with a meritorious patent claim may find that the best law firms for its case would prefer to charge by the hour. Yet, if the same plaintiffs want protection against the risk of collecting nothing—and want to sell a portion of their claims for cash—the software company may have a much easier time than the personal injury victim, who will likely be forced to borrow from a cash advance firm at an extraordinarily high interest rate. Although law and economics scholarship has considered, in theory, how the sale of litigation claims might impact settlement dynamics, almost nothing has been written about the various fledgling litigation markets that exist today, and no one has drawn a connection between these fledgling markets and the overarching civil procedure goal of promoting accuracy in adjudication. To the contrary, litigation finance has been treated as something of an ugly stepsister by the academy, the legal profession, and the capital markets. If legal academics can begin to examine candidly the litigation finance markets that exist today—and to reveal not only the flaws in existing markets, but also their potential to do good and promote accuracy in adjudication—then the legal profession and the capital markets may begin to shed some of their reluctance to view litigation claims as marketable commodities. Whether we ultimately move toward a free market in legal claims, we will at least be able to weigh the costs and benefits of a free-market approach.

A caveat is in order before I proceed. Although litigation risk transfers could

27. See infra notes 77–81 and accompanying text.
28. See infra section II.B.2.a.
work for both plaintiffs and defendants, and this Article addresses both, the emphasis here will be on plaintiffs, as most of my analysis of defense-side risk transfers appear in a separate article, published last year in the University of Chicago Law Review.30 There are two major differences between plaintiff-side and defense-side risk transfers that lead me to approach them separately. First, lawsuits very often pit one-time plaintiffs against repeat-player defendants, particularly where a defendant is insured and insurance companies control the litigation. Accordingly, the need for plaintiffs’ side risk transfers may be significantly greater. Second, for reasons I will explain, the creation of a market in plaintiffs’ claims is more easily done than the creation of a market to off-load a defendant’s risk. Indeed, there already exists a limited market for risk transfers on the plaintiffs’ side—notably, the contingent fee arrangement that permits plaintiffs to shift some litigation risk and expense to lawyers who hold a diverse portfolio of litigation risk and are better able to bear it. Because the need to offset risk imbalances on the plaintiffs’ side is greater and the creation of a market in litigation claims is easier, I will focus in this paper on risk transfers by plaintiffs. The companion article addresses, and seeks to overcome, the more significant obstacles posed by risk transfers on the defense side.31

I. TRADITIONAL EFFORTS TO PROMOTE MERITS-BASED RESOLUTIONS

Given that the vast majority of lawsuits settle, civil procedure scholarship concerned about accuracy in adjudication appropriately tends to focus on the pretrial process, rather than on trial practice. The goal of this scholarship is to promote early settlements that accurately reflect the underlying merits of the lawsuits being settled. The discussion below addresses the problems that civil procedure scholars confront in trying to promote accuracy, the strategies scholars have employed in tackling these problems, and the shortcomings of these preferred solutions. The traditional efforts may succeed on some fronts, but they have done little to address the problem of bargaining imbalances.

A. THE PROBLEM: THREE FORCES THAT MAY LEAD SETTLEMENTS TO STRAY FROM THE Merits

In evaluating strategies to promote merits-based settlements, it is important to keep in mind three different, albeit related, forces that drive settlement levels.32 First, there are the parties’ perceptions of the merits and predictions for trial. What are the chances of a plaintiff’s verdict versus a defense verdict? What is the range of possible jury awards, and what is the relative likelihood of each

30. See Molot, supra note 16, at 376.
31. See id. at 378.
32. The literature addressing the reasons that litigants settle is too vast to try to capture here. See generally Robert D. Cooter & Daniel L. Rubinfeld, Economic Analysis of Legal Disputes and Their Resolution, 27 J. ECON. LITERATURE 1067, 1075–82 (1989), for a review of such literature in an economic framework.
possible outcome? If the parties are mistaken on these questions, they may strike settlements at odds with the merits (or fail to settle at all).  

Second, there are litigation expenses. Parties will base settlement amounts not only on what they expect to pay or receive in a judgment, but also on the cost of litigating all the way to a judgment. If litigation expenses are large enough to dwarf, or even rival, potential jury awards, then parties may strike settlements based on projected expenses rather than the merits.

Third, there are the parties’ respective risk tolerances. Faced with a choice between settling for a sum certain, or proceeding to trial and facing an uncertain outcome, a party’s willingness to settle will depend not only on its perceptions of the merits and its likely litigation expenses, but also on its risk tolerance. If there is a significant imbalance in the parties’ risk preferences—and one party is less fearful of proceeding to trial—this can affect settlement amounts significantly. Our procedural system’s principal goal of accurate application of law to fact will be met, and settlements will accurately reflect the merits, only if the pretrial process is able to offset imbalances in risk preferences that may otherwise skew settlements.

The first two of these problems are very much in tension, and the conflict between them has occupied much civil procedure scholarship. On one hand, the most obvious way to educate the parties and the judge on the true merits of a lawsuit—so they are in a position to produce an accurate resolution based on the merits—is through a full-blown information exchange. Yet such a full-blown pretrial process can be incredibly expensive. In recent decades, the task for scholars of the pretrial process has been to come up with a less expensive substitute for trial—one that can replicate its accuracy without being nearly as resource intensive. Most efforts to balance these two concerns seek to incorporate some aspects of adjudication into the pretrial process, and thereby make pretrial resolutions look more like adjudication, albeit an abbreviated, more efficient variant of adjudication.

In balancing the competing concerns of accuracy and efficiency, however, traditional efforts to improve pretrial resolutions have largely overlooked the third major force that drives settlement levels: risk preferences. Indeed, the conventional approaches described below do very little to redress imbalances in bargaining power that can otherwise skew settlements. The discussion below suggests that if we want to make sure that settlements are driven by the merits, rather than by imbalances in risk preferences and bargaining power, we will have to look beyond the traditional solutions and explore alternatives.

33. See Miller, supra note 5, at 21–22; Molot, Changes, supra note 20, at 1002–03; Shavell, supra note 2, at 602.
34. See Molot, Changes, supra note 20, at 995–98.
35. See Rosenberg, Class Actions, supra note 8, at 564.
36. See, e.g., Molot, Old Judicial Role, supra note 20, at 40 & n.42 (citing scholarly sources urging for more judicial control of pretrial litigation in order to curb expensive delay tactics and focus on the merits).
B. THE TRADITIONAL SOLUTIONS: STRATEGIES EMPLOYED TO MAKE PRETRIAL
RESOLUTIONS LOOK MORE LIKE ADJUDICATIONS

The strategies available to promote merits-based resolutions may vary, but they generally try to make pretrial resolutions look more like adjudications, incorporating some aspects of the adjudicative process into the pretrial settlement process. By moving forward some aspects of adjudication, scholars seek to ensure that the parties, judge, or both (1) are sufficiently well-informed on the merits to fashion fair resolutions, and yet, (2) are spared the effort and expense of full-blown adjudication at trial. In so doing, scholars seek to address two of the three forces that might otherwise lead settlements to diverge from the merits.

The discussion below discusses three such mechanisms: formal judicial intervention in the pretrial process, informal judicial intervention, and extrajudicial substitutes for judicial intervention. The three approaches strike somewhat different balances between the goals of accuracy and efficiency, but all three seek to ensure that resolutions are accurately grounded in the relevant law and facts, without being equally resource intensive to a full-blown trial.

1. Formal Judicial Intervention

The most obvious way to make pretrial resolutions look more like adjudications is through actual adjudication: that is, through pretrial motions designed to dispose of meritless claims or defenses before cases are settled.37 If a court grants a motion to dismiss or a motion for summary judgment—even if only to dispose of a portion of the claims or defenses—the court will largely guarantee that the resolution of those claims accurately reflects the underlying merits of the lawsuit. So long as a meritless claim is dismissed early on, the plaintiff will not be able to extract any settlement value for it. Conversely, where a claim is so strong that there is no genuine dispute over its merit, the court can ensure that the defendant pays full value for that claim by granting summary judgment for the plaintiff.38

But formal motion practice works only when claims or defenses are so strong, or so weak, as to entitle one party to judgment as a matter of law. Motion practice does nothing to weed out weak, but not quite meritless, claims or defenses, and it does not guarantee victory for strong, but not quite strong enough, claims or defenses.39 Moreover, motion practice can be quite resource intensive. The discovery required in preparation for a summary judgment motion and the actual exchange of briefs will typically require many lawyer hours and a great deal of out-of-pocket expenses on both sides. The time that must be devoted by a judge to grant summary judgment is significant as well.

---

37. See Molot, Changes, supra note 20, at 1030–32.
38. But cf. Samuel Issacharoff & George Loewenstein, Second Thoughts About Summary Judgment, 100 YALE L.J. 73, 92 (1990) (survey of 140 contested summary judgment motions found that 122 were made by defendants and only 18 were made by plaintiffs).
39. See Miller, supra note 5, at 38–39.
judge can deny summary judgment with a single-sentence opinion declaring that a genuine issue of material fact remains for trial—an opinion that is essentially immune from appellate review (because it is not a “final judgment”). A judge who grants summary judgment, in contrast, must write an opinion explaining why there is no issue for trial, knowing that the opinion will be subject to de novo review by an appeals court.

Although formal judicial intervention in the form of motion practice may be less resource intensive than trial itself, it still is quite resource intensive, particularly when one considers that lawsuits typically will settle on their own, without any judicial intervention at all. The judge with a crowded docket may lack the time and energy to intervene via motion practice to not only make sure the case settles (which it likely will anyway), but also that it settles for an amount that accurately reflects the merits. The overburdened judge may simply leave it to the parties to ensure that the settlement they strike is fair and accurate.

2. Informal Judicial Intervention

Because true pretrial adjudication in the form of motion practice is resource intensive and works only for clear-cut cases where there is no factual dispute, many scholars, judges, and lawyers have advocated for less formal judicial intervention designed to replicate aspects of the adjudicative process and promote settlements that reflect the merits. Rather than intervening through formal motion practice, a judge may promote settlements in line with the merits—and indeed pressure the parties to settle—simply by providing his views of the merits and his predictions for trial at a judicial settlement conference. Preparation for a settlement conference is not nearly as resource intensive as motion practice. The parties may prepare memos for the judge’s benefit, but they need not submit lengthy briefs with reams of supporting materials. Similarly, the judge need not devote the resources required to write a formal summary judgment opinion when he intervenes informally at a settlement conference. He may read the parties’ submissions so that he is sufficiently well informed as to formulate an opinion on the merits. But because the goal is settlement, rather than adjudication, the judge need not write an opinion justifying his position. Rather, he can convey his impressions orally and informally. He need not worry about setting precedent or creating a record for appellate review.

Informal judicial intervention may have advantages over formal judicial intervention, but informal judicial intervention brings with it a serious disadvantage. When a judge decides a motion for summary judgment, he performs an

40. See Molot, Changes, supra note 20, at 1032–33 (noting that despite the benefits associated with liberalizing partial summary judgment, the corresponding increase would impose additional work on district judges).
41. See, e.g., Miller, supra note 5, at 52.
42. See id. at 52 (noting the shortcomings of mediation as compared to preliminary judgment motions).
adjudicatory function that is very much at the core of his institutional competence. As an adjudicator, the judge resolves a dispute that has been framed for him by the parties and he grounds his decision in an identifiable body of governing law.43 When a judge initiates settlement talks and attempts to influence settlement amounts, he performs a somewhat different function. As a mediator, as opposed to an adjudicator, the judge will often play an active, rather than a passive role, in framing the matter. To be sure, he will take some cues from the parties, but it will be up to him to decide how best to promote a fair settlement—whether by providing his predictions regarding the jury’s likely views, by educating the parties on the risks and rewards each side faces, or by remaining silent and leaving the parties to negotiate as they deem fit. Moreover, as a mediator, the judge may not be all that constrained or guided by governing law.44 While his views of the merits will loom large in his approach, he will proceed unconstrained by anything like the summary judgment standard of Rule 56 of the Federal Rules of Civil Procedure (or comparable state rules). Indeed, the judge will exercise a great deal of discretion both in formulating his opinion of what a “fair settlement” would entail and in trying to get the parties to agree to such a settlement.

