Third-Party Involvement in Litigation: An Economic Analysis

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This paper provides an economic analysis of how different forms of third-party litigation funding arrangements affect the incentives to engage in litigation. Alternative funding schemes can take the form of equity, debt, or donations, which may be fixed-sum or create marginal cost reduction. Each alternative has divergent effects on litigants' expected value calculations and marginal costs/benefits when deciding whether to file suit, invest in their case, or settle. The analysis shows third-party funding can address underinvestment due to budget constraints, but can also lead to overinvestment and distorted settlement incentives depending on the funding structure. From an organizational perspective, third-party funding often misaligns investor and litigant interests, leading to principal-agent problems. However, incentives can realign when both parties' returns are tied to the lawsuit's outcome. The paper concludes that some forms of litigation funding can expand access to courts and properly align incentives. Still, regulators should consider incentive distortions created by concealed forms of funding more accessible to corporate litigants. Overall, this economic analysis enriches our understanding of how third-party funding arrangements affect organizational behavior in the legal process.

INTRODUCTION

The conventional view of third-party litigation funding envisions a financially sophisticated corporate entity that loans money to a poor plaintiff, typically the victim in a personal injury case, to cover legal expenses. In return, the investor requires high interest on their investment or a portion of the damages award.[1] In recent years, some institutions have offered third-party litigation funding to other kinds of litigants, including corporations (plaintiffs and defendants) and representative plaintiffs who file class action lawsuits.[2] Nevertheless, the overall financing structure remains the same—third-party litigation funding usually involves providing direct funds to the litigant or their attorney and receiving some form of financial benefit after the conclusion of the litigation process. [3] This article aims to expand our understanding of litigation funding by comparing for-profit funding to other ways in which third parties can affect the cost of litigation. Consider the following example.

> Example 1. *Petroleum refinery*. A petroleum refinery operates near a crowded city. During its operation, the refinery emits pollutants into the air. The residents wish to sue the refinery for excess morbidity and mortality. The costs of litigating the case are substantial for both sides, and both parties seek to lower

[1] A loan to fund a litigation is similar in essence to any sub-prime loan to finance a risky asset, justifying a high interest rate. *See* Susan Lorde Martin, *Litigation Financing: Another Subprime Industry that Has a Place in the United States*, 53 VILL. L. REV. 83, 95 (2008).

[2] Maya Steinitz, *Whose Claim is This Anyway – Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1277 (2011) (hereinafter: Steinitz, Whose Claim is This).

[3] Some funders provide loans to lawyers and not to their clients. *See* Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns and Unknowns,* RAND Corporation (2010); Elizabeth Chamblee Burch, *Financiers as Monitors in Aggregate Litigation*, 87 N.Y.U. L. REV. 1273, 1302-1303 (2012).

their out-of-pocket expenses.[4]

Both the residents and the refinery can seek to finance their litigation with a third-party funder. The residents can use the expected proceeds from the litigation as collateral and raise the needed capital by promising the investor a high interest rate on a non-recourse basis, thus limiting their risk.[5] Alternatively, residents may offer the investor a share of the proceeds if they win.[6] The refinery may secure a loan to cover its own litigation expenses, promising investors to pay them back with interest once the case is concluded.[7]

There are other ways, however, in which both parties can reduce their litigation costs. One such way is to seek third-party investors who are willing to finance the litigation without expecting a return on their investment. For instance, residents can search for interest groups such as environmental organizations who are willing to donate money to support a lawsuit against refineries to promote their cause. [8] Similarly, the refinery might contact others that emit the same pollutants for support. These polluters might fear that if a court decides that these pollutants cause excess morbidity and mortality among the residents, their own liability risk will increase.[9] However, if the refinery successfully proves

[4] The example is based on the facts in Baker v. Chevron USA, Inc., 2007 U.S. Dist. LEXIS 6601, where 360 residents who reside near a petroleum refinery, owned and operated by Chevron, sued the company for personal injury alleging the pollution emitted from the refinery caused various illnesses.

[5] Several large litigation funders expressed interest in funding environmental cases, seeing it as an untapped business opportunity. *See* Marialuisa Taddia, *European Funders Bet On ESG Class Litigation*, August 3, 2022, https://rb.gy/b1war (claiming that the recent changes in class action litigation in Europe create an opportunity for funders to invest in ESG litigation); Isabella Kaminski, *An Ocean of Opportunities? Climate Litigation is Doing so Well it's Now Being Eyed By Investors*, Feb 1, 2023, https://rb.gy/bbo9t (Claiming that the successes of environmental class actions create unique business opportunities for funders).

[6] For a discussion on the different types of investments in litigation, *see infra* section II.B.

[7] Emily Samara, *The Business of Defense: Defense-Side Litigation Financing*, 83 U. CHI. L. REV. 2299, 2304-2305 (2016) (discussing the practices of financing defendants litigation costs). For an example of a funder offering financial support to defendants *see* Lake Whillanss' website, at https://lakewhillans.com/articles/defense-side-litigation-funding-in-practice/. The structure of the funding agreement ensures that the defendant will not have to pay back the principal amount if it lost its case.

[8] For example, the Environmental Defender Law Center created a grant program to cover expenses in public interest litigation against companies that engage in resource development projects in developing countries, which harm the local communities and the environment. *See* Environmental Defender Law Center Website, at https://edlc.org/our-work/giving-grants/.

[9] STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW, 397 (2004) (Stating that once the court determines that the causation requirement is satisfied, many other similarly situated plaintiff will file a claim); Catherine Albiston, *The Rule of Law and the Litigation Process: The paradox of Losing by Winning*, 33 LAW & SOC'Y REV. 869, 880 (1999) (Claiming that among the various factors, prior similar cases outcomes can influence the parties' decisions whether to sue or settle).

to the court that there is no causal link between air pollution and excess morbidity and mortality, it may discourage future plaintiffs from suing polluters, which will ultimately reduce their liability risk. Since the outcome of the litigation affects these polluters, they are incentivized to support the refinery's litigation, even without expecting any future payment.

Furthermore, interested third parties (e.g., environmental organizations and other polluters) can affect the cost of litigation in several ways other than providing funds directly to the litigants. For example, third parties can assist litigants in finding representation, using their better bargaining position to reduce the costs of legal representation and expert opinions, investing in scientists and other professionals that can later offer expert testimony, or grant litigants excess to evidence that pertains to their dispute, thus lowering the cost of evidence production.

An interesting way for a funder to effectively reduce litigation costs for one party is to increase the litigation costs for its opponent. This opportunity arises because each party's investment decision influences the other party's investment incentives. For instance, if the plaintiff provides little evidence to support their claim, the defendant does not need to invest much to deal with the case. However, if the plaintiff introduces an expert testimony, the defendant will likely increase its investment to counter this additional evidence. This effect means that when third parties reduce the investment costs for one party, they are likely to increase the litigation costs for the other party. The opposite is also true – a third party can assist one litigant by increasing the litigation costs for the other litigant. In the petroleum refinery example, if the interested third-party polluters can limit the residents' access to evidence or experts, the residents will have to invest more in litigation (for example, to find a willing expert). Increasing litigation costs to the residents effectively lowers the costs the refinery needs to invest to reach the same expected outcome.[10]

We refer to these indirect ways in which third parties can influence litigation costs as *concealed third-party litigation funding*.

The article has two main goals. First, it broadens our view of litigation funding to include several practices that affect parties' out-of-pocket expenses. Second, it aims to inform policymakers about the optimal regulation of litigation funding.

