TO FUND OR NOT TO FUND: THE NEED FOR SECOND BEST SOLUTIONS TO THE LITIGATION FINANCE DILEMMA

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TO FUND OR NOT TO FUND: THE NEED FOR SECOND-BEST SOLUTIONS TO THE LITIGATION FINANCE DILEMMA

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Abstract

Litigation financing promises to promote greater justice and efficiency in tort law by reducing financial barriers to litigation and changing the allocation of litigation risks. In the case of personal injury cases, however, broad litigation financing also has the potential to diminish justice and efficiency by increasing the total amount of litigation, increasing the frequency of frivolous litigation, and distorting the incentives for bringing and maintaining lawsuits generally. This article adds to the litigation financing literature by addressing the danger of path manipulation, a form of judicial rent-seeking. In a system of binding precedent, litigation financiers will be faced with incentives to use case selection to maximize profits by pressuring the courts to open new areas of tort liability. These efforts, driven by investment returns instead of justice, could divert tort law from both justice and efficiency objectives. The costs of litigation financing make it prudent to consider alternative financing regimes that can capture some benefits of litigation financing while minimizing costs and distortions.

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I. Introduction

> A poor man may have the right upon his side, but be without means to enforce such rights in the courts, and possibly against some powerful adversary.[2]

Over a century ago, the Colorado Court of Appeals expressed the frustration of many tort victims: that compensation for the wrongful damages they have suffered is beyond their reach simply because they lack the resources to file and maintain their claims. The intervening years have not served to minimize the financial barriers; to the contrary, the financial barriers to litigation have increased dramatically, leaving many poor and middle-class victims at a disadvantage in pursuing their claims.[3]

The question is not whether tort litigation is becoming more costly, but what efforts, if any, are necessary to aid litigants in the pursuit or defense of legitimate claims. Some have argued in favor of a full assignment regime, where someone other than the tort victim would purchase the right to prosecute the claim.[4] Others have argued for something short of full assignment, allowing third parties to finance lawsuits, purchasing a share in any damages award or settlement by funding the legal and living expenses of the tort victim.[5] It is even possible to argue that the ideal answer to this problem lies in the reform of our credit markets, allowing tort victims to borrow against the value of their claims much as homeowners borrow against the equity in their homes.

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[2] Casserleigh v. Wood, 59 P. 1024, 1026 (Colo. App. 1900).

[3] Various forms of litigation financing already exist, such as contingency fee arrangements and collateral sources, *infra* section IV.A and B, but increases in the cost of litigation appear to have outpaced all attempts to overcome them.

[4] *See, e.g.*, Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697 (2005); Peter Charles Coharis, *A Comprehensive Market Strategy for Tort Reform*, 12 YALE J. ON REG. 435 (1995); Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J. LEGAL. STUD. 329 (1987).

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

Implementation of any of these solutions would likely require the relaxation of legal rules prohibiting assignment of claims,[6] maintenance,[7] champerty,[8] and fee sharing with non-lawyers.[9] Loosening these restrictions may be nothing more than refusing to be governed by "blind imitation of the past."[10] Throwing off antiquated rules[11] may be liberating and beneficial. Some might even argue that these rules are nothing more than rules designed to protect lawyers' cartel power.[12] However, it is also possible that these rules are based on an understanding of human nature and the incentives that arise in a common law system.

Each of the bold proposals described above rely on certain assumptions regarding the incentives of potential litigants, lawyers, and potential third-party financiers. If they are correct, and the ideal circumstances hold, each proposal would likely result in a much more efficient and just tort system. Unfortunately, the world we live in may not be able to achieve the ideal circumstances, and there are significant dangers involved with attempting an ideal solution under non-ideal circumstances. In the case of litigation finance, those dangers include the possibility that increased frivolous litigation would degrade whatever justice and efficiency presently exist in our tort system. Opponents of broader litigation finance are often criticized for failing to justify their claims that a broader financing regime would lead to greater volumes of litigation

[6] Under a regime that allowed assignment, the plaintiff could sell her legal claims to any other individual, who could then pursue all available remedies against the defendant.

[7] Black's Law Dictionary defines maintenance as "[a]n officious intermeddling in a lawsuit by a non-party by maintaining, supporting or assisting either party, with money or otherwise, to prosecute or defend the litigation." BLACK'S LAW DICTIONARY 954 (6th ed. 1990).

[8] Champerty is a form of maintenance, and is defined by Black's Law Dictionary as "[a] bargain between a stranger and a party to a lawsuit by which the stranger pursues the party's claim in consideration of receiving part of any judgment proceeds." BLACK'S LAW DICTIONARY 231 (6th ed. 1990).

[9] In every United States jurisdiction except the District of Columbia, ethical rules prohibit lawyers from sharing fees with non-lawyers, making it difficult for a potential financier to contribute funds via the law firm. Jonathan T. Molot, *A Market Approach to Litigation Accuracy*, SEARLE CTR. ON LAW, REG., AND ECON. GROWTH 28 (2009), *available at* http://www.law.northwestern.edu/searlecenter/papers/Molot_Accuracy.pdf.

[10] Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

[11] Coharis, *supra* note 4, at 463-64.