Simply because a judge strays from his traditional adjudicatory role in settlement negotiations does not mean that the judge will always do harm. Many judges, in many cases, may succeed in promoting fair, efficient settlements. But if the goal is to promote settlements based on the merits, rather than on non-merits factors, it is far from clear that judicial intervention in settlement negotiations routinely advances this goal. Some judges intervene in a way that promotes settlement simply in order to clear dockets—without regard to whether the settlement is a fair one. Other judges hesitate to intervene strongly in favor of what they view to be the merits because they have only limited knowledge of the case and therefore may question whether their own view is truly accurate. The very same attributes that make judicial promotion of settlements more attractive than formal judicial intervention via motions—the limited resources required and its utility in close, difficult cases as well as clear, easy cases—may strip a judge of his confidence in his views on the merits. The judge will tend to know much less about the case than the parties at a settlement conference. Asked to weigh in on the merits of a close case after only limited preparation, a

43. See E. Donald Elliott, Managerial Judging and the Evolution of Procedure, 53 U. Chi. L. Rev. 306, 311 (1986) (“A judge who narrows the issues in a case by granting a motion to dismiss or for partial summary judgment must act according to law and provide a reasoned justification, subject to appellate review. The idea that decisions to foreclose certain issues and lines of inquiry are ‘managerial,’ on the other hand, implies that these decisions are not based on the legal merits of the parties’ positions.”); Miller, supra note 5, at 52 (explaining that, as opposed to mediation, actual judges are in charge of writing preliminary judgment motion opinions); Molot, Old Judicial Role, supra note 20, at 44–45.

44. Miller, supra note 5, at 53; see also Judith Resnik, Managerial Judges, 96 Harv. L. Rev. 376, 408 (1982) (explaining judge-initiated pretrial judicial management provides judges with more information while imposing fewer evidentiary restrictions).
judge may appropriately believe that he is ill equipped to make such a determination.  

Moreover, the very same factors that may lead the careful judge to refrain from weighing in too strongly on the merits may lead the confident judge to intervene in a way that poorly reflects the merits of the case. A judge who walks into a settlement conference after only a cursory review of the parties’ preconference submissions may formulate an uninformed opinion of the case. A party may resist his efforts to promote a particular kind of settlement and try to educate him as to why his view of the merits is wrong, but the judge may mistake this resistance for hard bargaining and fail to accept that he has misjudged the merits. A settlement conference may require less work on the part of the judge and the parties than a summary judgment proceeding, but it also provides less opportunity for the parties to educate the judge—and the judge to educate the parties—on the merits of the parties’ positions.

3. Extrajudicial Alternative Dispute Resolution

Scholars bent on improving pretrial resolutions generally acknowledge that informal judicial intervention only works in some instances. Judges certainly may help when they have the time and inclination to learn about a case. But when judges lack that time or inclination to provide an accurate, objective assessment of the merits, scholars have embraced other quasi-adjudicative methods to promote more accurate settlements. They rely on someone other than the judge to educate parties on the merits of their positions and to narrow the information gap that may otherwise interfere with settlement negotiations. Extrajudicial methods may include private mediation, nonbinding arbitration, and the summary jury trial—all of which have the potential to provide parties with a better sense of how objective third parties view their cases and to educate them on the most likely outcome if they proceed to trial instead of settling.

In a judicial system characterized by scarce judicial resources, extrajudicial alternative dispute resolution (“ADR”) efforts can be much more promising

45. See Molot, Old Judicial Role, supra note 20, at 92 n.291 (“Given that judges during pretrial ordinarily know a great deal less about the merits of cases than do attorneys, there is the risk that a judge will not be able to determine when a party’s refusal to settle on proposed terms reflects the party’s honest views of the merits as opposed to an attempt to extract bargaining surplus from the opponent.”).

46. See Miller, supra note 5, at 10. See generally Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich, Inside the Judicial Mind, 86 CORNELL L. REV. 777, 829 (2001) (concluding that the authors’ study demonstrates judges, like laypersons, are “vulnerable to cognitive illusions that can produce poor judgments”).


49. See, e.g., Molot, Old Judicial Role, supra note 20, at 91.
than judicial intervention. Often the ADR process may be court-annexed—and the court may be the one who encourages the parties to pursue it and who picks the relevant mediator or arbitrator. But regardless of whether a mediator is court appointed, the mediator should have more time available than the judge to learn about the case and to devise a strategy to resolve it. Moreover, to those who worry about whether judges can remain impartial in presiding over a trial after failing to settle it, there may be an advantage to selecting someone other than the judge to preside over the ADR process.

To be sure, there are some disadvantages to extrajudicial ADR. Given that judges preside over so many trials, they may be best suited to educate the parties on the most likely result should they fail to settle and proceed to trial. Moreover, a judge’s time constraints may actually help to ensure that the ADR process remains efficient. A mediator with unlimited resources (particularly one who is compensated by the hour) may preside over an ADR process that is more extensive and more resource intensive than would ever be the case for a judicial settlement conference. But generally, a mediator’s availability is a positive, rather than a negative, particularly for complex cases that take a great deal of time to understand. Where judges lack the time or inclination to learn enough about a case to educate the parties on the merits and promote accurate settlements, extrajudicial substitutes for judicial intervention may offer the most promising way to promote accurate settlements. ADR may require time and resources, but it typically costs less than full-blown adjudication at trial, and yet, may provide the parties with enough of a sense of what would happen at trial as to promote merits-based settlements.

C. SHORTCOMINGS OF THE TRADITIONAL, ADJUDICATION-FOCUSED APPROACHES

When we look at the three traditional approaches to promoting accurate pretrial resolutions—formal judicial intervention, informal judicial intervention, and extrajudicial ADR—we find different balances struck between accuracy and efficiency, but almost no attention paid to risk preferences or bargaining imbalances. The approach with perhaps the most promise to promote accuracy at modest expense—extrajudicial ADR—does very little to offset bargaining imbalances. Alternative dispute resolution mechanisms like mediation, nonbinding arbitration, and the summary jury trial are designed to help where parties disagree, for example, about the likelihood of a defense verdict versus a...
plaintiff’s verdict or on the likely size of possible jury awards. And, to the extent that ADR reduces uncertainty and narrows the range of possible jury outcomes that the parties are considering, then it also may reduce the effect of imbalances in risk preferences on settlements. After all, imbalances in risk preferences will have less of an impact in cases that seem less “risky.” However, ADR is less helpful where parties agree on the range of possible trial outcomes—and understand just how risky a case is—but settle based not on that shared perception of the merits, but rather, on an imbalance in their risk preferences. Simply because a mediator or mock jury picks a particular jury award as the “fairest” or “most likely” at trial does not make it unlikely that a real jury will render a very different verdict. Aware that actual trial outcomes might depart dramatically from the compromises suggested in the ADR process, the parties’ relative eagerness to settle based on feedback from ADR will depend upon their risk preferences. And a party with a bargaining advantage over its opponent will remain free to reject extrajudicial feedback from the ADR process, and hold out for a settlement that is better than what it deserves on the merits.

When judges intervene in pretrial practice, they at least have the potential not just to educate parties on the merits, but also to induce the parties to settle based on the merits. A party that holds out for a better deal faces the prospect of a trial before a hostile judge whose advice on settlement it has rejected. For better or worse, a judge may not only provide his objective assessment of the merits, but also pressure the parties into settling based on that assessment and threaten the party who holds out for a better deal.

But this byproduct of judicial intervention has more often been viewed as a negative than a positive attribute of judicial settlement efforts. Many scholars complain that when judges try to coerce the parties into settling based on the judge’s, rather than the parties’, assessments of the merits, judges may deprive parties of their right to a neutral arbiter. At the extreme, this practice may even violate due process. Moreover, to those few who might view judicial coercion as a welcome method to offset bargaining imbalances, all of the weaknesses of judicial intervention addressed above would serve to undermine this method. Judges often lack the time and inclination to formulate an accurate assessment of the merits, let alone to coerce the parties into settling based on that assessment.

II. AN ALTERNATIVE APPROACH: MAKE PRETRIAL RESOLUTIONS LOOK LESS LIKE ADJUDICATIONS AND MORE LIKE MARKET TRANSACTIONS

If we want to address the bargaining imbalances that can lead settlements to

52. See, e.g., Resnik, supra note 44, at 380, 425–30 (arguing that managerial judging, among other things, negatively affects due process safeguards).

53. See Molot, Old Judicial Role, supra note 20, at 43–44, 59 & n.129 (arguing that judicial settlement conferences reveal judges have moved away from their relatively passive “traditional judicial role”).
stray from the merits we must look at the problem of inaccurate settlements through a different lens. Sometimes, inaccurate settlements may properly be considered a problem of procedure—a problem susceptible to procedural solutions. Where information asymmetries threaten to interfere with merits-based settlements, it makes sense to infuse some elements of adjudication into the pretrial process. By making pretrial resolutions look more like adjudicated resolutions, we may be able to overcome these information problems and promote accurate settlements.

But where settlements are skewed by imbalances in risk preferences, the problem is not only a procedural problem, but also a market problem. Settlements may sometimes be skewed not because our procedural system fails to educate the parties or the judge about the true merits of the case, but rather, because parties base settlements on their relative bargaining power, in addition to their perceptions of the merits and expectations for trial. Parties may see eye-to-eye on the range of possible jury awards and the most likely outcomes at trial. But one party may be a repeat player who is indifferent between settling for the mean damages award and proceeding to trial, while the other party may be a one-time participant who is fearful of rolling the dice, proceeding to trial, and risking a total loss. In those scenarios, the repeat player will be able to hold out for a better deal. Indeed, by holding out for a better deal in every case, a repeat-player defendant who faces many suits from one-time plaintiffs can routinely expect to settle cases below the mean damages award, thereby undermining substantive law goals like accurate deterrence, just compensation, and retributive justice.

If we want to address the bargaining imbalances that can lead settlements to stray from the merits, we must look at a litigation settlement not only as the resolution of a lawsuit, but also as a market transaction susceptible to market forces. When we view litigation settlements through this lens, we begin to see mispriced settlements as a market failure, rather than just a procedural failure. And, we begin to see that the most promising remedy is to embrace a free market in litigation claims.

The discussion below first explores why skewed settlements sometimes reflect a market failure, as well as a procedural failure, and why a market solution may help promote more accurate resolutions of lawsuits. The discussion then turns to the limited markets that already exist in legal claims, and the obstacles that have thus far prevented these markets from maturing into a viable solution to the problem of inaccurate settlements.

A. UNDERSTANDING THE PROBLEM OF SKEWED SETTLEMENTS AS A MARKET FAILURE SUSCEPTIBLE TO A MARKET SOLUTION

Why would a defendant ever pay more for a lawsuit or a plaintiff ever accept less than the expected value of the suit? There are two basic reasons why parties favor settlement over trial: litigation expenses and risk aversion. Parties settle so as to save the expense of going to trial and to eliminate the risk of a worse-than-
expected trial outcome. To the extent that both parties stand to benefit equally from a settlement—that is, both would save litigation expenses and eliminate risk—one would not expect either litigation expenses or risk preferences to interfere with merits-based settlements. To be sure, each party will try to capture a larger share of the bargaining surplus (the savings to be reaped through a settlement). But if the parties possess roughly equal bargaining power and stand to gain equally from settling, then one would expect these bargaining tactics to offset one another and settlements to gravitate toward the expected value of the suit if it were to proceed to trial. So long as the parties are sufficiently well-educated on the merits and see eye-to-eye on the range of possible trial outcomes, their settlement should end up approximating the mean expected jury award.

Where, however, the parties have different risk tolerances, this imbalance in risk preferences may lead to an imbalance in bargaining power and to a settlement that departs dramatically from the mean expected jury award. A one-time, risk-averse party will be more fearful of the worst-case scenario than a repeat player because the risk-averse party cannot absorb and redistribute the costs imposed by an adverse ruling, unlike the repeat player who holds a diverse pool of litigation risk. For this reason, a one-time defendant worried about a catastrophic loss may agree to pay more than the mean expected damages award to eliminate that risk. Conversely, a one-time plaintiff worried about recovering nothing at all may agree to accept less. Where a lawsuit pits a one-time, risk-averse party against a repeat-player, risk-neutral party, the imbalance may skew settlements significantly. The weaker party in these lawsuits may be willing to settle for an amount that departs dramatically from the mean damages award in order to eliminate the risk of a worst-case loss.

Whether an imbalance in risk preferences is likely to skew settlements, and just how far it may skew a settlement in an individual case, will depend upon two things. First, it will depend upon the distribution of potential jury awards—that is, just how risky is the case? A suit with a wider range of possible outcomes—and with possibilities that range from a defense verdict to a blockbuster

54. See, e.g., Rhee, Effect of Risk, supra note 23, at 227–28. Timing is a third factor that leads plaintiffs to settle—both because of the time value of money and because personal injury victims may be strapped for cash. And, of course, settlements may depart from expected values where parties are mistaken about that value due to information asymmetries.

55. See Grundfest & Huang, supra note 1, at 1275–76 (describing the traditional expected value mode of analysis which suggests that risk-neutral parties will settle for the expected value of a suit). Compare id. at 1276–78, 1281, for a discussion of why settlements might depart from the expected value of a suit even if the parties are risk neutral. Analogizing a lawsuit to an option, Grundfest and Huang point out that volatility—or uncertainty over the ultimate outcome of the lawsuit—may contribute to the option’s value just as much as the expected value of the suit. Id.