Regulators often justify limiting third-party funding by citing fears that funding encourages filing frivolous claims while it discourages settlements. As this article shows, assuming concealed funding is

[10] This does not necessarily mean that the refinery *will* invest less, but just that it would need to invest less to reach the same expected outcome. By changing the parties cost structure, the marginal investment for the refinery might decrease, inducing higher investment. However, the overall costs for the refinery (including both investing in litigation and the expected outcome of the litigation) will decrease.

difficult to regulate (as it is concealed), regulating or prohibiting direct funding while ignoring concealed funding may result in lower excess to justice, biased outcomes, excessive investments in litigations, and fewer settlements.

The article will continue as follows.

Part 1 redefines third-party litigation funding to include various motivations to invest in third-party litigation and account for indirect investment vehicles.

Part 2 examines how different funding schemes can affect the parties' incentives to file claims, invest in litigation, and settle. It shows that some concealed funding schemes encourage plaintiffs to file negative expected value (NEV) suits, increase their investment in litigation, and discourage settlements. Direct third-party funding, on the other hand, may allow plaintiffs to file positive expected value (PEV) suits that they would otherwise not file. At the same time, it is unlikely to encourage plaintiffs to file frivolous cases. Furthermore, direct funding may inefficiently encourage parties to settle and reduce investment in litigation below the optimum.

Part 3 reexamines calls for regulating or prohibiting third-party litigation funding. Building on the analysis in part 2, it shows that most reasons for regulating litigation funding may apply to concealed third-party litigation funding, which is unregulated, it does not apply to direct litigation funding. Thus, one problem with limiting access to the less harmful direct funding alternative is that it drives some parties to look for concealed litigation funding opportunities to fund their litigation costs. Furthermore, limiting access to one source of funding may have a regressive effect since some types of litigants have easier access to concealed funding than others.

Part 4 concludes the discussion.

I. REDEFINING THIRD-PARTY LITIGATION FUNDING

The article seeks to broaden our view of litigation funding in two ways: by accounting for indirect benefits, third-party funders recoup from litigation, and by including other practices that affect litigation costs other than directly funding the litigation. For this purpose, we define third-party funding arrangements between a funder and a litigant as arrangements that have the following four characteristics: (1) the funder invests resources; (2) the investment allows a litigant to lower its out-of-pocket expense for the same expected outcome; (3) the parties to the litigation remain the same (the litigant remains a party and the funder does not become a party to the case); and (4) the funder receives a benefit (financial or otherwise) if the litigant wins the case.

Notice that the traditional account of litigation funding, which involves direct for-profit funding,[11] exhibits all four characteristics - The funder invests money in the litigant's case; the litigant remains a party while the funder does not; and if the litigant wins her case, the funder receives an interest on its investment. However, this broader definition includes additional motivations other than direct financial profit, such as affecting the funder's litigation risk or advancing the funder's political interests. This broader definition also accounts for indirect ways the funder can help reduce the litigant's out-of-pocket expense. We first explore the motivations to fund litigation and then examine several possible funding schemes.

A. Funders' Motivation

Investors may fund litigation for reasons beyond financial gain. Affected parties may be motivated to get involved due to far-reaching consequences of litigation outcomes. For example, governments may wish to fund private litigation to promote legal clarity or protect their citizens' rights. The Canadian government offers financial support to Canadians who wish to bring test cases that clarify constitutional and human rights issues, through the Court Challenges Program (CCP).[12] Similarly, the Israeli government provides funding for selected public interest class action cases that promotes public or social interest.[13]

Private parties may also fund cases to promote their constitutional and human rights views. In 2016, billionaire Peter Thiel paid $10 million to fund former wrestler Hulk Hogan's (Terry Gene Bollea) case against Gawker Media, stating he did so to promote his views about privacy protection.[14]

Funders may also be interested in the effect litigation might have on the parties and not just the legal issue. For instance, politicians and their supporters can use litigation to gain political advantage by attacking political rivals. Several wealthy supporters of political candidates have funded lawsuits against the opposing candidate to damage the opponent's political career. In the case of Paula Jones against Bill Clinton, some reporters argued that right-wing businessmen funded her litigation and possibly instigated it.[15] Interestingly, the eccentric billionaire Abraham Hirschfeld also invested in the litigation, this time in support of Clinton,

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[11] *See supra* note 1, and accompanying text.

[12] *See* The Court Challenges Program website, at https://pcj-ccp.ca/.

[13] In 2006 the Israeli government established the "National Class Action Financing Fund" that provides funding for worthy class action cases. In case the representative plaintiff wins the class action or secures a settlement he or she may have to pay back the amount received to fund the litigation, but with no interest. *See* § 27, Class Action Law, 5766-2006, LSI 2054 264, as amended (Isr.).

[14] *See* In re Gawker Media LLC, 2017 Bankr. LEXIS 1798 (Bankr. S.D.N.Y. June 28, 2017).

[15] See Steinitz, Whose Claim is This, *supra* note 2, at 1268.

offering Jones $1 Million to settle her case.[16] More recently, in 2023, billionaire Reid Hoffman, a harsh critic of former president Donald Trump, funded Jean Carroll's defamation suit against Trump.[17]

Funders might also support a litigant, hoping to receive an indirect financial gain if the litigant wins. For example, when a generic drug manufacturer is sued by consumers claiming that the drug is defective, other manufacturers of the same generic drug face liability risk, which largely depends on the outcome of the first case.[18] If the defendant wins the case, the outcome affects the likelihood of other manufacturers being sued and the probability that they will prevail, assuming they are sued.[19] Similarly, as discussed in the example of the refinery above, polluters that emit the same toxic material have an interest in ensuring that if either of them is sued for causing health or environmental harm, the defendant will win the case, since a loss means that other polluters are more exposed to liability (and winning reduces their potential liability).[20] Potential plaintiffs are similarly interested in seeing current plaintiffs win a comparable case for the same reason as potential defendants. There are significant differences, however, between potential plaintiffs and defendants. First, defendants tend to be a relatively small group of corporate entities, meaning that each potential defendant has a vast

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[16] See Michael A. Fletcher, *Magnate Gives Paula Jones $1 Million*, WASHINGTONPOST.COM (Nov. 1, 1998), https://www.washingtonpost.com/wp-srv/politics/special/clinton/stories/jones110198.htm.

[17] *See* Benjamin Weiser & Charlie Savage, *LinkedIn's Co-Founder Helped Fund the Suit Accusing Trump of Rape*, NYTIMES.COM (APRIL 13, 2023), https://www.nytimes.com/2023/04/13/nyregion/trump-carroll-lawsuit-hoffman-linkedin.html. Trump later wanted to provide evidence to the jury about the identity of the funder and the funder's political views. The court refused, stating that given what the jury already knows about Carroll's distaste for Trump "the prejudice inherent in such an exercise would outweigh substantially any probative value". *See* Carroll v. Trump, 2024 U.S. Dist. LEXIS 4453, 4 (S.D.N.Y. January 9, 2024)

[18] In the famous DES litigation, several generic drug manufacturers were sued for distributing a defective drug that caused the daughters of the pregnant women who used the drug to develop tumors. *See* McCreery v. Eli Lilly & Co., 87 Cal. App. 3d 77 (1978); Sindell v. Abbott Laboratories, 26 Cal. 3d 588 (1980). The DES cases are famous for dealing with uncertainty regarding the identity of the manufacturer who produced the drug used by each victim. However, if one of the manufacturers could have proven that the drug did not cause the tumors, it would reduce the liability risk of other manufacturers in later cases. For other cases against drug manufacturers, *see e.g.*, T.H. v. Novartis Pharmaceuticals Corp., 4 Cal. 5th 145 (2017).