[12] *Id.* at 475.

and, specifically, greater numbers of frivolous cases.[13] This article attempts to answer those challenges, identifying the incentives presented by broader financing that would lead to more frivolous litigation. However, it does so with a few important caveats. First, the arguments here are limited to personal injury cases and may not extend well to commercial tort litigation.[14] Second, this article contrasts a world in which all litigation funding is prohibited with the broad financing regimes described above to illustrate both the benefits and costs of financing generally.[15] This article also offers examples of intermediate, alternative solutions, each of which has its own strengths as well as weaknesses that account for the impossibility of achieving the ideal solutions.

The argument proceeds in four parts. Section II introduces the economic theory of the "second-best," which offers insights into how society should proceed when the ideal solution proves suboptimal. Section III discusses the moral and economic advantages of broad financing regimes. Section IV shows how the self-interest of financiers and lawyers will likely lead to increased litigation costs, increased litigation, and increased path manipulation. Section V examines some intermediate forms of third-party financing in an effort to better define what a second-best solution to the problem of litigation funding would look like. The article concludes with some ideas for future works.

II. A Brief Introduction to the Theory of the Second-Best

[13] Anthony J. Sebok, *Betting on Tort Suits After the Event: From Champerty to Insurance*, 60 DEPAUL L. REV. 453, 455 (2011).

[14] For a discussion of why commercial and private tort litigation face different incentives and should therefore be treated separately, see Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 97 (2010).

[15] Neither of the two extremes adequately represents the present state of the American legal system. Instead, the present state of the American system represents a midway point between extremes. Understanding the costs and benefits of the two extremes will allow society to better choose whether a move towards either extreme is likely to be beneficial.

Much of economic analysis relies on simplifying assumptions about the world. Economists are not alone in this—most disciplines that employ predictive models use assumptions that may not perfectly reflect reality. The use of simplifying assumptions is not necessarily fatal to the analysis conducted. So long as the assumptions reasonably approximate reality, then the conclusions predictive models reach tell us *something* about the scenario being modeled. But what do we do when the assumptions do not reasonably approximate reality?

In the theory of the second-best,[16] economists have developed a method for determining the optimal course of action when pursuit of the ideal is inadvisable. When the number of ideal assumptions that cannot be reconciled to reality grows, the ideal outcome may be out of reach. Moreover, pursuit of the ideal under those circumstances may lead to a decidedly suboptimal outcome. As a rough example, consider climbers somewhere on the slopes of Mount McKinley, the highest peak in North America. They may wish to reach the highest point on Earth, the summit of Mount Everest, but if they begin to walk there directly without accounting for surrounding terrain, they may find themselves in the Pacific Ocean. Given the immediate constraints that they face, the best they can do is to concentrate on getting to the peak before them, which may mean saving Mount Everest for another day.

For a more topical example, consider that societies regularly face a choice between establishing rules or standards to govern the conduct of individuals. In an ideal world where information was costless and resultant errors rare, legal systems could provide detailed standards that would allow factfinders to accurately weigh and consider all relevant facts and provide highly-tailored guidance to private parties. In the real world, however, information is costly and errors occur. As a result, it will often be optimal to adopt bright-line rules that regulate categories of cases, even though those rules will often be over- or under-inclusive in terms of

[16] R. G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. OF ECON. STUD. 11 (1956).

their fit with the facts of a given situation.[17] Thus, while standards might be optimal in an ideal world, in the world of the second-best we often turn to rules as the least-costly alternative—even though we know that those rules sometimes will result in errors.

To determine whether or not the theory of the second-best applies here, we must first identify one or more first-best litigation financing options. We can then determine whether pursuit of those options will lead to improved or degraded conditions in the American tort system. Finally, we can attempt to identify some second-best solutions.

III. Broad Litigation Financing as a First-Best Option

The question of how to solve litigation financing problems is not new. Many thoughtful proposals have been offered, including full assignment of claims[18] and broad financing by hedge funds and other investment firms.[19] Both of these solutions have the advantage of allowing new markets to arise, which, as a general rule, is presumed to enhance efficiency for participants in the new market.[20] To the list might be added credit market reforms that would allow individuals to borrow against the value of their claims at normal market rates, much as they now may borrow against the value of their homes or other physical assets.[21] To understand why these options are likely first-best solutions, we must review why litigation funding is a problem in the first place.

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[17] Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEG. STUD. 257 (1974).

[18] Abramowicz, *supra* note 3; Coharis, *supra* note 3.

[19] Molot, *supra* note 13. In the United States, there are six companies willing to openly invest in litigation; two of these are publicly traded corporations that were established for the express purpose of litigation financing: Juridica Investments and Burford Capital. Jason Lyon, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 578 (2010); Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND CORPORATION, 14-16 (2010), http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf. These companies invest almost exclusively in commercial litigation, as opposed to personal injury tort litigation, leaving personal injury victims with only one option—cash-advance firms. *Id*. at 12.

[20] Paul H. Rubin, *On the Efficiency of Increasing Litigation* (Searle Ctr. on Law, Regulation, & Econ. Growth Pub. Policy Roundtable on Third Party Financing of Litigation, Sep. 24-25, 2009), http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf.