56. See Shukaitis, supra note 13, at 336 & n.40 (noting a stronger bargaining position for a risk-neutral defendant, compared to a risk-averse plaintiff, because of the uncertainty in litigation); cf. Grundfest & Huang, supra note 1, at 1276–78, 1281 (noting that uncertainty may affect a lawsuit’s settlement value—and skew it away from the expected value of the suit—even if both parties are risk neutral).
plaintiffs’ award—is going to have a different impact on a risk-averse party than would a suit with a narrow cluster of possible outcomes. The riskier the lawsuit, the greater the effect on settlement of a disparity in risk preferences. Second, of course, is the question of just how different the parties’ respective risk preferences are. Does a suit pit a one-time, risk-averse party against a repeat-player defendant? Are the damages at stake a large amount compared to one party’s net worth and a small amount compared to the other’s? To figure out just how often, and to what extent, bargaining imbalances may lead settlements to stray from the merits, one would have to know whether the range of possible outcomes strays significantly from the mean jury award, and whether the lawsuits pit one-timers with a small net worth against repeat players with a large net worth.

In at least one very important category of cases—personal injury lawsuits—empirical evidence reveals that both of these criteria are met: the spread of possible damages is large and the disparity between the parties is enormous. As to the riskiness of the lawsuits, the award range is not only wide, but it is characterized by a vast difference between the mean damages award (the numerical average of all judgments) and the median damages award (the award level that is greater than half of all judgments and less than half). The mean damages award for personal injury suits in jurisdictions for which data are available is much greater than the median damages award—roughly three to five times bigger according to a number of studies.57 This is true because a very small portion of plaintiffs win very large jury awards, while the majority of plaintiffs either collect relatively small amounts or lose at trial.58 Indeed, studies reveal that roughly half of personal injury plaintiffs who proceed to trial collect nothing at all, and a sizeable majority collects less than the defendant’s highest settlement offer.59

This disparity between the median and mean damages award is particularly important when one looks at the second factor that can lead risk imbalances to


58. Samuel R. Gross & Kent D. Syverud, Getting to No: A Study of Settlement Negotiations and the Selection of Cases for Trial, 90 Mich. L. Rev. 319, 338 fig.2 (1991) (finding, from a sample, that 45% of plaintiff victories resulted in awards over $10,000). The disparity between the mean and median for any individual case may not be as large as the multiple that divides the mean and median for a large pool of cases. That is because the distribution of jury awards over a pool of cases is a product not only of juror discretion, but also of the very different fact patterns that may characterize different cases in the pool. In any given case, the plaintiff will look to the “typical” jury award for a case involving similar facts, and the defendant will look to the mean expected award for that fact pattern. Even if the mean and median do not differ as dramatically in individual cases as they do for the pool as a whole—and frankly it is impossible to know the precise distribution of potential outcomes in a single case that gets tried once—it is commonly understood by plaintiffs’ attorneys and repeat defendants alike that the potential distribution of jury awards in individual cases has the same lognormal shape as for the pool as a whole, and that the mean is significantly higher than the median.

59. Id. at 335 fig.1, 339 fig.3.
skew settlements: the nature of the parties involved. Personal injury lawsuits typically pit cash-strapped, one-time plaintiffs against larger entities, often repeat players such as insurance companies or product manufacturers. As a result, plaintiffs and defendants in tort suits will look to different benchmarks in valuing lawsuits for settlement purposes. The cash-strapped, one-time plaintiff will be told by his lawyer that as many as half of personal injury plaintiffs who proceed to trial collect nothing at all and that those who do win at trial typically collect modest jury awards. Being familiar with the distribution of jury awards, the lawyer may also tell the plaintiff that there is a small chance of collecting a much larger amount, but that the chance is remote. For the one-time plaintiff, then, the best benchmark in settlement negotiations may be the median expected jury award, for that is the more likely outcome for a one-time participant. This is not to say that the plaintiff will always seek to settle the case at the precise mathematical median. For example, where more than half of plaintiffs are likely to collect nothing so that the median is zero, plaintiffs would seek to collect a “typical” jury award that is higher than zero, but probably less than the median of all non-zero awards. Moreover, the risk aversion of the one-time plaintiff may be offset to some extent by his contingent fee attorney, a repeat-player likely to be somewhat less risk averse. The lawyer, thus, may encourage the plaintiff to hold out for more than the median. But overall, the median expected damages award would offer a better benchmark for the plaintiff than the higher, mean expected damages award. If the defendant were to offer the plaintiff an amount that the plaintiff and her lawyer considered to exceed that typical award, the plaintiff would be inclined to accept it.

To understand the pressure faced by a one-time plaintiff to accept an offer at the median, even if it falls well below the mean, consider a case with the following (simplified) distribution of possible trial outcomes: a 45% chance the plaintiff will recover nothing, a 45% chance the plaintiff will recover $100,000, and a 10% chance the plaintiff will recover $1,000,000. In such a case, a one-time plaintiff would be hard pressed to turn down a $100,000 settlement offer, even though the mean expected damages award would be $145,000. To reject a $100,000 offer would be to take almost a one-in-two chance of recovering nothing at all in exchange

60. See id. at 333, 349.

61. In some categories of tort litigation, such as medical malpractice, there may also be reputational concerns that drive defendants not to settle. See id. at 364.

62. However, their difference in risk preferences may itself be offset, at least in part, by the manner in which contingent fee arrangements allocate the benefits and burdens of future litigation—with the attorney bearing all the opportunity cost of proceeding to trial but reaping only one-third of any additional recovery. See Jonathan T. Molot, How U.S. Procedure Skews Tort Law Incentives, 73 Ind. L.J. 59, 88 (1997); cf. Neil Rickman, Contingent Fees and Litigation Settlement, 19 Int’l Rev. L. & Econ. 295, 306 (1999) (“Certainly, holding the level of damages constant, a cost-bearing contingent fee lawyer’s self-interest will lead her to receive and accept lower settlement amounts than her client would wish.”).

63. Gross & Syverud, supra note 58, at 384 (“For a plaintiff . . . the median is closer to the mark.”).

64. \( (0.10 \times 1,000,000) + (0.45 \times 100,000) + (0.45 \times 0) = 145,000 \).
for a mere one-in-ten chance of winning $1 million.

But from a repeat-player defendant’s perspective, a settlement at the median may represent a significant savings from what a lawsuit is really “worth.” The mean damages award is the best approximation of what would happen if all cases went to trial. The definition of the mean, after all, is the total damages paid out over a pool of cases divided by the number of cases in the pool. If the defendant were to pay the mean award as a settlement in every case—$145,000 in the hypothetical above—it would pay the same overall amount in settlement that it would pay in judgments if it were to proceed to trial in every case. Where, however, a defendant routinely settles cases at the median, rather than the mean, it substantially undermines our goal of ensuring that settlements approximate what defendants would pay at trial.65

In trying to correct this failure—and reduce the disparity between settlement amounts and trial outcomes—we may look at it both as a failure of procedure and as a market failure. Inaccurate settlements caused by imbalances in risk preferences are, in part, a procedural problem. It is our system of procedure, after all, which permits jury awards to vary so dramatically. If jury awards were more predictable and less varied, this would dampen the potential effect of imbalances in risk preferences on settlement negotiations. If the distribution of potential jury awards in a case was a narrow band surrounding the mean—and if the mean and median were closer together—it would likely reduce the importance of bargaining power and risk preferences in settlement negotiations.

But when viewed through a procedural lens, the skewing effects of unequal risk preferences are all but impossible to correct.66 To reduce unpredictability in litigation—and constrain jury discretion—we would need not only to adjust the pretrial settlement process, which has been the target of most of the procedural reforms described above, but to overhaul our entire system of trial by jury. Such an overhaul would run up against centuries of tradition and perhaps the Seventh Amendment of the Constitution.67 No doubt, some limited efforts have been made on this front to promote greater predictability in trial outcomes. The Supreme Court’s relatively recent attempts to cabin juror discretion on punitive damages awards—and generally to limit them to ten times compensatory damages68—represent a modest effort to reduce variability in trial outcomes. But, by definition, the cases that we send to juries are ones where material issues of fact

65. To those who view large judgments as outliers, without any normative value, the median, rather than the mean, might be a more appropriate amount for defendants to pay. But as our jury system allows juries discretion to award a wide range of recoveries to plaintiffs, it is hard to see the normative basis for eliminating these larger awards or stripping them of influence over defendants’ payments and plaintiff recoveries.

66. See Grundfest & Huang, supra note 1, at 1282, 1318–19.

67. See U.S. Const. amend. VII.

68. State Farm Mut. Auto. Ins. Co. v. Campell, 538 U.S. 408, 425, 429 (2003) (holding a 145-to-1 ratio between harm to the plaintiff and the punitive damages award was unconstitutional under the facts of the case, and instructing that “[s]ingle-digit multipliers are more likely to comport with due process”).
remain and reasonable people could decide differently. The cases that are not weeded out in motion practice are cases where reasonable juries could disagree over liability and over the extent of damages. Putting the question of punitive damages aside, the range of compensatory damages that juries can award for such intangible injuries as pain and suffering is inevitably large. We might try to do for civil jury awards what the sentencing guidelines tried to do for variability in criminal prison sentences. But that two-decade experiment was an effort to cabin judges, not juries, and even that effort ultimately was struck down as unconstitutional. To cabin juror discretion in civil cases would be a much greater undertaking.

A much simpler, and more promising, solution would treat the problem of risk imbalances as a market problem rather than a procedural problem. Instead of trying to change the distribution of jury awards at trial—through radical procedural reforms designed to make litigation less risky—we could harness market forces to level the playing field between parties who are not otherwise equally well-suited to cope with litigation risk. At its simplest, consider what would happen if a large group of similarly situated plaintiffs were able to band together and refuse to settle for an amount equal to the median jury award, spreading the risks and rewards of winning or losing any individual suit at trial over the entire pool of plaintiffs. By proceeding to trial in every case where the defendant offers less than the mean expected damages award in settlement, the plaintiffs would likely increase their recoveries. Instead of settling individually for the median damages award, they would, as a group, receive the mean damages award—either at trial or in settlement. If the empirical evidence on the disparity between mean and median jury awards for a large pool of cases is any indication of the disparity between the mean and median in a given case, plaintiffs might increase recoveries significantly.

Such a simple scenario—in which plaintiffs themselves just band together—is in fact too simple. Because each lawsuit is different, it would not be workable for each plaintiff to share equally in the collective recovery of the

---

69. See Fed. R. Civ. P. 56(c)(2); see also Grundfest & Huang, supra note 1, at 1319 (vague statutes and “minimalist” judges may also inject “substantial uncertainty” into the law (quoting Debra Livingston, Police Discretion and the Quality of Life in Public Places: Courts, Communities, and the New Policing, 97 Colum. L. Rev. 551, 628 (1997))).
71. Booker, 543 U.S. at 227 (2005) (Breyer, J.). Then, again, the Sentencing Guidelines’ mandatory nature was held to violate the Sixth Amendment right to a jury trial in criminal cases rather than the Seventh Amendment right to a jury trial in civil cases. Id.
72. Gross & Syverud, supra note 58, at 378 (“Given . . . strategic bargaining by defendants . . . it is in plaintiffs’ economic self-interest to pursue many cases that they are likely to lose, as well as those that they expect to win.”).
73. Recall, though, that the distribution of damage awards for a pool of cases is a product not just of unpredictability, but also of the differences among the various cases. See supra note 58.
entire group. In one suit, the expected distribution of jury awards might have a median of $10,000 and a mean of $20,000. Another suit might have an expected distribution of jury awards with a median of $100,000 and a mean of $200,000. Both plaintiffs would be better off proceeding to trial than accepting the median expected damages award in settlement, so long as they could spread the risk of collecting less than the median over a larger pool of cases. But it would not work for the plaintiff with the $20,000 claim to share equally with the plaintiff who has a $200,000 claim. Rather, the pool would have to find a way to allocate the collective recovery among individual plaintiffs based upon the merits of their cases and the extent of damages they suffered. Each plaintiff would be entitled to the mean expected jury award for his case, rather than for the pool as a whole.

To price each plaintiff’s claim accurately—and give each his fair share of the pool’s recovery—we would need some sort of market mechanism. We might rely on a middleman, an insurer, a for-profit investor, or some other market participant to perform this function—and price each plaintiff’s suit in the pool—and the discussion below will explore the various options. But whatever market mechanism we employ to value individual claims and construct a pool of litigation risk, the result would be to offset a repeat-player defendant’s bargaining advantage and level the playing field in settlement negotiations. If the entity negotiating on the plaintiff’s behalf represented the interests of a collective pool of plaintiffs, rather than one individual plaintiff, its risk profile would be very similar to the defendant’s. Instead of pitting a one-time, risk-averse plaintiff against a repeat-player, risk-neutral defendant, settlement negotiations would proceed between two similarly situated parties with roughly equal bargaining power. In that circumstance, one would expect settlement levels to return to the mean—and to be based on the underlying merits of lawsuits.