[19] *See* Aaron S. Kesselheim, Jerry Avorn & Jeremy A. Greene, *Risk, Responsibility and Generic Drugs*, 367 N. ENGL. J. MED. 1679, 1679-1681 (2012) (adverse legal judgments against a generic drug manufacturer for failure to update warning labels can increase the liability risk for other manufacturers of the same drug) .Other types of potential defendants who are affected by litigation in the same industry includes, for example, manufacturers of tabaco products and asbestos manufacturers. For an example of litigation against asbestos manufacturer, *See* Borel v. Fibreboard Paper Prods. Crop., 493 F.2d 1076 (5th Cir. 1973). For an example of litigation against cigarette manufacturer, *see* Cipollone v. Ligget Group, Inc., 112 S. Ct. 2608 (1992).

[20] *See supra* note 4.

interest in the outcome of litigation and is likely informed about the litigation of other defendants. More importantly, potential defendants know almost certainly that they will face future litigation (especially if the current defendant loses). Conversely, each resident who lives next to a polluting factory or consumer who bought a defective product might have only a small chance of ever filing a claim and is unlikely to know about other cases.

B. Alternative Investment Schemes

The previous section demonstrated that the revised definition of litigation financing includes other forms of benefit that litigation funders might expect to receive from their investment, other than a direct payment. The broader perspective on third-party litigation funding also allows us to consider practices that affect the litigant's out-of-pocket expenses, other than providing funds to litigants.

Litigating a case requires litigants to pay for court fees, legal representation, evidence collection, and expert witnesses. Any intervention that lowers the costs of one of these components for a litigant is equivalent to providing that litigant with financial support, as it lowers the out-of-pocket expense required to achieve the same expected result in litigation. Interested third parties can affect the costs of representation, evidence collection, and expert testimonies in several ways. Assume, for example, that a plaintiff finds a lawyer willing to represent her in a personal injury case for $1000. A third-party funder can assist the plaintiff by providing the plaintiff with $300, meaning the plaintiff must spend only $700 out of her pocket to acquire the attorney's representation. Alternatively, the third-party investor might pay the lawyer $300 directly, or it can assist the plaintiff in finding a different lawyer that will offer the same quality of representation for only $700.[21] Lastly, the funder can use its better bargaining position to negotiate a lower fee of $700 by the same lawyer, for the same services. Each of these alternatives achieves the same outcome as providing the plaintiff $300 to cover the costs of her lawyer's fees.

Similarly, third parties can reduce the costs of evidence and expert opinions by paying for these services directly. Funders can also indirectly reduce the price of expert testimonies by funding research. For example, the American Petroleum Institute (API), established in 1919, offers research and lobbying services to its members - 600 American petroleum

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[21] For example, Edward Blum, a well-known proponent of affirmative action, assist in the conservative fight against universities' affirmative action policies, among other ways, by connecting plaintiffs with attorneys and rising money to fund litigation. *See* Catherine Ho, *The Washington Duo Behind Texas Affirmative Action Case*, WASHINGTONPOST.COM (March. 4, 2012), https://www.washingtonpost.com/business/capitalbusiness/the-washington-duo-behind-texas-affirmative-action-case/2012/02/28/gIQAEfsrqR_story.html

companies. Many of the articles funded by the API claim to disprove the causal connection between pollutants produced by petroleum refineries and adverse health outcomes.[22] This type of research lowers the costs of litigation for petroleum refineries in two ways: first, by encouraging scientists to author favorable scientific papers, expert witnesses will have an easier time finding supporting evidence for their opinions; second, the API-supported scientists develop ties to the industry, and can later serve as experts for these companies. We can think of the API as a third-party investor established to promote the interest of American petroleum companies, and it realizes this goal (also) by lowering each company's costs of defending legal claims. Alternatively, we can view the API as a vessel for the real investors – 600 American petroleum companies. The members of the API invest in lowering litigation costs for each other and other petroleum companies that are not members of the API. In return, they improve the chances these defendants will win in litigation, thus lowering their own liability risk.

Noticing that litigation costs are not constant reveals other ways to fund litigation. Each party's decision regarding how much to invest in litigation (i.e., how many hours their lawyer should work on the case, which expert to take, how much to invest in collecting evidence, and so forth) depends on the expected outcome they wish to receive, given their opponent's investment in the case. Understanding that the investment decision is continuous and depends on the other party's actions shows that an investor may be able to lower the litigation costs for one party by increasing these costs for the other party. For example, suppose an investor lobbies the state to increase court fees. In that case, it may discourage plaintiffs from filing cases or otherwise reduce their available funds for litigation, effectively lowering litigation costs for defendants. Similarly, suppose the investor can limit one party's access to evidence

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[22] See, *e.g*., Linda J. Roberts et. al., *Health Assessment of Gasoline and Fuel Oxygenate Vapors: Developmental Toxicity in Rats*, 70 REGUL. TOXICOL. & PHARMACOL. S69-S79 (2014) (The study concluded that emissions of gasoline pose minimal risk to human prenatal development. Several of the authors were employed by the API during their work on the study, and some of them continued employment as consultant for the API after the study was concluded); D. Swick et. al., *Gasoline Toxicology: Overview of Regulatory and Product Stewardship Programs*, 70 REGUL. TOXICOL. & PHARMACOL. S3-S12 (2014) (research was funded by the API and the authors either work for the API or gave expert opinions in legal proceedings for the API); P.S Price et.al. *A Reanalysis of the Evidence for Increased Efficiency in Benzene Metabolism at Airborne Exposure Levels Below 3 p.p.m*, 33 CARCINOGENESIS, 2049-2099 (2012) (Researchers do a reanalysis of another study, and show that there is no danger at low exposure levels of benzene). Importantly, the criticism over the influence of industry on scientific research is not just poor optics. Impartial assessment of funded studies suggests that some studies are purposefully flawed, intending to obscure the health risk created by the industry. *See. e.g*., M. Rappaport et. al., *Low-Dose Metabolism of Benzene in Humans: Science and Obfuscation*, 34 CARCINOGENESIS, 2-9 (2013) (Concluding that the article by Price et al. intentionally tried to hide the effects of benzene on health and suggesting withdrawing the article).

or experts. In that case, it increases the effort that the party needs to exert, which reduces the costs of litigation to the other party. For example, if physicians refuse to give their expert opinion to support plaintiffs in medical malpractice cases, they reduce the supply of experts, thus increasing the price for plaintiffs.[23]

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The following section of this article delves into the impact of various funding schemes on the decisions made by the parties involved in litigation. Through an analysis of both conventional litigation funding and concealed funding, we aim to determine which of these practices motivates parties to initiate claims, how much they will spend on litigation, and how frequently they will settle their cases.

II. THE EFFECTS OF THIRD-PARTY LITIGATION FUNDING

Most opponents of traditional third-party litigation funding, mainly firms financing plaintiffs by lending them money on a non-recourse basis, claim that funding promotes frivolous litigation, discourages settlements, and prolongs litigation.[24] Others claim that these firms take advantage of unsophisticated consumers, offering them loans with outrageously high interest rates.[25] Last, others have raised institutional opposition to litigation funding, claiming that funders take an active role in the litigation, in contradiction to the purpose of the court system in settling disputes between the parties to the litigation. This active role is especially problematic when the funders' interests conflict with the litigants' interests.[26]

The broad definition of litigation means that litigation funding might affect the plaintiffs' decisions in several different ways. Analyzing the

[23] Carl E. Wasmuth, *The Conspiracy of Silence: Physician's View*, 15 CLEV-MARSHALL L. REV. 85, 86 (1966).

[24] Jason Lyon, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 590-598 (2010) (Claiming that, among other things, funding promotes frivolous litigation, discourages settlements and prolongs litigation).