[21] Each of these proposals is innovative because of the direct connection between financing and the lawsuit. Less direct methods of financing have been available for some time, but they are not typically considered in discussions of litigation financing because of their indirect nature. For example, a law firm has a range of assets against which it may borrow in order to finance additional cases, and a defendant corporation (or individual) may borrow against the

A. Not Having Litigation Funding is Costly

Any litigant must weigh the costs of pursuing a case against the perceived benefits of prevailing, adjusted for the probability of success.[22] If the expected returns are greater than the cost, then the case will proceed. In a perfect system, claims with clear legal support would be easily resolved, leading to low costs and assuring that "good" claims would yield positive net returns. Within that perfect system, the more speculative a claim is, the greater the uncertainty regarding its validity; as a result, the expected benefit would be low, the cost of resolution would be high, and "frivolous" claims would yield negative net returns.[23] As a result, litigants would bring the vast majority of legitimate claims, while filing very few frivolous claims.[24] However, the fact that individuals have differing levels of willingness and ability to accept the costs and risks associated with bringing a lawsuit complicates this simple scenario in reality.

In a world where litigation funding is entirely absent, litigants must bear all the costs of litigation. Those costs not only include the costs associated with formal resolution of a legal claim—lawyers' fees, court-imposed filing fees, expert witness fees, etc.—but also the

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value of various corporate assets (or a family home) to finance a defense against legal claims. These less-direct methods of financing are fundamentally different from the type of direct litigation financing being discussed here and elsewhere. While they provide funds for litigation, the funds are not tied to the litigation itself, but are merely a means by which the litigant or law firm accesses wealth they already possess in the form of illiquid assets.

[22] Of course, some litigants will derive sufficient utility from pursuit of the claim that they will move forward even in the absence of a reasonable probability of success. For example, a medical malpractice victim may see very little chance of recovery, but may believe that there is a moral obligation to create a formal complaint regarding the alleged malpractice.

[23] The term frivolous has unfortunate negative connotations and is often used only as a pejorative to describe cases that seek to expand liability in ways that the speaker or author finds disagreeable. I attempt to use the term in a more technical, albeit admittedly imprecise manner. For the purposes of these arguments, a frivolous case is one that has no support in existing precedent, either directly or as a reasonable extension. *See* FED. R. CIV. P. 11(b)(2). Every lawsuit is subject to some uncertainty, so the existence of uncertainty regarding the outcome cannot be the standard; instead, a lawsuit is frivolous if a truly ethical lawyer could not attest that the claim meets the requirement of Rule 11. Some have suggested such alternative descriptors as "innovative lawsuits" or "entrepreneurial lawsuits," but even these terms could give rise to significant misunderstanding. I will therefore retain "frivolous," with the technical definition implied by Rule 11.

[24] Even in that perfect world, some legitimate claims will never be brought if the marginal utility to the individual litigant is sufficiently lower than the marginal utility to society. It is an interesting question, although not one I will attempt to address here, whether society should consider mandating prosecution of such claims, in order to improve total social welfare.

opportunity costs of litigation, such as time spent away from work and other productive activities. Those with lower levels of wealth and income, for example, will face higher opportunity costs when choosing to pursue a legal claim, especially when doing so requires forgoing wage income that is needed for food, shelter, and even recuperation. The costs of filing and maintaining a lawsuit may, for those with lower incomes and wealth, become insurmountable obstacles.

Consider the following hypothetical scenario, which occurs in the zero-finance world.[25] Wendy, a wealthy investment banker, Martin, a middle-class electrician, and Phil, a poor college student who works at a retail clothing store, all have lunch at the same delicatessen in Manhattan. The building in which the deli is located is being renovated, and GenCo, the general contractor responsible for the renovations, is working on the exterior of the building. By coincidence, the three of them finish their lunches at the same time and leave the deli, intending to return to their respective jobs. One of GenCo's workers negligently dislodges a large piece of granite, which falls to the ground and shatters. Wendy, Martin, and Phil are all struck by the resulting shrapnel, suffering severe lacerations. Each is physically incapacitated for six months of medical treatment and rehabilitation. In addition to the fact that each victim has been unjustly harmed, there is also a loss of productivity as three employers are deprived of the victims' labor and human capital for six months. Corrective justice would require that GenCo compensate the three victims for their injuries,[26] and a law and economics approach would, in the name of efficiency, typically require that compensation be paid to the three victims to deter such wasteful negligence in the future.[27]

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[25] By a zero-financing world, I mean a world in which contingency fee arrangements are disallowed, and even minor options such as insurance subrogation, Mary Carter Settlement Agreements, and others are absent.

[26] *See, e.g.*, Jules L. Coleman, *The Mixed Conception of Corrective Justice*, 77 IOWA L. REV. 427, 433-35 (1992).

[27] *See, e.g.*, Richard A. Posner, *A Theory of Negligence*, 1 J.L. STUD. 29 (1972).