Introducing a repeat-player, risk-neutral entity on the plaintiffs’ side 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. A market participant or middleman that relieves a risk-averse plaintiff of litigation risk might try to buy out the plaintiff for as little as possible—attempting to pay the plaintiff just what the defendant would have paid, and subsequently, turning around to extract a profit via a higher settlement with the defendant. But in a free market for litigation claims, this market participant would be subject to market forces that do not currently constrain litigation defendants. There might be a bargaining imbalance between the plaintiff and the middleman, just as there currently is between the plaintiff and

74. This is a problem confronted, and in some cases overcome, in class action litigation.
75. See section II.B.2.a–c.
76. But cf. Grundfest & Huang, supra note 1, at 1275–76, 1281–82 (noting variance may skew settlements away from expected value).
the defendant, but market forces could counter the effect of that bargaining imbalance and permit the plaintiff to shop around his claim and get the best offer possible. No longer forced to deal with a single counterparty, even the most risk-averse plaintiff would have a chance at a fair recovery.

B. EXISTING LITIGATION MARKETS AND OBSTACLES TO THEIR MATURATION

If the free exchange of litigation claims would facilitate more accurate litigation settlements—and promote substantive law goals like accurate deterrence and just compensation—the next question civil procedure scholars must ask is how we would go about fostering such market exchanges. One could imagine a variety of solutions ranging from a cooperative, mutual-insurance type model, along the lines of the hypothetical introduced above, to a more traditional market that commodifies litigation claims and permits their free exchange among disinterested investors. Rather than create a market in litigation risk from scratch, however, it is worth considering the limited markets in litigation claims that already exist. As shown below, these markets are not nearly robust enough in their current form to address the problem of unequal bargaining power in a meaningful way. But they are a start, and if we examine these markets carefully, and consider the obstacles that have prevented their maturation, we may see a path toward a workable solution.

1. A Long-Standing, Albeit Limited, Market: The Contingent Fee System

The principal market for litigation claims in this country is found in the contingent fee system. A great many plaintiffs, for quite a long time, have been permitted to sell a portion of their claims to their lawyers in exchange for legal representation. Plaintiffs who either lack the funds to pursue legal claims or otherwise have the funds but fear losing a suit which they bore the cost of bringing can off-load some of the risk of a loss to their attorneys. Plaintiffs’ attorneys will fund the litigation—dedicating their own time and often advancing out-of-pocket expenses as well—in exchange for a share of any recovery. In this manner, contingent fee arrangements transfer litigation risk from one-time plaintiffs, who are ill equipped to bear that risk, to attorneys who hold a diverse portfolio of lawsuits and, therefore, can more easily bear the risk of losing any one suit.

A plaintiff who uses a contingent fee arrangement can significantly enhance his or her bargaining power vis-à-vis the defendant. Indeed, a contingent fee plaintiff can file a lawsuit, and even reject low-ball settlement offers and proceed to trial, without any downside risk of losing money. Empirical studies comparing trial outcomes with settlement negotiations for a range of different cases suggest that

77. See Painter, supra note 29, at 626–27 (noting contingency fees most often arise in the personal injury arena, in addition to spreading to corporate- or securities-related suits).
78. MODEL RULES OF PROF’L CONDUCT R. 1.5(c) (2002).
79. See Molot, supra note 62, at 82; Painter, supra note 29, at 678–80 (explaining that contingency fee lawyers with a diverse portfolio of cases are able to assume the risks associated with litigation, though noting diversification is difficult to achieve for the average lawyer).
plaintiffs who paid their lawyers a contingent fee were more willing to proceed to trial than plaintiffs who paid their lawyers by the hour. The hourly fee-paying clients willing to reject settlement offers and proceed to trial were generally only those with very strong cases who were very confident of victory.

But if the contingent fee system bolsters plaintiffs’ bargaining power by permitting them to off-load some litigation risk to their lawyers, this “market” for legal claims is inefficient and incomplete. For one thing, only lawyers are permitted to take a share of the plaintiff’s claim under a contingent fee arrangement. Ethical prohibitions against fee sharing with nonlawyers have prevented attorneys from passing on their shares of recoveries to nonlawyer capital providers. Moreover, lawyers are permitted to pay for their shares of claims only in kind: namely, with the provision of legal services and advancement of out-of-pocket litigation expenses. Ethical rules prohibit attorneys from paying cash for a portion of their clients’ claims. Finally, because lawyers can only pay with their services and cannot purchase claims outright, the portion of a claim that lawyers can purchase is necessarily limited. Typically, lawyers are entitled to only one-third of their clients’ recoveries (and in some contexts, are prohibited by ethics rules from taking more). The client retains the remaining two-thirds of the recovery.

These restrictions on contingent fee arrangements have two negative consequences. First, the prohibition against lawyers sharing legal fees with nonlawyers creates a serious inefficiency in the market for legal services. Some plaintiffs’ firms earn super-competitive profits because risk-averse, hourly fee firms are unwilling to compete with them for contingent fee business. These contingent fee firms may end up charging their clients the standard rate of one-third of the recovery, even if the risk or labor required would not warrant such a percentage in a competitive market. Other, less successful plaintiffs’ firms sometimes take on cases that they lack financing to handle effectively, and therefore, may litigate the cases poorly or settle them too early for too little.

See, e.g., Gross & Syverud, supra note 58, at 349–50, 378–79 (examining 529 civil jury trials in California over the course of a year, and concluding that, in general, plaintiffs in personal injury cases can afford to bring suits, regardless of the likelihood of success, because of California’s uniform practice of contingency fees).

See id. at 379 (comparing commercial cases to personal injury cases and finding that, with respect to the former, plaintiffs’ lawyers are usually paid at an hourly rate and “many plaintiffs can only afford to take likely winners to trial”).


See Model Rules of Prof’l Conduct R. 1.8(e) (2002).

See Lester Brickman et al., Rethinking Contingent Fees 29 (1994).

See Model Rules of Prof’l Conduct R. 1.5(a), (c) (2002).

See Painter, supra note 29, at 671–72. See, for example, Jonathan Haar, A Civil Action (1996), narrating the story of a plaintiffs’ firm which brought a tort case against, among other parties, a large...
As a result, plaintiffs do not get the best legal services for the money they pay.87 A second, and more important, shortcoming of the contingent fee system is that even where lawyers have the financial resources they need to work effectively for a contingent fee, they can only provide limited relief to their risk-averse clients. The one-time plaintiff who hopes to collect millions, but fears that she will collect nothing, can use a contingent fee arrangement only to off-load the risk of bearing litigation expenses in the event that he loses. The contingent fee system does nothing to assuage the plaintiff’s risk aversion with respect to the broad range of trial outcomes that remain.88 The one-time plaintiff will still be inclined to accept any settlement offer that exceeds the typical, or median, expected jury award for a plaintiff in her circumstance, even if the mean expected award is much higher. If we want to offset the bargaining advantage of a repeat-player defendant, we would need to give the one-time, risk-averse plaintiff a mechanism either to sell off a portion of his claim or, at least, to buy insurance that will guarantee the plaintiff some minimum recovery. If we want to bolster that plaintiff’s bargaining power, we need to protect him not only against bearing litigation expenses but also against walking away with nothing at all.

2. Emerging Markets in Litigation Risk

Although to date lawyers have been prohibited from paying cash for their clients’ claims, nonlawyer investors have recently begun to find ways to profit from litigation. In so doing, these investors have followed the lead of investors in some other countries. While the United States traditionally has excluded third-party capital providers from the market for litigation claims and permitted only lawyers to finance litigation, England has done the exact opposite. In England, lawyers are prohibited from working for a contingent fee,89 and non-lawyer capital providers may finance plaintiffs’ claims in exchange for a share of the recovery.90 Funders generally do not control the course of litigation or unduly interfere with the attorney–client relationship,91 and more recently, there

---

87. See infra pp. 98–99 and notes 116–18.
88. See Shukaitis, supra note 13, at 339.
89. See 1 RUPERT JACKSON, REVIEW OF CIVIL LITIGATION COSTS: PRELIMINARY REPORT 189 (2010) (quoting Rule 2.04 of the Solicitors’ Code of Conduct and Rule 405 of the Code of Conduct of the Bar of England and Wales, each of which respectively impose a general bar on solicitors and barristers from entering into contingency fee arrangements). As commonly understood, contingency fees have a narrow sense as “fees which (a) are payable if the client wins and (b) are calculated as a percentage of the sum recovered.” Id. This definition therefore excludes conditional fee arrangements, which are also expressly permitted by law. See id. at 165–68 and infra text accompanying note 95.
90. See JACKSON, supra note 89, at 160–63.
91. See id. at 160, 163 (explaining that case law prohibits third-party litigation funding agreements which contravene public justice and that “[f]unding agreements do not generally give funders any control over the conduct or settlement of litigation” for “fear that any mechanism of control could give rise to allegations of champerty).
have been proposals to regulate litigation finance. But, the English (and Australian) model differs from the American model insofar as it relies on nonlawyers, rather than lawyers, to absorb litigation expenses and risks from litigation claimants.

Recently, there has been some convergence between the approaches in England and the United States, as the flaws associated with both nations’ restrictions on litigation finance have become all too apparent. In England, lawyers have begun working for a “conditional” fee under which they agree to a reduced hourly fee in exchange for a premium payment over-and-above the total amount billed, but only should the plaintiff prevail. Conversely, in America, nonlawyer capital providers have begun to exploit inefficiencies and shortcomings in the contingent fee system in an attempt to profit from litigation claims. There are several different ways that U.S. investors have sought to profit from investments in litigation claims, each of which is briefly discussed below.

a. The Cash Advance Industry for Personal Injury Victims. Over the last decade or so, a relatively new “cash advance” industry has developed. Cash advance firms offer personal injury victims cash advances while their personal injury lawsuits are pending. Most of these firms structure their advances as nonrecourse loans. The transactions are loans insofar as the cash advance firm charges a fixed interest rate on the funds advanced, rather than receiving a specified percentage of the plaintiffs’ recovery the way attorneys do under a contingent fee arrangement. Yet, they are nonrecourse loans because the plaintiff need only pay back the advance if the lawsuit succeeds. The cash advance firm accepts the risk that the lawsuit will result in a defense verdict or a recovery that is less than the amount owed by the plaintiff.

There are serious problems with this cash advance system. The problems stem from the very high interest rates charged by cash advance firms—typically 3% to 5% monthly interest, and often much higher. The high interest rate is a problem for two reasons. First, it strips the risk-transfer mechanism of much of its value for the plaintiff. If our goal is to ensure that plaintiffs receive what they are entitled to under substantive law, it does no good if the plaintiff must pay away much of that value in interest. Second, the rapid accumulation of interest


95. JACKSON, supra note 89, at 166–68.

undermines our goal of bolstering plaintiffs’ bargaining position vis-à-vis repeat-player defendants. A plaintiff whose net recovery declines the longer he or she goes without settling will have strong incentives to settle quickly, and have a much harder time rejecting low settlement offers and holding out for more. In this way, the high interest-rate structure may undermine our dual goals of accurate compensation and deterrence.

The high interest rates charged by cash advance firms are partly a product of the risk involved, but they are also partly a byproduct of government regulation. Cash advance firms structure their products to avoid two areas of government regulation. First, by charging a fixed interest rate, rather than taking a share of the plaintiffs’ recovery, cash advance firms avoid prohibitions against champerty and maintenance that historically have prevented third parties from funding litigation in exchange for a share of the recovery. While some states have repealed such prohibitions—and now expressly permit the financing and outright sale of part or all of a litigation claim—some have not. To avoid having to craft their products to comply with often unclear and untested laws on the subject, cash advance firms simply charge a fixed interest rate. Yet, because the risk associated with litigation is higher than that of nonpayment for conventional loans, cash advance firms charge high rates of interest. Indeed, the rates are so high that, in many instances, they might violate usury laws were they subject to those laws. With compounding, after a relatively short time frame (by litigation standards), a plaintiff may end up owing a cash advance firm more than two or three times what he borrowed—sometimes more than he will collect in judgment. To avoid usury restrictions imposed on traditional loans, the cash advance firms make repayment of the advances entirely conditional on success in the lawsuit. So far, with the exception of Ohio where the

97. See generally 14 Am. Jur. 2d Champerty, Maintenance, and Barratry §§ 1–15 (2009) (defining and describing the doctrine of champerty and maintenance). Maintenance is the provision of support for a lawsuit to which one is not a party, and champerty is a form of maintenance that involves acquiring an interest in the recovery from the lawsuit. See Choharis, supra note 29, at 460–61.