[25] Jeremy Kidd, *To Fund or Not to Fund: The Need for Second-Best Solutions to the Litigation Finance Dilemma*, 8 J. L. ECON. & POL'Y 613, 641 (2012) (Suggesting limiting interest rates for financing a lawsuit in order to deal with the problems caused by litigation funding). Several states placed limits on the interest rates litigation funding firms are allowed to ask for. Tennessee was the first to enact a restrictive legislation, in a law known as the Tennessee Litigation Financing Protection Act. *See* TENN. CODE ANN. §§ 47-16-101 – 47-16-110 (2014). For limitations by other states *see, e.g.*, INDIANA CODE § 24-4.5-3-202 (2016); ARK CODE § 4-57-109(A)(2) (2015).

[26] John H. Beisner & Gary A. Rubin, *Stopping the Sale on Lawsuits: A Proposal to Regulate Third-Party Investments in Litigation*, U.S. CHAMBER INST. FOR LEGAL REFORM 1, 4-5 (2012) (Claiming that when there is a third-party funding, the funding firm will try to exert control over the decisions in the case); Anglo-Dutch Petroleum Int'l, Inc. v. Haskell, 193 S.W.3d 87, 104 (Tex. App. 2006) (In order to allow a third-party financing, the court examines, among other things, the amount of control of the financier in the lawsuit compared to the amount of control of the plaintiff).

ways in which funding schemes affect litigants' incentives is crucial before deciding if we should regulate and how to regulate third-party funding. In addition, we must examine why funders may need to play a more proactive role in legal proceedings to counteract litigants' suboptimal incentives to invest in litigation. Under certain funding schemes, recipients may choose to invest less and settle for less than they might have otherwise.

Transactions between funders and the litigants have two main components that affect the litigant's incentives – how the funder supports the litigant and how the funder receives its payoff. Additionally, parties may agree on some joint decision-making mechanism regarding key litigation issues, such as settling or dropping the case.

Funders have two options when providing financial assistance to plaintiffs for litigation. Firstly, they may offer a fixed sum to the plaintiff, which can be used as per their requirements. Secondly, funders can assist a plaintiff in paying for a specific cost of litigation, such as legal representation. In this case, the litigant's out-of-pocket expense may vary depending on how much they utilize the service. These alternative methods of financial support provided by funders can significantly affect the incentives of the litigant to file a claim, invest in litigation, or settle.

The funder's means of recouping the investment also affects the litigant's decisions. We consider three cases: the litigant is not required to pay anything back (donation); the litigant must pay back the principal amount plus interest if it wins the case (debt); or – the funder receives a share of the plaintiff's award (equity).[27] Again, these alternatives affect litigants' incentives differently.

A. Fixed or Marginal Investment

Funders can assist litigants by providing them with a fixed sum or by reducing the cost a litigant needs to pay for a service essential for litigation. Consider again the petroleum refinery example.[28] Environmental organizations that wish to help pollution victims can offer them money to cover their expenses or cover part of the lawyer's hourly fee.[29]

To see how these two options may distort the litigant's incentives, we first need to describe the socially optimal behavior regarding filling claims, investing in litigation, and settling cases.[30] From a social

[27] There is a fourth alternative, according to which the plaintiff is required to pay back only the principal amount, with no interest, and only of he or she wins the case. For example, this is the typical funding model of the Israeli National Class Action Financing Fund. *See supra* note 13.

[28] *Supra*, note 4.

[29] *See supra*, note 5 and accompanying text.

[30] The article promotes a very wide definition of litigation funding, including any third-

standpoint, we want plaintiffs to file only PEV suits, meaning all the cases that have higher expected value than the cost of litigation.[31] When managing their case, litigants should invest in the case only insofar as the cost of the investment is lower than the expected benefit that it creates.[32] For example, a litigant should invest in collecting and presenting evidence whenever, and only to the extent that, the cost of collecting additional evidence is lower than the benefit this evidence is expected to create in its favor. Last, plaintiffs should want to settle their case whenever the settlement offer is higher than what the plaintiff expects to gain from continuing with the litigation, considering the expected outcome of the litigation and the costs of continued litigation.[33]

Plaintiffs may refrain from filling a PEV case mainly for liquidity constraints and risk aversion. Filling a case requires the plaintiff to invest money that might not be returned for a long time or not at all. Theoretically, plaintiffs should always file a PEV case since these cases offer, by definition, a good investment opportunity (they have a positive expected value). However, not everyone who is faced with a good investment opportunity can make use of it. If the plaintiff does not have the available resources, it cannot invest in the case. If plaintiffs lack the resources to invest in the litigation, even if they are willing to take a loan to cover the costs, they may not have the means to pay back the loan if they lose their case. Banks, and other traditional financial institutions will likely view this loan as extremely risky.[34] Since traditional financial institutions lack the expertise to estimate the likelihood the loan will be

party investment, done before or after the commencement of the case, that affects the costs of litigation, and done at least partially with the intent of the investor to reduce these costs. This might mean that many cases, or even most cases, have third parties litigation funding occurring on one or both sides.

[31] *See* SHAVELL, *supra* note 9 (Plaintiffs will file a claim only if the expected value of litigation is lower than the cost). Since litigation might take a very long time, the value a plaintiff might eventually receive in a verdict must be discounted to present value.

[32] As Richard Posner shows, from a social perspective view parties have excessive incentive to invest in litigation. Litigation is a zero-sum game, meaning that whenever a party has a benefit from its investment in litigation it creates a negative externality on the other party. Since each party internalizes only its benefit and externalizes some of the costs, parties tend to overinvest in litigation *See* Richard A. Posner, *An Economic Approach to the Law of Evidence*, 51 STAN. L. REV. 1477, 1486, 1490-1491 (1999). Furthermore, when parties present more (1999). Furthermore, when parties present more evidence and submit additional motions they add to the court's workload. This additional cost is further disregarded by the parties. These externalities have been traditionally managed by procedural limitation and evidence admissibility law. *See* Ronen Avraham & William H.J. Hubbard, *Civil Procedure as the Regulation of Externalities: Toward a New Theory of Civil Litigation*, 89 U. CHI. L. REV. 1, 3, 22 (2022) (discussing the externalities of litigation).

[33] When the parties have similar beliefs regarding the outcome of the case, they should always reach a settlement to avoid litigation costs. *See* SHAVELL, *supra* note 9, at 406 (Claiming that if the settlement offer exceeds the expected benefit from continuing the procedure, there is a greater chance of reaching a settlement).

[34] Indeed, third-party litigation funding is viewed as a form of sub-prime loan. *See supra*, note 1.

paid back and the timeframe for the conclusion of the litigation, plaintiffs are unlikely to secure a loan from these institutions to fund their claim.

Even if plaintiffs have enough capital to fund their litigation needs, some might refrain from filling PEV cases because of the risk litigation entails. Suppose for example that the plaintiff must invest 50 to file a case with a 50% chance of losing, and 50% chance of winning 120 (in present value terms). This case has a positive expected value of 10 (50% of 120 minus the cost of 50). The case also carries substantial risk- the plaintiff might lose 50 or gain 70 with equal probability. If the premium the plaintiff assigns for this 'lottery' is higher than the expected value of the case (10), it will refrain from suing. Risk aversion and liquidity constraints may also limit the plaintiff's investment in the case, and encourage lowball settlements, to save the plaintiff from the need to raise capital to continue with the litigation and reduce the risk of an unknown outcome.[35]

Providing a litigant with a fixed sum can affect the decision to file a claim. This is not necessarily a positive thing. Since receiving the sum of money is conditional on filling the claim, the plaintiff may decide to do so even if the case has negative expected value (NEV), meaning the cost of litigation is higher than the expected outcome of the case. Assume, for example, that the costs of a case are 50, and it has a 50% chance of winning 80 (in present value terms). The expected value of this case is negative 10 (50% of 80 minus the cost of 50). Nevertheless, if the plaintiff receives a donation of 30 to cover litigation costs, it will pursue the case, internalizing only 20 in litigation costs, privately seeing the case as having a positive expected value of 20 (50% of 80 minus the cost of 20).