If GenCo refuses to voluntarily make the three victims whole, each must determine whether to file a lawsuit and pursue remedies through formal channels. The costs of doing so would be similar for each victim, if measured in monetary value, but the burden of those costs will not be felt equally. Starting at the bottom of the income ladder, a poor college student like Phil will find it difficult to obtain redress because he has little or no disposable income or savings to sustain him for the duration of a lawsuit.[28] A middle-class laborer like Martin will also find the road to compensation equally challenging. A higher salary may have allowed Martin to build up some savings, and personal frugality may provide him with some disposable income, but any claim will have to be prosecuted on a shoestring budget, if it can be prosecuted at all. Phil and Martin must also consider that prosecuting a claim offers only some probability of future compensation, compared to the certain and immediate needs of food, shelter, clothing, and so on.[29] If the costs, alone, are insufficient to deter the filing of a claim, the risks associated with doing so may tip the scales.[30] Of the three, only Wendy will find the path relatively unobstructed, due to a higher disposable income and the resulting likelihood of having savings and passive income. The nature of her employment is also more likely to allow her to continue working during her convalescence, unlike the other two. These and other factors mean that Wendy will likely have little difficulty shouldering the various costs (court costs and medical and living expenses) of pursuing compensation from GenCo.

The disparities arising in this example are troubling on a number of levels. On a very basic level, it is disquieting to think that certain socioeconomic classes in our society may find themselves effectively barred from the remedial institutions designed to protect all citizens,

[28] I assume that all of the victims have sufficient knowledge to understand the existence of a valid claim, in order to avoid an interesting but tangential discussion regarding the role of imperfect information in tort victims' decisions.

[29] Shukaitis, *supra* note 3, at 334-35.

[30] Molot, *supra* note 13, at 68-69.

regardless of means. From an economic standpoint, the prospects are equally disturbing, for the inability of lower socioeconomic classes to obtain compensation for tortious harms means that tort law will provide woefully incomplete deterrence to behavior which burdens not only the victim, but also society's economic productivity. Moreover, if tort law provides deterrence unequally between socioeconomic classes, there will be distortionary effects.

Potential tortfeasors balance the costs and benefits of wrongful behavior, and tort damages are a potential cost that must be considered. Because poor and middle-class victims are unable to bring a lawsuit in a zero-finance world, there is no credible threat of tort damages and potential tortfeasors can effectively ignore the possibility. At the margin, therefore, potential tortfeasors will aim their negligent behavior in the direction of the middle class and the poor. As one possible example, imagine a home construction company that builds every type of housing, from mansions for the ultra-wealthy to low-rent duplexes for the poor. Always looking for ways to improve its bottom line, the construction company will be tempted to cut corners and, given the potential for tort liability, there is a strong probability that the corners that will ultimately be cut will be those affecting low-rent properties. To see why this is so, recall that there will be few financial barriers to a wealthy client seeking to recover for negligent construction of her mansion. In contrast, the inhabitants of low-rent properties will find it nearly impossible to bring a lawsuit if their domicile is negligently constructed. To the extent wealthy individuals or corporations own the low-rent properties, and to the extent that the negligent construction impairs the owners' ability to rent the property, a lawsuit might still be brought, but it would likely seek compensatory damages under contract, rather than tort, and the resulting damages would be significantly lower.[31] In more concise terms, the inability of low-rent tenants to bring

[31] WILLIAM LLOYD PROSSER, THE LAW OF TORTS § 92, 613 (4th ed. 1971) (noting that tort and contract law exist to protect different interests and to foster different incentives).

lawsuits lowers the probability of a lawsuit and, in this particular case, shifts the damages from tort to contract, reducing the total potential liability.

These factors combine to yield a lower expected cost of negligence, which will lead to greater negligence on the margin. This also has both moral and economic consequences. The legitimacy of a legal system must be questioned if it promotes negligent exploitation of those least capable of bearing those burdens. Likewise, those sectors of the economy that rely heavily on the poor and middle class—either in production or in consumption—will be negatively impacted, potentially causing repercussions in other areas of the economy.

Before proceeding, an important distinction must be made. It is that the concern is not simply that people who feel aggrieved cannot have their day in court. The courts have long employed screening procedures that keep people from accessing the halls of justice.[32] Screening cases at an early stage allows the courts to eliminate those claims that are based on inadequate legal grounds. In other words, the courts expend some resources early on to stop frivolous claims from proceeding. Frivolous lawsuits impose costs without providing any remedial or deterrence benefits; by definition, they are not based on legitimate claims.[33] In fact, frivolous claims may reduce deterrence by diverting precautionary efforts away from legitimate dangers or by using up judicial resources and reducing the likelihood that legitimate claims can be heard in a timely fashion. Therefore, to the extent that screening procedures are successful in filtering out frivolous lawsuits, they can increase efficiency.

The problem is that, in a zero-financing world, financial barriers exclude based on socioeconomic status, not on the strength of litigants' claims. The only way financial barriers

[32] *See, e.g.*, FED. R. CIV. P. 12; Ashcroft v. Iqbal, 556 U.S. 662, __, 129 S. Ct. 1937, 1949-50 (2009).