98. See, e.g., Abramowicz, supra note 29, at 700–01 (listing Massachusetts, New Jersey, and Texas); Painter, supra note 29, at 641–42 (categorizing California, Arizona, New Jersey, New York, and Louisiana as states that “avoid champerty and similar doctrines”); see also Choharis, supra note 29, at 464 (“It is doubtful that the tort of champerty is available as a separate cause of action in any state, while prosecution of champerty as a criminal misdemeanor ended long ago.”).

99. See, e.g., Choharis, supra note 29, at 464 (“At least sixteen states directly prohibit champerty, barratry, or maintenance.”); Painter, supra note 29, at 641–42 (listing Florida, Illinois, Kansas, Missouri, Pennsylvania, South Dakota, and Wisconsin as states that bar champerty); see also Shukaitis, supra note 13, at 330 (“Most states prohibit the assignment of personal injury tort claims . . . out of a professed fear of maintenance, champerty, and barratry . . . .”).

100. The high interest rates may also be a product of the weak bargaining position of cash-strapped personal injury victims.

101. See, e.g., Rancman v. Interim Settlement Funding Corp., 98 Ohio St. 3d 121, 2003-Ohio-2721, 787 N.E.2d 217, at ¶ 8 (describing the lower court’s holding that the contingent advances on settlements were illegal loans because the potential profit exceeded the legally allowable interest rate, though ultimately deciding the case on separate grounds).
Ohio Supreme Court banned litigation cash advances as a form of champerty\textsuperscript{102} (only to be overturned by the Ohio legislature\textsuperscript{103}), cash advance companies have been able to argue successfully that neither champerty prohibitions nor usury laws apply to nonrecourse advances solely repayable out of litigation recoveries.\textsuperscript{104}

Rather than paying a high, compounding interest rate a plaintiff might be far better-off simply selling a percentage of his recovery to a cash advance firm, just as he does to his attorney. A plaintiff might give away a third of any recovery to his lawyer in exchange for legal services, another third to a cash advance firm in exchange for a cash payment, and finally, retain the remaining third for himself. Just as plaintiffs today can use contingent fee arrangements to protect themselves from the downside risk of losing and being on the hook for legal fees, so too could plaintiffs sell an interest in a third of their cases to cash advance firms, thereby protecting themselves from the risk of collecting nothing. With some cash in their pockets and no interest accruing, plaintiffs might have the luxury of holding out for a better settlement. Indeed, the outright sale of a percentage of a claim would better align the interests of the plaintiff, lawyer, and funder—each of whom might share one-third of the rewards from holding out for a higher settlement.\textsuperscript{105}

There are two obstacles to this shift from charging high interest rates to taking a share of the recovery. The first is economic. The diligence required of a cash advance firm to ensure that a lawsuit is worth more than a fixed amount is not as great as the diligence required to put a precise value on the suit. If the funder believes the suit is worth more than $100,000, it can feel comfortable lending $30,000, knowing that even if the suit results in a recovery somewhat lower than $100,000, the recovery should be sufficiently large to repay the loan with interest. If, however, the cash advance firm will be repaid with one-third of the recovery, then recovery of an amount lower than $100,000 will result in a loss. Funders might advance smaller amounts or demand a larger percentage of the recovery to compensate for the risk of mispricing a lawsuit, and they presumably will find ways to pass along to plaintiffs the costs associated with the additional due diligence undertaken to address this risk.

State regulation is a second obstacle that prevents cash advance firms from charging a percentage of the recovery. As noted above, although many states

\textsuperscript{102} Id. ¶ 19.


\textsuperscript{105} But cf. Miller, supra note 5, at 18 (noting conflicts of interest between contingent fee attorneys and clients).
have done away with champerty and maintenance restrictions, others have not.106 Before cash advance firms could routinely take shares of recoveries from personal injury victims, they would need to seek clarification or reform of the law and would have to structure their transactions very carefully.107

b. Investment in Commercial Litigation by Investment Funds. A second recent development in litigation finance involves a different kind of litigation and a different transaction structure. Some investment funds and investment banks have begun to buy interests in commercial lawsuits. If we are looking to build a market in litigation claims, this would certainly be one of the models we could build upon.

Hedge funds, and some traders at investment banks, have long viewed litigation risk as attractive because it is uncorrelated with markets—the outcome of a lawsuit will not depend upon fluctuations in the stock or bond markets. For this reason, hedge funds seeking a diverse portfolio of investments have tried to earn returns by betting on litigation.108 Sometimes, they have been able to do so through trades in public markets. Where a publicly traded company is a party to a lawsuit and the company’s stock price reflects the market’s expectations for the lawsuit, a hedge fund can make money if it predicts the outcome of the relevant lawsuit with greater precision than the market can. The patent challenge to Research In Motion, Ltd.’s (RIM) BlackBerry device offers a prominent example of investors buying or selling stock based on their predictions for a pending lawsuit.109 In the period leading to the ultimate settlement of that lawsuit, RIM’s stock price fluctuated wildly based on investors’ changing expectations regarding the lawsuit’s likely conclusion.110

But betting on litigation through trades in public markets is not always feasible. Even if a fund can accurately predict the outcome of a pending lawsuit, the stock price of the company that is a party to that lawsuit will depend upon many factors outside of the pending litigation. The fund might buy the company’s stock, betting correctly that it will win a prominent lawsuit, but regardless, the company’s stock may decline either because the company’s sales are down that quarter, prices for a commodity it sells happen to decline, or the stock market declines generally.

For a fund that wants to make a clean bet on a lawsuit—a bet that will expose it to pure litigation risk while neutralizing other factors that can affect a company’s share price—the most attractive course is to make a direct investment in the lawsuit. The hedge fund can offer the plaintiff cash for a portion of

106. See Choharis, supra note 29, at 465.
107. A discussion of potential reforms of champerty and maintenance laws is reserved for Part III below.
108. See Molot, supra note 16, at 399.
109. See, e.g., Shares Hit by Suit over E-mail Patents, CHI. TRIB., Nov. 7, 2006, § 3, at 2.
the recovery where the plaintiff needs cash or simply wants to reduce his exposure to litigation risk. Indeed, litigation finance of this sort is especially attractive for small, start-up companies with large intellectual property claims against established companies.111 The small start-up may need cash to fund the lawsuit, as the best patent lawyers are often at law firms that charge by the hour rather than working for a contingent fee. The plaintiff may also need money to fuel its own growth—for example, to pay salaries and cover expenses as it tries to develop other software products. By selling part of its claim, the plaintiff can both eliminate the cost of pursuing the claim and monetize a portion of the claim to fuel the company’s growth. Although the small intellectual property company may not be quite as destitute as the personal injury victim, it may be similarly eager for cash and, likewise, may be facing a large, repeat-player defendant. By enlisting the help and cash of a third party, the plaintiff may be able to bolster its negotiating position vis-à-vis the defendant, thereby increasing its recovery (indeed, so much so that software giants have rallied against so-called patent trolls who buy up intellectual property rights in order to file lawsuits against deep-pocketed infringers112).

Where commercial claims are involved, rather than personal injury claims, it is easy to structure transactions so that the capital provider takes a percentage of the recovery without running afoul of any potentially applicable maintenance or champerty restrictions. Lawsuits that are held by corporate entities can be sold simply by selling ownership interests in the relevant corporate entities—ownership interests with returns that may be tied to the recovery in the relevant lawsuit. Indeed, complicated structuring may be entirely unnecessary because most champerty and maintenance laws are confined to “personal” actions, like personal injury suits, and do not restrict the sale of commercial claims.113 Moreover, the pricing problems that may get in the way of cash advance firms buying a percentage of a personal injury claim are less daunting in the commercial claim context. It is much less costly and time consuming to value one $50 million commercial suit than to value one-thousand different $50,000 lawsuits, provided that each suit has its own individual set of facts and legal issues. Expected returns can cover the diligence expenses associated with such a large investment.

113. See Painter, supra note 29, at 643; see also id. at 640 (noting that although the common law “forbids . . . assignment of all or part of a cause of action” there are “many exceptions to this rule,” and “[c]ontract claims are generally assignable as are many types of tort claims for property damage”). See Benjamin C. Esty, The Information Content of Litigation Participation Securities: The Case of CalFed Bancorp, 60 J. FIN. ECON. 371, 373–74 (2001), for an example of how plaintiffs’ claims have not only been transferred, but securitized and traded on an exchange.
But if the hedge-fund investment model works for large commercial claims, it has thus far been limited to that arena. Hedge-fund investment may help level the playing field between a small start-up intellectual property company and a large, repeat-player defendant, like Microsoft or Intel, but so far, it has not worked for smaller claims or for personal injury claims held by individuals. Investment funds have sometimes invested in the cash advance companies described above, but when they do so, their capital is passed along to personal injury victims using the same flawed structure described above—one that employs high-interest, nonrecourse loans rather than the purchase of an equity stake in the outcome of a lawsuit.

c. Law-Firm Finance. Investment-fund capital has been of some use not only to small companies with large commercial claims, but also, in some instances, to law firms that want to take in capital and off-load risk associated with contingent fee cases. Recall that one limitation of the contingent fee system is that it does not permit lawyers to share fees with nonlawyers. However, some of the same entities that buy interests in lawsuits from plaintiffs have recently found ways to make investments in litigation via law firms. These investments in law firms, like investments in personal injury claims, are structured as loans rather than as the sale of a portion of claims.114 Unlike maintenance and champerty restrictions that have been relaxed in many states to permit litigation plaintiffs to sell portions of their claims, the ethical prohibition against attorney fee sharing is uniform.115 Only the District of Columbia permits lawyers to share fees with nonlawyers, though this permission is limited to other professionals, like accountants or lobbyists, who work side-by-side with lawyers in partnerships and take a share of profits for their work.116 No state permits lawyers to give away a portion of their legal fees—whether contingent fees or hourly fees—in exchange for a capital infusion from an investment fund.

Lawyers are, however, permitted to borrow money. And, just as cash advance firms make nonrecourse loans to personal injury victims, so too might investors make loans to law firms that are recoverable only out of the law firms’ revenues for legal services rendered. The interest rates for these law-firm loans might not be quite as high as for personal injury victims, but they would still be quite high—25% per year or greater, depending upon the risk involved.117 For a fund that is looking to double its money every five years (a typical goal for many investment funds), the fund could reach its target by investing $50 million in a

115. See supra notes 82, 97–99 and accompanying text.
lawsuit in exchange for an expected recovery of $100 million five years later, or it could do so by lending a law firm $50 million at a 20% annual interest rate that would produce a repayment of roughly the same $100 million five years later. (A 25% interest rate would lead to a tripling of money in five years.)

Why, one might wonder, would a law firm ever agree to pay such a high rate of interest? Do law firms really need outside financing? Outside the U.S., the answer has been yes, and at least regulators in Australia have moved toward allowing lawyers to raise capital from outside investors and even toward offering shares to the public.118 Instead of being owned by law firm partners, shares of a publicly traded law firm may be traded on a stock exchange, just like shares in any other money-making venture.

In the United States, where equity-based financing is prohibited,119 would lawyers similarly be inclined to resort to outside financing, even if it must be in the form of debt, rather than equity? Different law firms may have different reasons for raising capital from outside investors or lenders.120 A law firm that generally works for a contingent fee may find that it has taken on a large, potentially quite profitable case, but lacks the resources to litigate a large, drawn-out battle with the defendant. The most successful plaintiffs’ firms are self-funding—they take in a diverse pool of cases, relying on settlements to sustain their operational costs, such as salaries and overhead, and permitting the firms to continue fighting to collect large recoveries in other cases. But some plaintiffs’ firms may miscalculate; perhaps they have taken on a case that is more expensive than expected,121 or perhaps they have distributed profits to partners after a big victory but not held back sufficient reserves to cover expenses for pending cases. Whatever the reason, plaintiffs’ firms may find themselves with a substantial amount of potentially profitable contingent fee work, but without the financial resources to pursue all of it. Conventional bank loans may not suffice given the extent of the risk involved. For lawyers unwilling or unable to guarantee their law firms’ loans personally, borrowing money from an investment fund at a high rate of interest may make sense. If the cases are sufficiently large and promising, the lawyers may still hope to make a great deal of money after paying off loans at a 25% interest rate (particularly where repayment of loans is conditioned upon receiving recoveries and earning contingent fees large enough to cover them). Indeed, although there is little formal acknowledgement of it, it is widely understood that contingent fee law firms in need of cash often accept funds from other, better financed law firms, in exchange for a share of...

119. See id.
120. Under the model in the United States, partners who create value by building a law firm over the course of their careers cannot cash out. They typically are subject to mandatory retirement and see their annual incomes decline as they move into retirement. If they could sell their partnership interests to third-party investors, this would enable them to cash out as other entrepreneurs do. See infra note 140.
121. See HAAR, supra note 86.
the contingent fee.