However, while providing plaintiffs with a fixed sum may cause plaintiffs to file unwarranted NEV cases, it will not result in excessive investment in the case or unwillingness to settle. After receiving the money, the plaintiffs internalize the entire cost and benefit from every decision, meaning they act as if they did not receive any assistance, apart from not having budgetary constraints (which are inefficient).

Alternatively, funders might offer to cover the costs of a service, such as the lawyer's hourly fee. When the funder reduces the cost of a service, it changes the marginal cost of litigation, inducing the plaintiffs to invest more in litigation than they would have otherwise. Consider, for example, the decision of whether to write a pretrial motion. Suppose it would cost \$100 to write the motion, increasing the expected outcome of the trial by \$70. If the plaintiffs received a fixed sum to fund their litigation, they would not ask their attorney to do the extra work. If, however, the funder covers half of the cost, the plaintiff must only invest

[35] *See* Andrew F. Daughety, *Settlement*, ENCYCLOPEDIA OF LAW AND ECONOMICS, VOL. V, 95, 146-147 (B. Boukaert & G. Degeest eds., 2000); *See* SHAVELL, *supra* note 9, at 406-407 (Claiming that risk averse parties tend to settle due to the inherent risk of trial).

$ 50$ to get the extra $70 from litigation and will choose to do so.

Knowing that reducing the costs of services induces plaintiffs to acquire more of these services, why would funders consider offering this type of assistance in the first place? There are three reasons funders might prefer reducing the marginal cost of litigation instead of providing the litigant with a fixed sum.

First, and most importantly, funders may wish to induce parties to invest more in litigation. Consider once again the petroleum refinery example. Petroleum refineries, and other polluters, can invest in research institutions, which, among other benefits for the industry, lowers the cost of expert opinions.[36] If the sole goal of the investment is to assist defendants to fund their litigation, polluting companies could have instead provided defendants with money. This, however, will not serve the needs of other companies. Each defendant's decision to invest in their case or to settle it is determined by its own costs and benefits, disregarding the externalities the outcome of the trial may have on other potential defendants (and other potential plaintiffs). Industry organizations may wish to invest in lowering the marginal cost for defendants precisely to induce defendants to invest more.[37] One might think that it is socially desirable for parties such as the refinery to increase their investment in litigation to account for the externalities of the case on other polluting companies, but this is generally untrue. While winning the case reduces the liability risk of other polluters, it also reduces the chances residents who live near pollution will be compensated, creating a negative externality and vice versa.

A second reason a funder might assist a litigant in reducing the marginal cost of litigation is that it might be cheaper for the funder to provide this type of assistance. For example, as discussed before, a third party can assist a litigant in lowering the cost of legal representation by negotiating on the litigant's behalf, using its superior negotiating position to lower the litigant's out-of-pocket expense.[38] While having the same effect on the litigant's out-of-pocket expense, negotiating on behalf of the litigant costs less for the funder than providing the litigant with the difference in cash.

The third and final reason funders help litigants by reducing their marginal cost of litigation is that the funder itself might be constrained

[36] *See supra*, note 4 and accompanying text.

[37] From the industry's perspective, each company internalizes the entire cost of litigation, but only a share from the benefit of investing in litigation, since the outcome impacts the entire industry, especially in novel cases. By covering part of the costs, the industry, through a joint organization, can reduce the share of the costs of litigation to equal the private benefit from litigation. This will induce each company to act as if it internalized the entire cost and benefit. For a general discussion about proportional internalization of costs and benefits, *see* Omer Y. Pelled, *The Proportional Internalization Principle in Private Law*, 11 J. LEGAL ANALYSIS 160 (2019).

[38] *See supra*, note 21 and accompanying text.

in the way it can assist the litigant. Lawyers, for example, may wish to assist their clients to fund their litigation, believing that the case has merits and should not be abandoned because of budgetary constraints. Theoretically, a lawyer can provide the client with a loan with which the client can pay for the lawyer's hourly fee. However, lawyers are not allowed to give their clients a sum of money to assist them with their financial needs.[39] Indeed, lawyers are allowed to fund some of their clients' litigation costs, but they might face budgetary constraints as well.[40] However, when the client and the lawyer agree on a contingent fee, the lawyer funds, in practice, the cost of legal representation, essentially reducing the marginal cost of their work from the client's perspective to zero.

To conclude, without funding, plaintiffs might not file PEV cases, underinvest in litigation, and settle too quickly. Funding elevates these problems but may create opposite problems. Receiving a fixed amount from a third-party investor may cause plaintiffs to file NEV cases. When the funder reduces the marginal cost of litigation, besides incentivizing plaintiffs to file NEV cases, parties may also overinvest in litigation and decline to settle their cases.

B. Payback – Donation, Debt, or Equity

There are three ways in which the litigant is expected to pay back the funder in case of a favorable outcome: the investment might be a donation, in which case the litigant is not expected to pay the funder back at all; the investment may take the form of debt or a loan, meaning that the funder expects the litigant to return the money with interest; or – the funder may acquire equity in the case, meaning the funder is entitled to a share of the proceeds.

Donations are typical of concealed third-party funding, where the funder assists a litigant because a favorable outcome in the litigation serve the funder's interests (e.g., political views or litigation risk). When the litigant does not have to pay anything back to the funder, the donation does not affect the litigant's incentives to invest in the case or to settle, since the litigant internalizes the entire cost and benefit from every decision in managing the case.

When the litigant must pay the funder the principal investment with an interest, but only if the litigant wins, the structure of the loan affects the litigant in three ways: first, the marginal benefit from increased chances of winning is diminished, since the litigant only internalizes

[39] Model Rules of Prof'l Conduct R. 7.3 (2019)

[40] See supra, note 3; Nora Freeman Engstrom, *Re-Re-Financing Civil Litigation: How Layer Lending Might Remake the American Litigation Landscape, Again*, 61 UCLA L. REV. Discourse 110 (2013); Nora Freeman Engstrom, *Lawyer Lending: Costs and Consequences*, 63 DEPAUL L. REV. 377 (2017).

some of the winnings, considering that he or she need to pay back the funder. This effect causes the litigant to reduce its investment in measures that increase the chances of the case.[41] Second, knowing that the funder is only paid back if the litigant wins means that for the litigant, winning any sum that does not cover the loan is equivalent to losing. This means that litigants with access to funding will prefer cases with high variance, where they might win large amounts with low probability. Lastly, funding through debt encourages plaintiffs to settle the case earlier. Third-party funders require high-interest rates to reflect the high risk of non-payment.[42] Since plaintiffs' payments increase dramatically as litigation drags on, this high interest rate may encourage plaintiffs to accept earlier settlement offers since continuing the litigation carries an additional cost.

When the funder invests in equity, the litigant internalizes the entire cost from litigation but only a part of the benefit. This disproportional internalization causes the plaintiff to under-invest in litigation and settle its case too quickly.[43]

To illustrate how paying back funders distorts the litigant's incentives, consider the following simple example.

> Example 2. *Litigation funding*. Lucy sues Jim for damages. Lucy has to invest 20 to initiate her case, which she does not have. She receives 20 from a third-party litigation investor, promising to pay the investor back out of the damages award if she wins. Initially, Lucy believes the case has a 50% chance of winning and receiving 100 in damages.