[33] *But see* Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 105 (2011) (arguing that courts often define as frivolous claims those that impose high costs, even though the claims are based on "a plaintiff's idiosyncratic yet deeply held principles").

would enhance efficiency is if the strength of legal claims were directly correlated to financial status. Ultimately, that is a complex empirical question, but there is little theoretical support for such a link. Therefore, unlike traditional screening procedures, financial barriers are likely—over time—to reduce valuable deterrence by preventing legitimate claims.

Litigation financing options offer some ways to avoid that outcome. A full assignment regime would allow victims to sell their claims to someone who would then have the right (and presumably the resources) to prosecute the claims. A broad third-party financing regime would allow victims to contract with non-party investors and obtain funding for legal and living expenses in return for a share of any damages award or settlement. Finally, if it were possible to effectively reform U.S. credit markets to facilitate victims' borrowing against the value of their legal claims, banks would provide a defined sum—or perhaps a defined line of credit—under traditional loan terms.[34] These options differ significantly on a number of important points—who bears ultimate responsibility for financial decisions, who controls litigation strategy (including settlement), who bears the risk of failure, and so on—but each would eliminate financial barriers to litigation by providing the financial means to bring legitimate claims.

Even before the first financing check was written, efficiency would begin to improve. Recall that it is not the tort remedies themselves that deter wrongful conduct; by definition, those remedies are available only after tort damages have been inflicted. It is the credible threat of tort remedies that yield the increased deterrence benefits. With a litigation financing regime in place, the poor and middle class would find that the doors of justice had opened a little wider and that

[34] Some have argued that the market for tort claims should be extended to unmatured tort claims. Robert Cooter, *Towards a Market in Unmatured Tort Claims*, 75 VA. L. REV. 383 (1989). *See also* Stephen Marks, *The Market in Unmatured Tort Claims: Twenty Years Later* (Boston Univ. Sch. of Law Working Paper No. 11-14, 2011), *available at* http://www.bu.edu/law/faculty/scholarship/workingpapers/2011.html. Those proposals raise a host of additional questions, which are beyond the scope of this paper. Therefore, the arguments here are confined to proposals to expand financing options for matured tort claims.

their lives were improved by the reduction in tortious activities directed at them. Whether broad litigation takes the form of an assignment regime, a third-party financing regime, or a lawsuit-equity loan regime, it has the potential to improve both efficiency and fairness in our justice system.[35] That potential may remain unrealized, however, if conditions preclude a first-best solution. We must therefore consider what costs might be imposed by a broad litigation financing regime.

III. The Costs of Litigation Financing

Litigation financing makes it easier to file a lawsuit. That is the primary source of its benefits, as described above, but is also the source of its costs. According to the most basic of economic principles, when the price of something declines, the quantity demanded increases. Lowering the price of litigation should therefore result in an increase in litigation. If so, society would face increased costs, both in resources expended by litigants in pursuit of justice and in resources expended by society in order to provide a forum for the claims.

According to some scholars, those costs are not insignificant. It is estimated that the American tort system had a total price tag of $252 billion in 2007, with direct costs making up almost 2% of the nation's Gross Domestic Product, over half of which is the administrative cost of running the system.[36] There are also indirect costs. While tort liability has arguably made products safer, it has done so at a price. Increases in safety are accompanied by increases in price, and it is not clear that the increases in safety adequately compensate society for the

[35] Some scholars have noted that litigation financing, particularly an assignment regime, would improve the ability of litigants to bear the risk of litigation, allowing them to hold out for a settlement that more accurately reflects the true merits of the case. *See* Molot, *supra* note 13. That conclusion is almost certainly correct. However, the analyses that have been conducted to date have considered neither the additional costs that are incurred due to the perseverance of the parties—both private and social—nor whether continuance of the case is individually or socially optimal after consideration of those costs. Furthermore, increased settlements might actually be harmful, if they deprive society of useful precedents. Leandra Lederman, *Precedent Lost: Why Encourage Settlement, and Why Permit Non-Party Involvement in Settlements?*, 75 NOTRE DAME L. REV. 221, 268-69 (1999). It is therefore impossible to know whether more accurate settlements are a net benefit or cost of litigation finance.

[36] TOWERS PERRIN, 2008 UPDATE ON U.S. TORT COST TRENDS 3 (2008), *available at* http://www.towersperrin.com/tp/getwebcachedoc?webc=USA/2008/200811/2008_tort_costs_trends.pdf.

increased cost and corresponding reduction in total purchasing power.[37] In other cases, consumers have simply been denied the benefits of certain products entirely due to the potential costs to the producers of releasing the products for sale.[38] As a result, American businesses miss out on billions of dollars in lost sales each year,[39] and society suffers by the loss of the jobs those lost sales represent.

The rewards from litigation also divert numerous non-legal personnel from productive work, costing businesses thousands of man-hours in foregone productivity.[40] The riches transferred through the tort system draw talented youth into law schools to become tort lawyers (both plaintiffs' and defense), thereby drawing them away from more highly-valued social uses.[41] Finally, the fear of lawsuits results in wasteful defensive actions, such as "defensive medicine," which makes the avoidance of malpractice suits, rather than the best medical interests of the patients, the basis of medical judgments.[42] It is estimated that doctors expended, during 2007 alone, $124 billion in unnecessary health care costs in response to the threat of medical malpractice lawsuits.[43] When all direct or indirect costs are totaled, it is estimated that the

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[37] *See, e.g.*, A. Mitchell Polinsky & Steven Shavell, *The Uneasy Case for Product Liability*, 123 HARV. L. REV. 1437 (2010).