Outside financing might also be of value to a risk-averse law firm that generally bills by the hour and is presented with attractive contingent fee opportunities. For example, the previously mentioned hypothetical software start-up that might benefit from litigation financing might approach an hourly fee law firm because of its strong reputation in patent law. The law firm may receive many such opportunities from a broad array of contingent fee clients with promising patent law claims. Some of the law firm’s partners may be eager to take the cases on a contingent fee basis, recognizing that successful plaintiffs’ firms can be much more profitable than even the most successful hourly fee firms. Other, more risk-averse partners may worry about giving up a steady stream of billable hours in the hope of winning a large contingent fee. Partners with mortgages and school tuitions may care more about maintaining their annual incomes than about striking it rich.

If a third-party financier were able to absorb some of the risk of these lawsuits, this might enable an hourly fee law firm to take cases for a contingent fee. The financier could do so in two ways. First, the funder could structure a deal with the client—exchanging money for a share of the client’s recovery, which the client would subsequently pass along to the law firm in payment of hourly fees. Under such a structure, the law firm would bill by the hour and take no risk at all. Under an alternative structure, however, the law firm might take the case on a contingent fee basis, the financier might lend money to the law firm in amounts that would cover its hourly fees (or an agreed upon amount that might be discounted from its regular hourly fees), and the law firm would repay the loan plus interest out of its contingent fee. Under this latter scenario, the law firm would be guaranteed its hourly fee, for if the case results in a lower recovery, the terms of the nonrecourse loan would not entitle the lender to recover any more than the law firm collected in the case. But if the contingent fee ended up exceeding the hourly billings by an amount large enough to cover accrued interest and leave extra profit for the law firm, the law firm would reap those benefits. Moreover, if a law firm worked out an arrangement with a lender whereby a pool of loans would be collectible out of recoveries from a pool of cases, the lender would reap the benefits of diversification. Indeed, this might offer a way for an investment fund to gain exposure to a pool of smaller cases—and not just confine their investments to larger ones. The lender might provide the firm with enough to cover hourly billings for a group of cases, and then collect on its loans only out of the fees generated by that group of cases. If one case came up short but another resulted in a windfall, the lender could still get all of its money back.

Law-firm finance represents a way for attorneys to take on risk through contingent fee arrangements, and then spread that risk over a broader pool of investors who are better able to bear it. As with the cash advance industry, however, the high-interest loan structure is not ideal if the ultimate goal is to bolster the bargaining power of risk-averse plaintiffs pitted against repeat-player
defendants. A law firm paying interest on an outstanding loan, like a plaintiff who has received a cash advance, will have a strong incentive to settle early and repay its debt from the proceeds.

3. Shortcomings of Existing Markets

If the problem of inaccurate settlements is a market problem, as I have argued above, the limited markets that exist today in litigation risk are not robust enough to solve this problem. For the vast majority of one-time, risk-averse plaintiffs pitted against large, repeat-player defendants, existing market mechanisms do not offer a meaningful alternative to settling for less than the merits might justify. In all of the existing market mechanisms for legal claims—the contingent fee system, the cash advance industry, and investment-fund investment in commercial claims and law firms—we see the roots of a market solution, but only the roots. The contingent fee system helps bolster the bargaining leverage of cash-strapped, risk-averse plaintiffs by eliminating the downside risk of losing litigation expenses, but it is inefficient and fails to assuage a plaintiff’s risk aversion regarding the possibility of collecting nothing. The cash advance industry helps to guarantee plaintiffs some recovery, but it does so using a high-interest loan structure on terms that can strip plaintiffs of much of their compensation and incentivize them to settle early for too little rather than hold out for more. Hedge-fund investment in commercial claims, particularly intellectual property claims, probably offers the most promising market solution to risk imbalances between small, one-time plaintiffs and large, repeat-player defendants, but it works only for a narrow category of litigation claims and plaintiffs—commercial plaintiffs with relatively large claims. Finally, law-firm finance may help cure some of the market inefficiencies in the contingent fee system, but like the cash advance industry, it is saddled with a high-interest loan structure that is not well suited to bolstering the bargaining power of plaintiffs and their attorneys.

If we want to solve the problem of inaccurate settlements by making settlements look less like adjudications and more like market transactions, we will have to create a more robust market in litigation risk than any of the limited markets that exist today. The discussion below tries to sketch out what such a robust market in litigation risk might look like, and what it would take for such a market to develop.

III. Toward a More Robust Litigation Market

I have suggested that the problem of inaccurate litigation settlements is as much a market failure as a procedural failure. If one-time, risk-averse plaintiffs had a market alternative to settling with repeat-player, risk-neutral defendants, they would be better able to hold out for higher settlements that are closer to the mean expected damages award. And if our goal is to ensure that settlements accurately reflect the merits of lawsuits—so that defendants pay and plaintiffs receive roughly what they would if cases proceeded to trial—then we should try to give plaintiffs a market alternative to settling with defendants. In the absence of a meaningful market alternative, plaintiffs will often receive too little and
defendants will often pay too little for our system to achieve substantive law goals, such as accurate deterrence, just compensation, and retributive justice.

Unfortunately, the limited litigation markets that exist today are not robust enough to provide most plaintiffs with a meaningful alternative to settling with defendants. Moreover, unless public attitudes toward these limited markets begin to change, it is not obvious how they could ever mature into a meaningful market solution. Although I have applauded the limited litigation markets as a step in the right direction, this view is by no means widely shared. Contingent fee plaintiffs’ attorneys are often viewed with skepticism and even disdain by the general public, and even by many members of the bar. Cash advance firms are looked down upon for their willingness to profit from other people’s misfortunes, and capital providers that finance commercial intellectual property claims are referred to disdainfully as “patent trolls.” Indeed, some of these negative attitudes may be warranted. If our goal is to ensure that plaintiffs are adequately compensated for their claims, it is not enough that profit-hungry lawyers or litigation funders are willing to buy portions of their claims and assume some of their risk. If the lawyers or funders charge inordinate amounts for those risk transfers—for example, by taking a third of the recovery in exchange for very little risk or labor—then plaintiffs are not all that much better off. A plaintiff who retains an attorney on a contingent fee basis, or sells a portion of his claim to a litigation financier, may give away to the lawyer or funder the lion’s share of any gain he achieves vis-à-vis the defendant.

If we want to improve the limited market mechanisms that exist, and give those markets a chance to develop into a broader market solution, we would need to attract broader participation by a wider swath of lawyers and capital providers. In a climate characterized by both regulatory disapproval and low public esteem, reputable lawyers are generally unwilling to place themselves at the forefront of innovations in litigation finance. These lawyers will not jeopardize their reputations by advising clients on how to evade champerty and maintenance rules, let alone by trying themselves to navigate the ethics rules that otherwise prevent lawyers from working with third-party capital providers to provide plaintiffs with cash. The same is true of large, reputable capital providers such as banks and insurance companies. These entities have thus far stayed away, perhaps in part because of the legal uncertainty and stigma that surrounds litigation finance. Litigation finance has been confined to the dark corners of the capital markets and the legal profession. If, however, the law expressly permit-

122. Given the recent crises in the commoditization of other risks—for example, the securitization of home mortgages—some might question whether this is a good time to raise capital for a pool of litigation risk. Then again, investors looking for diversification may find litigation risk attractive precisely because it is uncorrelated with the other market risks that have been the subject of so much turmoil lately.

123. Likewise, if the funders make poor investments in weak claims—something they should not have an economic incentive to do, but may do in error—they will deserve their negative reputation among defendants and the defense bar.
tated plaintiffs to buy insurance against losing a lawsuit, conventional insurance companies might be induced to enter the market. So too might a personal injury victim’s bank be willing to participate in a risk-transfer solution for the plaintiff. If conventional banks and insurance companies were to participate, they might very well pass along some or all of the risk to a capital provider (like an investment fund) that specializes in litigation risk, but their participation nonetheless would help make the market more accessible to personal injury victims and more competitive. Broader participation and increased competition in the market for legal claims would inure to the benefit of personal injury victims, improving the terms upon which they could monetize their claims. Indeed, one could imagine a world in which lawyers would work with third-party capital providers, like banks or insurance companies, to have funds readily available for their clients who wish to monetize a portion of their claims. Whether the client is an individual with a personal injury claim or a small company with an intellectual property claim, the client might be made better-off—and in a stronger negotiating position vis-à-vis the defendant—if it could dispose of some litigation risk and sell a portion of its claim for cash.

If lawyers had funds readily available to satisfy their clients’ needs, the clients would not need to accept low settlement offers from defendants or else scrounge around for a deal from an unknown third-party financier. Rather than look for a high-interest loan from a cash advance company, a personal injury plaintiff could look to his own lawyer for help, or perhaps to the insurance agent who sold him homeowner’s insurance or to the bank where he has a savings account. Rather than try to find a “patent troll” willing to finance its patent claim, the small software company could likewise look to its lawyer, its bank, or its insurance company for help. Instead of searching for questionable deals with fledgling litigation finance businesses that may or may not help, plaintiffs could rely on a mainstream, reputable law finance industry to meet their needs and help level the playing field with defendants.

But to build a robust, mainstream market—with the participation and cooperation of reputable lawyers and capital providers—is no small feat. At least some of the legal rules that stand in the way—and the public perceptions that accompany those rules—are firmly entrenched, in some instances for good reason. The discussion below reconsiders the legal and regulatory obstacles that stand in the way of litigation risk transfers, and explores the costs and benefits associated with relaxing these restrictions. As noted at the outset, the goal is not to offer a definitive proposal for reform or to define a market solution with great precision. The ethical problems associated with a free market in legal claims—and with lawyers serving as market participants—are too complex to be re-

124. In England, plaintiffs and defendants alike can buy insurance against losing a case and having to pay the other side’s legal fees (because England is a loser-pays, fee-shifting jurisdiction). See Painter, supra note 29, at 632, 694; David Wilkinson, Mass Tort Treatment of Pharmaceutical Product Liability Cases in England, 73 DEF. COUNS. J. 264, 273–74 (2006); see also Gross, supra note 82, at 330–32 (describing Germany’s legal-insurance system).
solved definitively here. The goal instead is to encourage scholars, lawyers, legal regulators, and the capital markets to begin to take seriously a litigation finance industry that could be an engine for good but has thus far been ignored or disparaged. If we begin to see how litigation finance can actually improve the accuracy of our litigation system, then we may begin to reconsider the regulatory barriers and public hostility that thus far have prevented litigation finance from fulfilling its potential. If we can chip away at the skepticism that prevails among regulators and the public, perhaps we can begin a meaningful discourse on the role that litigation finance should play in our quest for litigation accuracy.

A. RECONSIDERING REGULATORY OBSTACLES TO THE FREE EXCHANGE OF LITIGATION CLAIMS

There are three sets of rules that stand in the way of the free exchange of legal claims today—and prevent the small fledgling markets described above from developing into a full-blown market solution. One set of rules—the prohibition on champerty and maintenance—targets nonlawyer capital providers. Two other sets of rules—ethics rules governing the attorney–client relationship and attorney relationships with third parties—restrict the participation of lawyers in a market for litigation claims.

It is important that we consider all of these rules—even if we are more open to relaxing some than others—because a market in litigation risk would not likely mature without the broad participation of both lawyers and nonlawyer capital providers. Although, historically, England has looked to nonlawyers and America has looked to lawyers to finance litigation, neither limitation makes sense. To build a robust market, we would need the participation, and cooperation, of lawyers and nonlawyers alike.

We need lawyers to play a significant role in litigation markets because they are at the center of the most well-developed, long-standing litigation risk market we have: the contingent fee system. Rather than create a new litigation market from scratch, we would be wise to build upon the contingent fee system that already dominates many types of litigation. Moreover, lawyers should remain at the center of any broader litigation market, even in those areas where contingent fee arrangements have not been common, because of several core advantages lawyers have with respect to building litigation risk markets.125 First, lawyers would be the most effective marketers of litigation risk transfers because they routinely see lawsuits where a risk transfer would make sense. Second, lawyers are ideally suited to evaluate and price lawsuits for risk transfers: they have the skill and experience to evaluate legal claims that nonlawyers lack; moreover, any effort they devote to learning about a case at the outset for pricing purposes

---

125. Cf. Rhee, Effect of Risk, supra note 23, at 253 (“Attorneys are instrumental in the proper pricing of disputes.”) (applying Ronald Gilson’s analysis of attorneys’ role in transactional work to the litigation arena, see Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 YALE L.J. 239 (1984)).
can be put to use again later when they proceed to litigate the case. Third, lawyers are in the best position to build and litigate a diverse portfolio of lawsuits, given both the sheer numbers of cases that lawyers routinely come across, and their ability to allocate litigation resources efficiently among cases in the pool as litigation progresses and cases are revealed to be more or less promising.