The example illustrates a PEV case having a net value of 30 $(100 *$

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[41] Let x denote the investment in litigation which affects both the probability of success, p, and damages award. d. If the litigant does not have to pay anything to a funder if the case wins, the litigant maximizes the sum of $(p(x)d(x) - x)$. Solving for the first order condition, the plaintiff invest until $1 = p'(x)d(x) + p(x)d'(x)$, meaning until the marginal cost of investment, 1, equals the sum of the marginal addition of the chances of success times the award, plus the marginal addition to the award times the probability of winning the case. When the litigant must pay a fixed sum, s, only if she wins, then she maximizes $(p(x)[d(x) - s] - x)$. Solving for the first order condition we obtain $1 = p'(x)[d(x) - s] + p(x)d'(x)$, meaning that the plaintiff's incentives to invest in increasing damages, given the probability of winning, are unaffected, but the plaintiff's motivation to invest in winning decreases. The intuition is clear – plaintiffs fully internalize an increase in compensation above s, but only internalize a portion of the benefit from winning, which equals $\frac{d(x)-s}{d(x)}$. As the size of s increases, the plaintiffs cares less about winning.

[42] This is a well-known agency cost of debt. *See, e.g.*, Gordon Donaldson, *Corporate Debt Capacity*, 93-120 (1961).

[43] This is a common problem with contingent attorney fees. *See* Mitchell A. Polinsky & Daniel Rubinfeld, *Aligning the Interest of Lawyers and Clients*, 5 AM. L. & ECON. REV. 243 (2007). For a general discussion on proportional internalization, *see* Pelled *supra* note 37.

$50\% - 20$). Assume that a funder invested in Lucy's litigation and considers two alternative ways in which Lucy can pay back if she prevails – either the funder receives 50, or the funder receives 50% of Lucy's winnings.[44] We consider how these alternatives might affect Lucy's incentives to fill and manage her case.

Assuming the funder has enough information about the expected outcome of the case, they will never fund an NEV case. If the costs of litigation are higher than the expected outcome, the funder will not see a positive return on its investment. This means that for-profit funding will not create this inefficiency.

However, the litigant's need to pay back the loan affects its incentives to invest in the case. Assume that after filing her case, Lucy's lawyer says that by investing another 6, she can increase her chances of winning by 10%. This investment is warranted (creating an expected value of 10 for the cost of 6), but Lucy will not invest. If Lucy must pay the funder back 50 from her winnings, from her perspective, the investment creates an expected value of only 5. The same is true if the funder is entitled to 50% of Lucy's winnings.

The effects are different if Lucy is presented with an opportunity to increase the damages awarded. Assume that Lucy can pay 6 for additional evidence proving her harm is 120. Again, the investment is warranted, creating an expected value of 10 (50% of 20) for the cost of 6. If the funder is entitled to 50% of Lucy's winnings, she will not invest in this evidence – Lucy internalizes only half of the increased damages award. However, if the funder is entitled to a fixed amount of 50 if Lucy prevails, she will invest in presenting this additional evidence, since she internalizes the entire benefit.

Regarding the willingness to settle the case, litigants are less willing to settle their case when the funding is structured as a debt than they would have been without funding. To see why, consider example 2 again. Before Lucy invests in the case, the expected value of the case is 30. If Lucy were to settle her case for 30, however, she would have to pay all of it, including the 20 she has received as funding, back to the funder. Even after she invests the 20 in her case, increasing the expected value of the case to 50, she will not settle for 50, as again she will have to pay the entire sum back to the funder.[45]

When the funding takes the form of equity investment, litigants will have excessive willingness to settle. The mechanism is the same as deciding to invest in the case. When the litigant refuses to settle, it needs to pay the entire cost of continuing with the litigation but receives only

[44] Since the outcome of the trial is initially a 100, in both cases the outcome is the same – 50.

[45] Generally, when the case is funded with debt litigants are less willing to settle, since settling requires paying back the debt with certainty, while continuing with the litigation means that the payback is discounted by the probability of winning the case.

some of the benefit. In Lucy's example, if Jim had offered Lucy 20 before Lucy invested anything in litigating the case, she would have received 10, on top of the 20 she got from the funder, and would have to pay back the funder only 10 (50% of her proceeds from the case).

To conclude this section, donations do not affect litigant's incentives to invest or settle their case. Debt causes litigants to underinvest in measures that increase their likelihood of winning and refuse fair settlement offers. Equity investment causes litigants to underinvest in their cases more generally and increases their willingness to settle cases inefficiently.

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Considering the structure of investment and return together, six combinations of litigation funding emerge. The following table summarizes the effects of these six funding schemes.[46]

[46] There are examples for each of these funding schemes. For example, when lawyers represent client's pro-bono, their action is a form of a marginal donation – the client is not required to pay the lawyer back, and the lawyer reduces the marginal cost of representation. The lodestar method for determining attorney's fees in a class actions is a form of marginal debt. According to the method if the lead attorney wins the case or reaches a settlement, he or she reports the number of hours the firm invested in the case to the court, and then receives the amount with an interest that reflects the risk of the case. In *Newby v. Enron Corp.* (*In re Enron Corp. Sec*.), the court explained that with regard to lodestar calculations, "a 50% chance of recovery implies a multiplier of 2, a 75% chance of recovery implies a multiplier of 1.5, and so on." 586 F. Supp. 2d 732, 818 (S.D. Tex. 2008); *see also* Joyce v. Federated Nat'l Ins. Co., 228 So. 3d 1122, 1126 (Fla. 2017).

		Investment	
		Fixed	Marginal
Return	Donation	Increases willingness to sue, both PEV cases and NEV cases.	Increases the willingness to file both PEV cases and NEV cases. Inducing over-investment in litigation. Reducing willingness to settle.
	Debt	Filling only PEV cases. Inefficiently reducing incentives for some investments and discouraging settlements.	Filling only PEV cases. May induce either over or underinvestment in litigation. Dramatically reducing incentives to settle.
	Equity	Filling only PEV cases. Inefficiently reducing incentives to invest in litigation. Excessive incentives to settle.	Filling only PEV cases. Other effects on incentives are unclear. Incentives to invest in litigation and to settle can be too high or too low.

III. REGULATING LITIGATION FUNDING

The last part of the article showed how litigation funding distorts the parties' incentives. However, not all funding schemes have the same distortionary effect on litigants. Marginal donations (i.e., interventions that reduce the marginal cost of litigation and require no repayment), for example, cause parties to file too many cases, overinvest in them and refuse to settle. Fixed equity funding (i.e., receiving a fixed sum and paying back a share of the proceeds), on the other hand, results in inefficiently low investments in the case and excessive willingness to settle. This part explores how best to regulate litigation funding to avoid its shortcomings.

A. Self-regulating

When analyzing the effects of third-party funding, we viewed the litigant's incentives, disregarding the funder's incentives. In some cases, the funder's incentives are aligned with those of the litigant, while in other cases, founders have countervailing incentives to those of the litigants who received funding.

Examples of the second group are traditional third-party litigation funding cases structured as an equity or debt investment.[47] In these cases, litigants invest too little in litigation after receiving the funds because they must share their winnings with the funder, while the funder prefers litigants invest too much in litigation since the funder enjoys the benefit from investing but does not have to pay for the additional cost.

The previous section focused on the litigant's incentives since the litigant controls the case, deciding how much to invest and if to accept a settlement offer. Since the funder and the litigant have diverging interests, the funder faces a principal-agent problem – the litigant manages the litigation, promoting its interests at the expense of the funder's interests.[48] Funders reduce this agency cost in several ways. First funders can include contract provisions which allow them to supervise and intervene in significant decisions, thus ensuring, for example, that the litigant does not agree to a lowball settlement (in the case of equity investor) or to a fair settlement that substantially reduces the risk from litigation (in case of debt investors). However, this solution is only relevant when the funder's investment and subsequent stakes in the outcome of litigation are substantial enough to justify the costs of supervising the litigant.