[38] Theodore H. Frank, *Riverboat Poker & Paradoxes: The Vioxx Mass Tort Settlement*, 23 LEGAL BACKGROUNDER 12 (2008), *available at* http://www.aei.org/files/2008/03/21/20080325_FrankLB1.pdf.

[39] LAWRENCE J. MCQUILLAN, HOVANNES ABRAMYAN & ANTHONY P. ARCHIE, JACKPOT JUSTICE: THE TRUE COST OF AMERICA'S TORT SYSTEM 26-28 (2007), *available at* http://www.pacificresearch.org/docLib/20070327_Jackpot_Justice.pdf.

[40] Laurence H. Silberman, *Will Lawyering Strangle Democratic Capitalism?*, 1978 REG. 15, 21 (1978).

[41] Theodore H. Frank, *Protecting Main Street from Lawsuit Abuse*, Testimony before the S. Republican Conf. (Mar. 16, 2009), *available at* http://www.aei.org/files/2009/03/16/Frank%20testimony.pdf.

[42] U.S. DEP'T OF HEALTH & HUMAN SERVS., CONFRONTING THE NEW HEALTH CARE CRISIS (2002), *available at* http://aspe.hhs.gov/daltcp/reports/litrefm.pdf. The U.S. Department of Health and Human Services reported that 79% of all physicians report ordering more tests than they believed were medically necessary because of litigation fears. *Id.* at 4. The same survey indicated that 74% report referring patients to specialists, 51% report recommending invasive procedures, and 41% report prescribing more medications than they believed medically necessary. *Id.* at 5.

[43] MCQUILLAN, ET AL., *supra* note 38, at 19.

American tort system costs between $600 billion and $900 billion per year, or between 4.3% and 6.5% of GDP.[44]

But the issue is not merely one of numbers. While high, these costs might be defended on the grounds that they are required to correct wrongful conduct. Costs imposed on tortfeasors, for example, are unavoidable and necessary for the moral and economic reasons discussed earlier. Taking it a step further, if those tortfeasors are doctors or manufacturers, then the increased costs of health care and manufacturing products may be nothing more than the cost of eliminating injuries resulting from bad medical or manufacturing processes. Those are the type of costs that we should expect from our tort system—in other words, they could be a feature, not a flaw. Also, because everyone in society benefits from having a system that will compensate all future victims, it is not inherently unjust to impose some tort-related burdens on society as a whole.

The question then becomes whether those costs are justified, and that requires an inquiry into whether or not claims tend to be frivolous. Before proceeding to that discussion, however, it is important to point out that it is not undisputed that litigation finance will increase the volume of litigation. The law of demand leads to that conclusion, but it relies, as do all basic economic principles, on the assumption of *ceteris paribus*—that all other factors are held constant. A number of scholars have suggested reasons why other factors would not be held constant and have argued that litigation finance would not increase the amount of litigation.

A. Must Litigation Finance Lead to Increased Litigation?

One persuasive argument is that the emergence of a market for tort claims will lead to more accurate and transparent pricing of tort lawsuits, as financiers are incentivized to

[44] Frank, *supra* note 40, at 2.

objectively price claims.[45] Because claims will be accurately priced, all parties will have better information about the correct value of claims.[46] Competition in the marketplace will require all financiers to keep their fees low, especially on less risky claims.[47] This, in turn, will minimize financiers' ability to subsidize high-risk claims.[48] Related to this conclusion is an argument, raised by Professors Ribstein and Kobayashi, that financiers will be able to diversify risk in capital markets, reducing the *need* to subsidize riskier cases with low-value "strike" suits.[49] Whether financiers are freed from their dependence on strike claims, or whether they give up strike claims only because they are no longer profitable, the resulting reduction in low-value, low-profit claims might outweigh any increase in high-value, high-profit claims, causing the total amount of litigation to decrease.[50]

This argument has much to recommend it, but there are also reasons to doubt it. First, the fact that financiers no longer bring low-value cases does not mean that those cases will not be brought by anyone. It is possible that a clever legal entrepreneur will find a different, more profitable way to process strike claims. The legal profession would be required to change to accommodate litigation financing, and those changes could be varied, including the emergence

[45] *See* Max Schanzenbach & David Dana, *How Would Third Party Financing Change the Face of American Tort Litigation? The Role of Agency Costs in the Attorney-Client Relationship*, (Searle Ctr. on Law, Regulation, & Econ. Growth Pub. Policy Roundtable on Third Party Financing of Litigation, Sep. 24-25, 2009), *available at* http://www.law.northwestern.edu/searlecenter/papers/Schanzenbach_Agency%20Costs.pdf. It is worth mentioning that, if true, this result would be only after a period of transition, during which pricing will be uncertain. For the purposes of this discussion, however, I assume that the transition period is short and mild.