But we also would need nonlawyer capital providers to play an important role in any market solution because lawyers alone lack the capital to create a robust market and lawyers’ capacity for risk taking is limited. Lawyers may be better suited than nonlawyers to identify pools of cases in need of risk transfers, to price those risk transfers, and to allocate litigation resources efficiently over the pool, but lawyers are not necessarily as well equipped to supply the requisite risk capital and bear all of the litigation risk. While some lawyers are willing to give up a steady stream of income from hourly fee billing in the hopes of earning large contingent fees, others are not willing to take that risk, and still others may be willing to take a case on a contingent fee only to learn later that they lack the capital to pay bills and cover overhead while the lawsuit is outstanding. Many lawyers would thus be better equipped to absorb risk from their clients through contingent fee arrangements if they were able to pass some of that risk along to nonlawyer capital providers. Moreover, even if some lawyers are willing and able to forego hourly fees in exchange for a contingent fee arrangement, this does not mean that lawyers have the capital and risk tolerance to go one step further and actually make cash payments to plaintiffs. Any market solution would need not only to absorb litigation expense, but also to protect risk-averse plaintiffs from the risk of collecting nothing. To come up with the capital to pay plaintiffs for their claims, we would likely need to look beyond lawyers to supply the requisite funding.

The discussion below first considers the legal obstacles that today inhibit participation by nonlawyers because these obstacles are relatively easy to understand and criticize. The discussion then turns to the more significant, and challenging, obstacles that lawyers would face if they were to participate directly in a litigation market, straddling the dual roles of market participant and client representative.

1. Champerty and Maintenance Prohibitions that Inhibit Third-Party Funding

If we want reputable capital providers to get into the business of buying litigation claims and relieving plaintiffs of litigation risk, we would have to consider repealing remaining prohibitions on the sale and financing of litigation claims.126 Personal injury plaintiffs who wish to monetize their litigation claims are worse off than commercial litigation plaintiffs seeking to do the same because they must rely on nonrecourse loans from upstart cash advance firms, rather than selling their claims outright to more established financial institutions, such as investment banks or large investment funds. Champerty and main-

126. See, e.g., Painter, supra note 29, at 687.
tenance restrictions are typically not interpreted to apply to commercial plaintiffs, and where they might apply, they are easily avoided by selling interests in corporate entities, rather than in lawsuits directly. By doing away with all champerty and maintenance restrictions we would free third-party funders to structure their cash payments to personal injury plaintiffs the same way that investment banks and hedge funds structure their funding of commercial plaintiffs, and encourage more established financial institutions to enter the business. Instead of having to repay high-interest loans—loans that incentivize them to settle early—personal injury plaintiffs could sell a portion of their claims and hold out for better settlements with respect to the portion remaining. Doing away with champerty and maintenance restrictions would in this way bolster the bargaining leverage of one-time personal injury plaintiffs in negotiations with repeat-player defendants.

But do champerty and maintenance restrictions serve some purpose that would counsel in favor of retaining them? Might there be negative side effects to repealing champerty and maintenance prohibitions? The principal purpose of champerty and maintenance restrictions is to prevent financiers from fomenting litigation—that is, from inducing plaintiffs to bring lawsuits that they otherwise would not file or to pursue lawsuits with greater vigor. But that is precisely the point of reform: when plaintiffs lack the cash or risk tolerance to pursue meritorious claims, we want to induce them to file suit and pursue their claims vigorously. This Article’s core premise is that the principal goal of civil procedure should be to enforce substantive law accurately. If a plaintiff fails to pursue a meritorious claim because of cash constraints or risk aversion, our system has failed. Third-party financing of litigation claims, just like lawyer financing through the contingent fee system, is a good thing because it helps cash-strapped, risk-averse plaintiffs bring meritorious claims.

Although opponents of third-party financing predict that such financing might encourage meritless filings rather than meritorious ones, the claim makes little sense. Why an investor would purposely invest money in a case that is weak on the merits and likely to lose is hard to understand. Although scholars have debated the viability of negative-value suits that may be brought by plaintiffs in an effort to extract settlements, third-party funders would be less

127. See supra note 113 and accompanying text.
128. See Choharis, supra note 29, at 460–64.
130. Compare Lucian Arye Bebchuk, A New Theory Concerning the Credibility and Success of Threats To Sue, 25 J. LEGAL STUD. 1, 23–24 (1996) [hereinafter Bebchuk, New Theory] (concluding, in part, that if the litigation process is sufficiently divisible, this might “provide plaintiffs with a credible threat, and it therefore might provide the defendant with an ‘economic’ reason” to settle a negative-value suit), Lucian Arye Bebchuk, Suing Solely To Extract a Settlement Offer, 17 J. LEGAL STUD. 437, 448 (1988) (concluding that informational asymmetries might permit plaintiffs with negative-value
likely to bring such suits (at least on purpose) than contingent fee attorneys and their clients. Whereas a contingent fee attorney might choose to take on more contingent fee cases than he expects to litigate successfully—knowing he can mitigate his losses on the bad picks by devoting less time to the weak cases than the strong—a litigation funder who lacks control over litigation decisions would not have that mitigation mechanism available. Upon making a bad investment, the funder would likely be stuck with it and would bear the loss of his capital investment. Perhaps these opponents of third-party financing might have a good argument for retaining restrictions that would prevent funders from obtaining complete control over litigation decisions so as to ensure that they would have even stronger incentives than contingent fee attorneys to screen cases carefully. They have not, however, made the case that third-party financing should be prohibited. While third-party funders might sometimes make mistakes and fund meritless cases, third-party financing of claims is much more likely to increase meritorious filings than meritless ones.

But is it possible that champerty and maintenance rules not only protect defendants from meritorious claims, but also, in some respects, protect plaintiffs or protect some other public interest? One might be concerned that a third-party financier seeking to buy a portion of a claim will not be as scrupulous as a lawyer seeking to buy a third of a plaintiff’s claim in exchange for his legal services. Might a third party not approach an unwitting plaintiff and buy a large portion of his claim for less than it is worth?

While there is always risk that unsophisticated plaintiffs will accept too little for meritorious claims, it is far from clear that a plaintiff would be any worse off dealing with a third-party funder than with a repeat-player defendant. To the contrary, once the plaintiff has the option of selling his claim to someone other than the defendant, the plaintiff need not accept the first offer he receives, but instead can bid out his claim to a variety of funders, relying on competition to fetch a better price for his claim. Moreover, where a plaintiff has already retained a lawyer, or is contemplating retaining a lawyer, the plaintiff could always look to the lawyer for advice on the value of his suit. Indeed, the lawyer could help the plaintiff sell his claim by shopping it around to a few funders. Expanding the options of one-time, risk-averse plaintiffs—and allowing them to sell either to defendants or to third-party funders—cannot be a bad thing for those plaintiffs. If we are worried about unfair practices of unscrupulous funders, we

suits to extract a settlement from defendants), and D. Rosenberg & S. Shavell, A Model in Which Suits Are Brought for Their Nuisance Value, 5 INT’L REV. L. & ECON. 3, 9–10 (1985) (concluding plaintiffs have the ability to file suits cheaply while imposing significant costs on the defendant, and thereby force advantageous settlements), with Warren F. Schwartz & Abraham L. Wickelgren, Advantage Defendant: Why Sinking Litigation Costs Makes Negative-Expected-Value Defenses but Not Negative-Expected-Value Suits Credible, 38 J. LEGAL STUD. 235, 251–53 (2009) (evaluating Bebchuk’s negative-value suit study, see Bebchuk, New Theory, supra, and concluding that, where both parties are informed about litigation costs and the chances of success, defendants with a negative-value defense may reduce the settlement amount by means of a sunk-cost strategy, but this does not help plaintiffs with a negative-value suit raise the settlement amount).
can always regulate the industry to prevent those excesses (and already, the nascent cash advance industry has established a trade association that has been working with state regulators to do precisely that). By bringing litigation finance out of the shadows and into the mainstream, we can invite participation by a broader array of more reputable capital providers and improve the terms upon which plaintiffs are able to dispose of their claims.

If repealing champerty and maintenance prohibitions would be fair to both parties and promote public values, like accurate deterrence and compensation, one might still wonder whether we would need to impose some limits on the free exchange of legal claims. Problems might ensue, for example, if plaintiffs sold not just portions of their claims, but their entire claims. From a court’s perspective, the plaintiff’s lack of interest in the suit might interfere with his or her cooperation in the prosecution of the case and render adjudication more difficult. From a third-party funder’s perspective, moreover, a plaintiff’s lack of incentive to win the case might render the claim less valuable; after all, if the plaintiff does not fully cooperate in the prosecution of the claim, the chances of victory would diminish. Given funders’ incentives to ensure that plaintiffs still have some “skin in the game,” we might rely on the market to ensure that plaintiffs have adequate incentives to cooperate, and there might be no need for further regulatory intervention prohibiting plaintiffs from selling claims in their entirety. But as a market in litigation claims develops, it would be worth monitoring the effects of claim sales on the litigation process to see whether further regulation might be necessary.

The balance of costs and benefits might change in unforeseen ways as a robust market in legal claims develops. Providing such a market to plaintiffs who need an alternative to settling with the defendant is a good thing. But if the free exchange of litigation claims becomes the norm, rather than simply an alternative to the traditional adjudicative process, this might have far-reaching and difficultly foreseeable effects. Scholars have observed, for example, how much litigation dynamics differ when institutional repeat players are substituted for individual litigants. And the effects of aggregation on tort law—whether through class action litigation or informal aggregation by repeat players—have occupied scholars over the last decade or so. Just how much a free market in

131. See supra note 92 and accompanying text; Shukaitis, supra note 13, at 347–48.
133. See Shukaitis, supra note 13, at 340.
litigation claims would accelerate the aggregation process, and alter the effects of aggregation, would depend upon the precise contours of the market that evolved. Regulators would have to pay careful attention to any unexpected negative consequences of aggregation. But the possible need for some regulation, as markets evolve in the future, should in no way be accepted as an argument against the repeal of existing champerty and maintenance prohibitions that currently stand in the way of transactions that would do some good.  

2. Ethics Rules that Restrict Lawyer Participation

More challenging than the laws that stand in the way of nonlawyer participation are the ethics rules that have, thus far, limited lawyer participation in a market for litigation claims. If we want not only third-party funders, but also lawyers to play a central role in any market solution, we would have to reconsider ethics rules that are much more firmly entrenched—with much greater justification—than the prohibitions against champerty and maintenance.

While one could imagine a world in which lawyers would have funds available to purchase portions of their clients’ claims—thereby freeing the clients from having to search for a deal elsewhere—there are two sets of rules that prevent lawyers today from doing so. First, there is the ethical prohibition against attorneys providing cash to their clients for claims.  

Second, there is the ethical prohibition against lawyers sharing fees with nonlawyers.  

If a law firm were to try to raise a litigation fund from third-party investors, and thereby have funds available to buy portions of their clients’ claims, the law firm would likely run up against both sets of rules: the firm would be paying cash to clients for claims and would be sharing its recoveries with nonlawyer investors. I address each of these prohibitions below.

a. Prohibitions Against Lawyers Paying Cash to Clients. If there is little doubt about the wisdom of repealing champerty and maintenance restrictions, and permitting third parties to pay cash for claims, the same cannot be said of the restrictions that today prohibit lawyers from advancing cash to their clients for a share of their recoveries. One of the core protections that help ensure that plaintiffs receive fair prices for their claims from third-party funders is the availability of a lawyer who can value claims and negotiate fair deals on plaintiffs’ behalves. This protection disappears, however, when lawyers themselves purchase plaintiffs’ claims. Whom can we rely on to protect a plaintiff when the plaintiff sells his claim to his lawyer?


To some extent, this problem already exists because plaintiffs routinely sell a third of their claims to lawyers without anyone there to protect their interests. Indeed, the problem is arguably worse where lawyers offer legal services, rather than cash, because it is much harder for the plaintiff to evaluate competing offers. Under the current regime, contingent fee arrangements are so standardized that lawyers compete primarily on quality—they all generally charge roughly a third of the recovery and the best lawyers get the biggest cases, with the smaller cases being left for lawyers whose reputations are not quite as strong. For large cases involving institutional plaintiffs (for example, state pension funds), lawyers may be willing to accept a smaller percentage of the recovery. And for class action litigation—where the judge ultimately approves the legal fee—lawyers may also collect a smaller percentage of the recovery. But for the most part, contingent fee lawyers compete based on their reputation for quality, rather than on price. And from a personal injury plaintiff’s perspective—or that of any layman—it may be difficult to distinguish among lawyers based on the quality of their legal services.

If lawyers were permitted not only to exchange their legal services for a portion of the recovery but to pay cash as well, this might foster additional competition among lawyers and make it easier for plaintiffs to evaluate competing offers. A plaintiff would be able to shop his case around to a variety of lawyers and try to get the best deal possible—that is, the most cash and the best legal services for the smallest portion of recovery.