When companies raise funds to support complex intellectual property litigation,[49] or a case alleging breach of commercial contract,[50] the litigation funding agreements include provisions designed to ensure that litigants do not under-invest in litigation. For example, funders may limit

[47] Funders may structure funding as marginal investment, only reimbursing the litigant for actual expenses, thus lowering the marginal cost of litigation. Structuring the funding as a marginal investment may resolve the litigant's incentive to underinvest in litigation, and the funder's interest in increasing the litigants' investment beyond the efficient level. *See*, *e.g*., the DiaMedica agreement, *infra* note 50.

[48] *See* John Armour, Henry Hansmann & Reiner Kraakman, *Agency Problems and Legal Strategies*, THE ANATOMY OF CORPORATE LAW, 35, 35-37 (Reiner Kraakman et al. eds., 2d. ed. 2009) (explains the neture of the principal-agent problem).

[49] *See*, *e.g*., Boston Scientific Corporation v. Biocardia, Inc., 524 F.Supp. 3d 914 (U.S. Dist., 2021). Biocardia sued Boston Scientific its subsidiaries for violation of intellectual property rights. Biocardia's lawsuit was funded by BSLF LLC., a litigation funding corporation. The funding agreement was later reported to the SEC as part of Biocardia's material contracts. *See* BioCardia, Inc., Annual Report (10-K) (Mar. 30, 2021), https://www.sec.gov/Archives/edgar/data/925741/000143774920007637/ex_181285.htm.

[50] *See*, *e.g*., DiaMedica Therapeutics, Inc. v. PRA Health Scis., Inc., 2020 U.S. Dist. LEXIS 171921. DiaMedica Therapeutics, a drug-developing company, sued PRA Health Scis., a company providing clinical trial services, for breach of contract. In 2019, DiaMedica entered into a litigation funding agreement with Legalist, a litigation financing firm, to cover some litigation costs in exchange for a share of the claim proceeds. DiaMedica reported added the agreement with Legalist to the company's annual report with the SEC. *See* DiaMedica Therapeutics Inc., Annual Report (10-K) (Mar. 23, 2020), *https://www.sec.gov/Archives/edgar/data/1401040/000143774920000102/ex_168050.htm*.

their funding to actual expenses that legal counsel recommended,[51] or require the plaintiff to cooperate with its counsel and exercise reasonable effort to prosecute its claims.[52]

However, the funders may find regulating the litigant's conduct challenging. When funding private plaintiffs, the funder's investment is often minimal and does not justify the costs of supervising the plaintiffs' conduct.[53] Furthermore, even if supervising the litigation is cost-justified, courts may nullify the contract for violating public interest under the champerty doctrine.[54] As a result, even when the litigant is a corporation, funders may wish to stipulate that the litigant retains control over the litigation, particularly over the decision to settle.[55]

When funders' involvement in the case is limited, they may require a more significant share of the case (if they purchase equity) or a higher interest rate (if they purchase debt) for their investments, anticipating lower rates of return due to the distorted incentives of the litigant. If regulators prevent funders from intervening in the litigation and increasing their interest rates, they may find the market unsustainable.[56]

A notable exception for rules limiting the funder's ability to intervene in the litigation or to increase their payment scheme to accommodate the risk of litigants underinvesting in their case are lawyers' contingent fees agreements. When lawyers forgo their hourly fee in favor of a share in

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[51] *See*, *e.g*., BioCardia funding agreement, supra note 49, section 2.2 (stating that "Litigant shall use the funding exclusively for legal fees and costs incurred in connection with the Litigation."); DiaMedica funding agreement, supra note 50, section 2.2 (stating that "Unless otherwise agreed by the Funder, the Funder will not pay and will not be liable under this Agreement for any unreasonable Costs and Disbursements… ").

[52] *See*, *e.g*., BioCardia funding agreement, supra note 49, section 6.2.1 (stating that "…cooperate with the Lawyers and Funder in all material matters pertaining to the Claims and the Litigation, and devote sufficient time and attention as is reasonably necessary to conclude the Claims successfully"); DiaMedica funding agreement, supra note 50, section 6.4 (stating that "… the Plaintiff agrees to take and follow the legal advice of the Lead Counsel at all appropriate junctures").

[53] Ronen Avraham and Anthoney Sebok examined a large data-set of a large litigation-funding corporation and found that in their sample the average plaintiff received less than $7,000, and most plaintiffs received less than $2,500. *See* Ronen Avraham & Anthony Sebok, *An Empirical Investigation of Third Party Consumer Litigant Funding*, 104 CORNELL L. REV. 1133, 1149 (2019).

[54] *See* Kidd, *supra* note 25; In re DesignLine corp., 2017 Bankr. LEXIS 182 (holding that when the funder controls various aspects of the litigation, including additional decisions to invest or replacement of counsel, the funder's involvement constitutes champerty and violates public policy).

[55] *See*, *e.g*., BioCardia funding agreement, supra note 49, section5.1 (stating that "Litigant shall not Settle the Claims or the Litigation without the prior consultation of the Funder… Litigant shall have the sole and exclusive right to settle on whatever terms it deems acceptable"); DiaMedica funding agreement, supra note 50, section 6.4 (stating that "The Plaintiff shall retain control over the conduct of the Claim(s) and in particular over settlements of the Claim(s) with the Defendant").

[56] *See* Avraham & Sebok *supra* note 53, at 1140; *See* Andrew G. Simpson, *Litigation Financing Firm Exits Tennessee As New Law Goes Into Effect*, Ins. J., July 3, 2014, at https://www.insurancejournal.com/news/southeast/2014/07/03/333772.htm

the outcome, the lawyer effectively provides the client with a marginal equity investment – the client pays the lawyer nothing for any additional work, meaning that the litigant's funding increases with the investment in the case, and the lawyer's investment reduces the marginal cost of litigation (to practically zero). The lawyer holds an equity interest in the case by receiving a share of the proceeds. If the client can tell her lawyer how much to invest in her case, she would require excessive investment in the case and refrain from settling since she does not have to pay for additional hours her lawyer has to put in. If the lawyer has complete control over the litigation, including when to settle, the lawyer will settle the case too quickly and invest too little.[57] Understanding that each party has opposite interests, both inefficient, the law governing legal representation gives the lawyer practical control over the litigation process, allowing the lawyer to decide how much to invest, but subjects the lawyers to fiduciary duty, requiring the lawyer to promote the client's interest to the best of its abilities.[58]

The critical takeaway is that absent market failure, when the funder and litigant divide the proceeds from the case (either with equity or debt investment), their combined interests *ex-ante* are similar to those of a single litigant with no budgetary constraints – they will choose to file only PEV cases, invest efficiently in litigation and settle their case whenever they expect to gain less from continued litigation than settling. That means regulators should limit intervention in third-party litigation funding only to market failures, for example, by inducing information sharing. Suppose there is no reason to believe that the funder has other interests besides maximizing its return on the investment. In that case, we should generally allow the parties to construct the investment agreement as they see fit. Otherwise, the funder may fear that the litigant will underinvest and, as a result, will require a higher share of the case or a higher interest rate to cover the added risk.