[46] *Id*. at 9.

[47] *Id*. at 2.

[48] *Id*. *But see* Abramowicz, *supra* note 3, at 738 (arguing that competition on legal fees is difficult to achieve because "litigants may interpret a low contingency fee as a signal of a low-quality lawyer").

[49] Bruce H. Kobayashi & Larry E. Ribstein, *Law's Information Revolution*, 53 ARIZ. L. REV. 1169, 1213-14 (2011).

[50] *Id*. at 1214.

of a price-taker market[51] in strike claims. If the number of strike claims remains constant, and the volume of high-value claims increases, total litigation would increase as well.

The second reason to doubt this argument is that, whether driven by competition or lured by diversification of risk, the increase in high-value claims may mean an increase in litigation financiers' willingness to finance frivolous claims. This point is developed at greater length below, but if financiers are motivated to change the type of cases normally brought, there is always the possibility that the new cases that are brought will be cases for which there is no legitimate legal basis.

A third, related concern is that competition among financiers may not occur solely in price, or the fee that financiers charge in return for financing a case. In most industries, competition occurs in both price and product quality. In litigation, product quality might mean the amount of damages that can be reasonably promised at the beginning of a case. There are limits to the amount that might be promised, but lawyers have previously been successful in expanding the limits of "reasonable" damages, and there is no reason to believe that financiers would not engage in the same behavior. Assuming reasonableness of the promised damages award, even risk averse clients would be willing to assume some additional risk in return for a higher promised award amount. If competition occurs in quality instead of price, or even simultaneous with price, claims that litigation finance could reduce litigation would be weakened.

Another possibility is that litigation funding could lead to more effective deterrence and thereby decrease the total number of torts committed. This would happen as a consequence of two separate trends. The first is that as more financing is available, more claims could be filed,

[51] A price-taker market is on in which no individual producer has market power. ARMEN A. ALCHIAN & WILLIAM R. ALLEN, UNIVERSITY ECONOMICS 287 (2d ed. 1964).

increasing the likelihood that tortious conduct would be punished. The second is that, as litigation finance leads to more accurate pricing of tort lawsuits, potential tortfeasors would have a clearer view of the cost of any wrongful actions and would be better able to adjust their behavior to avoid the consequences. Unfortunately, this argument only addresses the effects on legitimate claims; no deterrence is possible for the type of actions that lead to frivolous claims because those actions are not tortious and will not be punished. If, as described below, the availability of litigation finance causes an increase in frivolous litigation, increased deterrence potential may not lead to a reduction in total litigation.

A third possibility is that litigation financing will reduce litigation by encouraging settlements. Over time, litigation finance could lead to greater sophistication on the part of financiers and lawyers.[52] The parties would not only become more knowledgeable about the value of cases, but also about each other as parties.[53] This increased knowledge would reduce uncertainty and allow divergent expectations about the "value" of claims to converge over time.[54] This, in turn, could lead to early and increased settlement.[55] Auto collision is one area of law that has followed this path and has achieved efficiencies in reducing litigation costs. Most cases are resolved rapidly because insurers pay injured parties immediately, and then insurance companies negotiate amongst themselves regarding the companies' share of settlement costs. The companies are repeat players who are familiar with one another, and thus are incentivized to play nicely with each other. Under a litigation financing regime, other areas of law might gain the same benefits.[56]

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[52] Schanzenbach & Dana, *supra* note 44, at 11-12.
[53] *Id*.
[54] *Id*. at 12.
[55] *Id*.
[56] *Id*.

Unfortunately, it is not clear that litigation finance is the only necessary requirement to replicate the successes of the auto collision sector. Auto collision lawsuits in most states are tied to state no-fault regimes, which mandate rapid payment to victims and then remove them from the equation. At first glance, this looks like a mandatory assignment regime, which would raise a host of economic and ethical concerns.[57] However, it is also a regime with strict limitations on the amount of money that is awarded to victims, so negotiations do not include any discussion of the total amount in question. These are fundamental distinctions between a no-fault regime and litigation finance. While the notion of adopting no-fault regimes for other areas of tort law is not unheard of,[58] it is a different question than adopting a broad financing regime, and the successes of the former are no guarantee of success in the latter.[59]

There are potentially many more ways in which various aspects of a particular litigation financing regime would affect and therefore counter the general effect of increasing litigation. However, the general implications of the law of demand remain extremely persuasive. To date, the only empirical analysis of the issue, which considered the advent of litigation financing in New Zealand, has reached some conclusions consistent with the prediction of the law of demand, but without strong support for the ultimate conclusion that litigation financing caused an increase in the volume of litigation.[60]

B. Harms Arising from Litigation Financing

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[57] Abramowicz, *supra* note 3, at 760-70, 776.

[58] *See* Jeffrey O'Connell, Jeremy Kidd & Evan Stephenson, *An Economic Model Costing "Early Offers" Medical Malpractice Reform: Trading Noneconomic Damages for Prompt Payment of Economic Damages*, 35 N.M. L. REV. 259, 261 (2005).

[59] Schanzenbach and Dana also make a broader point regarding the similarities between litigation financing and liability insurance. Schanzenbach & Dana, *supra* note 44, at 12.