In some instances, a plaintiff might be able to rely on market competition, rather than attorney loyalty, to obtain the best deal. He might find that better lawyers, who have greater confidence in their ability to collect more, are willing to offer more cash or take a smaller percentage of the recovery, while less confident lawyers might offer less money or demand a larger percentage of the recovery. But in other cases, the plaintiff may have difficulty evaluating the competing offers. Does a greater cash offer mean that a lawyer is truly confident of collecting more, or does it simply mean that the lawyer is willing to work for less because he is not as successful and his opportunity cost is lower? Without a lawyer to advise him on the competing offers, the plaintiff may feel ill-equipped to make the right choice.

b. Prohibitions Against Lawyers Sharing Fees with Nonlawyers. The prohibition against lawyers sharing fees with nonlawyers also makes some policy sense and we should be careful about relaxing it. If we permit lawyers to share fees with nonlawyers, and even to sell law-firm ownership shares to nonlawyer capital providers, we risk sacrificing the autonomy and independence that have been hallmarks of the legal profession for so long. A litigator’s dual obligations—to his client and to the court—are sufficiently difficult to balance. We rely on a lawyer’s deep-seated professional obligations and strict compliance with codes of professional responsibility to help him navigate difficult ethical dilemmas. If, however, the lawyer were beholden to a nonlawyer capital provider—for ex-
ample, the management committee of a nonlawyer-controlled law firm—this might make it more difficult for the lawyer to protect the interests of the client and the court as vehemently. Lawyers are members of a profession, not just participants in a market for legal services, and the more we try to make them look like market participants, the greater the risk that they will ignore their professional obligations.

So far in the United States, only one bar has amended its rules expressly to permit lawyers to partner and share fees with nonlawyers. As noted above, the District of Columbia has recently allowed lawyers to do each with other professionals, such as accountants and lobbyists.\textsuperscript{139} The change reflects the reality that a client may need a range of related professional services in distinct fields and may benefit from being able to hire one firm to provide all those services. Where a client has a tax question that requires the advice \textit{both} of a tax lawyer and a tax accountant, a question about its balance sheet that requires \textit{both} the analysis of a lawyer and the assistance of a lobbyist, the client might be best off hiring just one firm to provide all these services. But to prevent nonlawyers in a law firm from leading subordinate lawyers astray, the D.C. bar imposes the same code of conduct on those other professionals as it does on lawyers. Moreover, it restricts partnerships and fee-sharing arrangements to those providing professional services. A lawyer cannot share fees with, or be subject to the management of, a nonlawyer capital provider. It is one thing for lawyers to answer to other professionals who work side-by-side with them, serving the same clients and subject to the same ethical codes. It is quite another for a lawyer to be beholden to a nonlawyer capital provider.\textsuperscript{140}

\textbf{B. WEIGHING COSTS AND BENEFITS OF THE LAWYER AS A MARKET PARTICIPANT}

The ethics rules that prohibit lawyers from buying claims and sharing fees may make more sense than the restrictions on litigation investments by nonlawyers, but these ethics rules, nonetheless, are quite costly—indeed, much more costly than anyone to date has acknowledged. Because the current regime

\textsuperscript{139} District of Columbia Rules of Prof’l Conduct R. 5.4(b) (2007).

\textsuperscript{140} If lawyers could sell shares in law firms to nonlawyers this would not only threaten lawyers’ independence, but also change the nature of law-firm practice. Cf. Susan Saab Fortney, \textit{Soul for Sale: An Empirical Study of Associate Satisfaction, Law Firm Culture, and the Effects of Billable Hour Requirements}, 69 UMKC L. Rev. 239 (2000) (discussing competitive pressures faced by firms); Ronald J. Gilson & Robert H. Mnookin, \textit{Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits}, 37 Stan. L. Rev. 313, 348 (1985) (same). Most large law firms today have partnership structures under which older partners retire and make room to add younger lawyers to the partnership rolls. If, however, older partners could “cash out” by selling their shares to third-party capital providers, there would be less equity left for younger lawyers working their way up through the law firm’s hierarchical structure. Instead of working to make partner, younger lawyers might earn stock options, much in the same way professional employees at large corporations are compensated. Such a revised structure might work to retain some junior lawyers for longer than they otherwise stay now—for options to vest—but whether it would keep lawyers at a firm for the eight or nine years it can now take to make partner at a large law firm is unclear.
prohibits lawyers from representing the interests of both plaintiffs and investors, litigation funders must generally hire a separate set of lawyers to price lawsuits, negotiate deals with plaintiffs, and monitor the ensuing litigation. The extra transaction costs associated with hiring a second set of lawyers—distinct from the lawyers who will represent the plaintiff in the litigation—inevitably consume a large portion of any gain that the litigation risk transfer creates vis-à-vis the defendant. Indeed, transaction costs may lead funders to offer plaintiffs modest amounts for their claims, in the hope of turning around and settling with the defendant for more, and using the difference to cover expenses and create a profit. To the extent that the additional transaction costs ultimately are borne by the very plaintiffs we are hoping to help, this would undermine one of the central goals of a litigation risk-transfer system: just compensation. In other cases, moreover, the transaction costs of hiring a second set of lawyers to price the lawsuit on the funder’s behalf may be large enough to make the deal uneconomical for the funder. Rather than bear the expenses of pricing the lawsuit, the funder may simply refuse to look at cases below a certain dollar threshold.141

A much more efficient way for plaintiffs to off-load litigation risk—particularly for smaller cases—is initially to pass on the risk to their lawyers and, subsequently, rely on these same lawyers to pass on the risk (or some portion of it) to third-party funders or investors. Such a structure would eliminate a great deal of duplication and gain three sets of efficiencies, enabling a single set of lawyers to source, price, and litigate cases. The structure would be more efficient from a sourcing perspective as law firms already see a wide variety of cases in need of legal services, some of which may need financing as well. If lawyers themselves could offer litigation risk transfers to prospective clients, this would save the marketing costs associated with having a third-party funding organization attempt to reach out to litigation plaintiffs directly.142 A lawyer-centered risk-transfer mechanism would also be more efficient from a pricing perspective because the same lawyers would learn about the case both to price it and to litigate it.143 Instead of hiring a second set of lawyers to second-guess the valuation of the plaintiffs’ lawyer, capital providers would rely on that lawyer to conduct the pre-litigation diligence; the capital providers could base their investment decisions on a law firm’s overall track record, rather than on the merits of any particular case, and could invest in a broad pool of the law firm’s

---

141. Alternatively, the funder may try to minimize diligence expenses by clinging to the high-interest loan structure that prevails today in the cash advance industry.

142. Litigation-finance companies can, and do, market through lawyers, but if we prohibit lawyers from sharing the benefits of a litigation risk transfer—through referral fees or shares of profits—then the marketing efforts would be less effective.

143. See Painter, supra note 29, at 682. Moreover, where the plaintiffs’ lawyers are themselves the ones pricing a suit, this avoids complicated work-product and privilege issues that might otherwise arise if the plaintiffs’ lawyers had to share confidential information about the suit with potential third-party funders. See Molot, supra note 16, at 381.
cases in exchange for a share of the pool’s recovery. Moreover, permitting law firms to serve as market participants would be more efficient when it comes to actually litigating the cases, for as litigation progresses, a law firm could devote more or less effort to a case, depending on how promising it looks. Having an ethical obligation to represent the client diligently, the law firm could not completely cease work on losing cases. But the losses associated with poor litigation investments would not be compounded by the devotion of excess resources to losing cases (a cost that third-party funders may otherwise have to bear when they commit to cover a plaintiff’s lawyer’s hourly fees).

But if the efficiencies associated with a free-market approach are sizeable—and they could translate into a significant increase in plaintiff recoveries—the efficiencies come with a cost. If we permitted lawyers to serve both as market participants and as client representatives—and allowed them to raise funds from third-party investors to invest in their clients’ cases—we certainly would create a serious conflict of interest for the attorney. Lawyers would be obligated to negotiate the highest possible transfer prices on behalf of their clients, and yet, would want to negotiate the lowest possible transfer price on behalf of investors.

To some, this conflict might not seem so intractable because it would only exist at the outset—before a lawyer has actually taken the case on behalf of a client. Such a conflict always exists at the outset of the attorney–client relationship—when the lawyer and client negotiate and agree upon hourly billing rates or the terms of a contingent fee arrangement. Once the lawyer and client agree to proceed together, the conflict would disappear and their interests would be aligned—all would benefit from a higher recovery. However, given that the lawyer would initially be looking out not only for his own financial interests, but also those of investors, some might view this conflict as intractable and inherently unwaivable. If we have to sacrifice efficiencies in order to ensure that the lawyer adequately represents his client’s interests, so be it.

The core dilemma we face, then, is whether we are best off relying on market efficiency or on attorney loyalty to protect plaintiffs. Do we want to require funders and plaintiffs to have separate counsel—even if the costs of additional counsel end up being borne by the very plaintiffs we want to protect? Or should we permit attorneys to work with investors to buy claims from their clients,

144. Just as insurance companies rely on reinsurers to reinsure a large “book” of insurance policies—knowing that the reinsurer will underwrite the book as a whole without spending too much time on any individual insurance policy within the book—so too would law firms look to a capital provider to back a pool of their litigation cases.


146. See Molot, supra note 62, at 86–87 (noting time efficiency of contingent fee attorneys).


148. See generally Model Rules of Prof’l Conduct R. 1.8(a) (2002), on the waiver of conflicts of interest.

149. See Painter, supra note 29, at 647–48 (noting that regulation of contingent fees “is an imprecise and ineffective substitute for a competitive market”).
hoping that market forces and competition from other attorneys will prevent attorneys from taking advantage of their clients?

For those who would consider a market approach, one way to protect plaintiffs against over-aggressive attorneys would be to require the structure of market transactions to align the interests of the lawyer with those of his client as much as possible. To those who would treat the conflict of interest as waivable—and would amend the ethics rules to permit lawyers to raise funds from investors and invest those funds in their clients’ cases—there might be a way to protect the plaintiffs’ interests through careful structuring of the lawyers’ compensation. We could perhaps require that where a lawyer is on both ends of a litigation risk transfer—representing the interests of investors and plaintiffs alike—the lawyer’s compensation must be structured so that his financial interests are at least as aligned with those of the plaintiff as with those of his investors. Consider a scenario under which a lawyer is compensated with 20% of the investors’ profits and 33% of a client’s recovery—the typical percentages for fund managers and for contingent fee attorneys. Under such a scenario, when the investment fund and client negotiate a transfer price, the “lawyer-fund manager” would find his interests more aligned with those of the client than with those of the fund. At the outset, every extra dollar the client receives from the fund would translate into a thirty-three cent gain to the lawyer in the form of a contingent fee, and a twenty cent loss of its share of the fund’s profits. Thus, every dollar increase in the amount paid to the plaintiff would correspond to a thirteen cent gain to the lawyer. Competition, of course, would be the most important driver of the price offered for the lawsuit—and the transfer price demanded by the plaintiff would likely depend upon what competing law firms and litigation funders had offered. But to those who worry about conflicts of interest working to the detriment of plaintiffs, a compensation structure that gives lawyers a larger share of the plaintiff’s recovery than the fund’s profits would help to ensure that lawyers do not help their investors take advantage of unsophisticated plaintiffs.

This Article does not purport to offer the definitive deal structure that we should embrace. Nor does the Article offer a detailed rule revision that would permit litigation-finance deals to flourish while protecting against excesses or abuses. Rather, I simply wish to point out that there are costs, as well as benefits, to the rules that today may stand in the way of litigation-risk markets, and I want to encourage legal regulators—and the bar and public more broadly—to be aware of these costs and to be open to new solutions. In grappling with emerging litigation markets and novel deal structures, legal regulators bent on protecting litigants should focus on checking excesses and curbing abuses, rather than on suppressing market innovations with overzealous regulation.

**Conclusion**

This Article has suggested that if civil procedure scholars want to foster accurate pretrial resolutions of lawsuits, we may want to make pretrial resolu-
tions look less like adjudications and more like market transactions. Where a one-time, risk-averse plaintiff accepts too little from a repeat-player, risk-neutral defendant, this is just as much a market failure as a failure of procedure. To promote merits-based resolutions, this Article suggested that we consider market alternatives to conventional judicial intervention. Rather than rely on the judge to bolster the bargaining power of a risk-averse plaintiff with a meritorious claim, this Article suggested that we empower the plaintiff to help himself via a market transaction. A plaintiff who has a market alternative to settling with the defendant will be less likely to settle for too little, and may be able to enlist the help of a repeat-player, risk-neutral entity to help him negotiate a better settlement.

This Article explored existing market mechanisms, highlighted their shortcomings, and considered reforms that might foster a more robust market in litigation risk. Although litigation risk markets would pose new challenges for the legal profession and its regulators, those challenges are worth facing. Rather than stifling innovation, we should monitor new arrangements carefully, paying close attention to the costs and benefits of permitting lawyers to function as market participants as well as client representatives. We should bring litigation finance out of the shadows and, instead of viewing the industry with suspicion and disdain, we should view it as a potential vehicle to promote accuracy in adjudication.