B. Regulating Fixed-Sum Donations

Fixed sum donations encourage plaintiffs to file more cases than they otherwise would have but do not affect the plaintiff's decisions regarding investments in the litigation or settling the case.[59] Regarding defendants, fixed-sum donations encourage defendants to litigate a case that they would have otherwise settled to save on litigation costs. These effects are neither good nor bad in and of themselves. We should encourage donations, like other forms of litigation funding, to allow disenfranchised parties access to courts that they otherwise would not have due to budgetary constraints or encourage them to file cases that would benefit

[57] *See* Pelled *supra* note 37; *See* Polinsky & Rubinfeld *supra* note 43.
[58] Yifat Naftali Ben Zion, *Moving Along the Continuum of Loyalty from a Standard Towards Rules*, 35 CAN. J. L. & JURIS. 187, 208 (2022).
[59] *See supra*, section II.B.

society.[60] On the other hand, we need to disallow donations designed to entice plaintiffs to file NEV cases or encourage defendants to litigate a hopeless case just to increase costs for plaintiffs.

Donations are generally warranted in one of two cases – when they allow poor litigants who cannot afford the cost of litigation to assert their rights or encourage litigation that will help clarify an unresolved legal question or further develop the law in another way. For example, the Canadian government funds constitutional test cases that further develop human rights protection, especially the protection of minorities.[61] Similarly, Israel funds innovative class actions that promote public interest beyond the interest of the class members.[62]

In other cases, encouraging litigation through fixed-sum donations is socially undesirable. It allows donors to abuse the legal system to promote their political or financial interests, disregarding the costs they impose on others by increasing the court's caseload and congestion.

Intervening in third-party litigation through charitable donations may be prohibited under the maintenance doctrine, defined as the intermeddling of a stranger in a suit to stir up strife and continue litigation.[63] Interestingly, a narrow interpretation of the maintenance doctrine is in line with the analysis of fixed-sum donations, permitting a good faith assistance to a person wishing to assert his or her right, but prohibiting the assistance in frivolous litigation. This might justify a mandatory disclosure of donations, so the court can later determine if it is indeed a good-faith donation.

C. Regulating Concealed Funding

Concealed funding practices (i.e., investments in evidence production, reducing the costs of experts, or increasing the costs of litigation for the other party) have three essential characteristics that make them more concerning than other forms of funding: they usually take the form of marginal investment donations; they often require no

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[60] Access to courts is viewed as a fundamental right in liberal societies. *See*, *e.g*., Mauro Cappelletti & Bryant Garth, *Access to Justice: The Newest Wave in the Worldwide Movement to Make Rights Effective*, 27 BUFF. L. REV. 181 (1978). Donations that support plaintiffs are not rare. For example, CrowdJustice is a fundraising platform enabling potential plaintiff with insufficient resources to bring their legal claims to court. *See* CrowdJustice's website at https://www.crowdjustice.com/. *See* also *supra*, note 8 and accompanying text.

[61] *See supra* note 12.

[62] *See supra* note 13.

[63] Ari Dobner, *Litigation for Sale*, 144 U. PA. L. REV. 1529, 1543-1545; Hall v. State, 655 A.2d 827, 829 (Del. Super. Ct. 1994); Rancman v. Interim Settlement Funding Corp., 99 Ohio St. 3d 121, 123 (2003). Notice that a donation does not fall under the definition of champerty, which requires a division of the proceeds between the litigant and the funder. *See*, Dobner, at 1543-1545; Capitol Plaza 2 Lot Subdivision & Capitol Plaza Maj. Site Plan, 2020 Vt. Super. LEXIS 22, 2-3, 5-7; Wilson v. Harris, 688 So. 2d 265, 269-270.

communication between the funder and the litigant it supports; and finally, they are more available to specific types of litigants.

When concealed funders reduce the marginal cost of litigation, they encourage plaintiffs to file cases, induce excessive investments, and discourage settlements. These are the main concerns of those who object to traditional forms of litigation funding. Furthermore, the goal of these investors is precisely this distortion in incentives. Unlike traditional funders, concealed funders and the litigants they support have the same interest – both would like the litigant to increase its investment in litigation and refrain from settling. This feature of concealed funding means there is no hope that self-regulation could resolve the problem of excessive investment.

Since concealed funders achieve their goals by reducing litigation costs, they do not need the litigant to accept their help. In fact, they do not even need to communicate their help to the litigant. This feature is one of the things that makes it possible to conceal this form of funding. It also what makes it nearly impossible to regulate. Think for example about physicians' decision not to testify against other physicians.[64] We cannot force experts to offer their opinion, and if we try, we cannot control what they will opine. Similarly, it is difficult to prohibit industry organizations from conducting research or donate to researchers. These actions reduce the cost of litigation, but they are not directly connected to the litigating parties, and not fall under any doctrine limiting litigation funding.[65]

While concealed funding practices may assist both plaintiffs and defendants, they do not affect all litigants alike. Think again about the petroleum refinery example. The litigation between the refinery and nearby residents may pique the interest of other refineries as well as other residents that live near these refineries. Arguably, both groups have an opposite but comparably strong interest in the outcome of the litigation. In practice, however, other refineries are much more likely to invest in each other's litigation, being a much smaller group with better access to legal information and concealed funding opportunities.

Generally, in any typical litigation between individuals and corporations, the group of companies in the same industry is a fraction of the size (in number) than the group of potential individual plaintiffs, making the stakes for any company much higher than those of each potential plaintiff. Furthermore, companies are better informed of litigation, legal risk and strategies to affect legal risk than most

[64] *See supra*, note 23 and accompanying text. The same may be true in other professions. Police officers may find it difficult to testify against another policeman. *See* David Rudovsky, *Police Abuse: Can the Violence Be Contained?*, 27 HARV. C.R.-C.L. L. REV. 465, 481 n. 60 (1992).

[65] For a discussion on the limits of champerty and maintenance doctrines, *see supra*, note 54, 64.

individuals. Last, it is important to note that while individuals who contemplate suing large institutions may face severe budgetary constraints (making litigation funding socially desirable), companies generally have more available resources to invest in litigation, meaning that litigation funding is more likely to be socially undesirable.

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While traditional litigation funding can have some adverse effects, they allow access to justice to poor litigants. In most cases when the parties are well-informed they will design the funding agreement in a way that minimizes the adverse effects of funding. This suggest that regulators should encourage disclosure and competition between funders, and intervene less in the design of the funding agreement.

This observation is not very novel.[66] This article offers another support for relaxing regulation of traditional litigation funding – the proliferation of concealed funding. Concealed funding practices are common, and support frequent litigants more than parties who usually look for traditional funding opportunities. It is nearly impossible to regulate or limit the effect of concealed litigation funding, meaning that limiting the availability of traditional funding skews the costs of litigation in favor of the rich, creating a strong regressive effect, on top of other negative effects this type of funding entails.

CONCLUSION

Despite wide criticism,[67] traditional investors in litigation can provide a valuable service by allowing disenfranchised litigants access to courts which they otherwise would not have, strengthening their bargaining position during settlement negotiations, all the while ensuring that litigants do not underinvest in their case.

The article showed that third parties' involvement in the costs of litigation are common and might even be inevitable. Many decisions litigants make in their own case, such as investment in experts, research, or producing evidence can lower the costs of similarly situated litigants in other cases.

While regulating concealed ways in which interested third parties can affect the cost of litigation might be impractical, regulators should not ignore these practices or their possible effects. Instead, regulators should

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[66] For other articles showing that litigation funding provides an important service, especially to disenfranchised individuals, *see* Steinitz, Whose Claim is This, *supra* note 2; Ronen Avraham & Abraham Wickelgren, *Third-Party Litigation Funding – A Signaling Model*, 63 DEPAUL L. REV. 233 (2014); Jonathan T. Molot, *Litigation Finance: A Market Solution to Procedural Problem*, 99 GEO L.J. 65 (2010); Douglas R. Richmond, *Other People's Money: The Ethics of Litigation Funding*, 56 MERCER L. REV. 649 (2005).

[67] *See supra*, notes 24-26.

acknowledge these effects exist when deciding how best to regulate other funding approaches, such as investments and donations.