[60] David Abrams & Daniel L. Chen, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes* 31-32 (U. Penn., Working Paper, 2011) (empirical evidence showing an increase in litigation in New Zealand resulting from expanded use of third party financing), *available at* http://www.law.upenn.edu/cf/faculty/dabrams/workingpapers/MarketforJustice.pdf.

The danger of litigation financing is not just that litigation will increase and society will be burdened with additional costs. That danger is real and potentially significant, especially in terms of efficiency, as much of the costs of litigation are not borne directly by the litigants and their lawyers, but are externalized to society as a whole.[61] However, even more troublesome than mere increases in litigation are increases in *frivolous* litigation and the potential for financiers to attempt to affect the law's evolution through development of inefficient and potentially unjust precedent.[62]

1. Increased Frivolous Litigation

Proponents of litigation finance argue that litigation financing will not result in an increase in frivolous lawsuits.[63] Their persuasive arguments are based on the rational self-interest of the financier: why would any financier knowingly invest in a lawsuit that is likely to be dismissed?[64] One answer is that a rational, self-interested financier would knowingly invest in a frivolous lawsuit because she knows that the courts' screening procedures are imperfect and that there is always a chance that a claim will slip through and either achieve a damages award from a jury or lead to a settlement offer by the defendant. The fact that rational, self-interested lawyers currently file frivolous lawsuits under the same circumstances makes clear that there is some positive net benefit to filing frivolous claims.

It is arguable that, under a litigation financing regime, incentives would change sufficiently that frivolous lawsuits would be further deterred. In fact, as described above, some

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[61] Michael P. Stone, *Optimal Attorney Advertising* 12-15 (Univ. of Conn. Dep't of Econ., Working Paper No. 2010-14, 2010).

[62] *See* Maxwell L. Stearns, *Standing Back From the Forest: Justiciability and Social Choice*, 83 CALIF. L. REV. 1309, 1350-52 (1995); Lederman, *supra* note 33, at 235.

[63] Sebok, *supra* note 31, at 106 ("Frivolous litigation is not a necessary byproduct of maintenance . . . ."); Sebok, *supra* note 12, at 455-56 ("The fear that a market in champerty will result in lawsuits that are more likely to be frivolous . . . seems far-fetched."); Molot, *supra* note 13, at 106 ("Although opponents of third-party financing predict that such financing might encourage meritless filings rather than meritorious ones, the claim makes little sense.").

[64] *Id.*

have argued that low-value strike claims would decrease under litigation financing.[65] I have argued that those claims are overstated, but even if true, they would only show that low-value frivolous claims would be less frequent. In return, the number of high-value frivolous claims could very easily increase, as such claims might offer sufficient potential for reward that they would be brought, even if the probability of making it through the screening procedures was low.

Recall that, as a general rule, whether or not the tort system's costs are justified depends on whether the claims being filed are frivolous or legitimate. The public resources expended on the judicial process are only one type of cost. Plaintiffs bear the costs associated with time delays in obtaining their day in court, including depletion of defendants' assets, which may not be available to satisfy any damages award. Defendants must expend resources defending themselves, including the opportunity cost arising from the time executives must expend participating in trials, as well as potential reputational harm.[66] All of these costs are legitimate to the basic functions of tort law—compensation, deterrence, etc.—so long as they arise from legitimate claims. If the claims are frivolous, the compensation is not legitimate and no reasonable deterrence is possible.

All that would be required for an increase in the total number of frivolous cases is for the total number of cases filed to increase and the frequency of frivolous lawsuits to stay the same. Even under those circumstances, however, it is possible that the percentage of frivolous lawsuits that make it through the courts' screening procedures would increase. The courts are responsible for "weeding out meritless claims,"[67] but the process is obviously flawed. This is not intended to disparage the courts' efforts, for screening cases is but one of the courts' many tasks, all of

[65] Schanzenbach & Dana, *supra* note 44, at 11-12; Kobayashi & Ribstein, *supra* note 48, at 1213-15.

[66] Todd J. Zywicki, *Spontaneous Order and the Common Law: Gordon Tullock's Critique*, 135 PUB. CHOICE 35 (2008).

[67] *In re* Silica Products Liability Litigation, 398 F. Supp. 2d 563, 636 (S.D. Tex. 2005).

which must be performed with limited resources. Lawyers file both frivolous and legitimate claims, and the two classes of cases compete for those limited resources. Sorting through the cases takes time and resources. If litigation finance results in an increase in case filings without a corresponding increase in judicial funding, the screening process will become more prone to mistakes, permitting more frivolous cases and potentially denying more legitimate claims. The greater the amount of financing, the greater the likely increase in litigation, and the greater the chances that the courts' screening procedures would be swamped and fail.

Screening procedures could fail even if financiers change nothing about the way cases are selected and prosecuted. The true danger of litigation finance, however, is that financiers are likely to engage in a pattern of behavior that could create costs and distortions that would far outweigh any potential benefits from litigation. The most pressing danger of litigation finance is path manipulation.

2. The Danger of Path Manipulation

Path manipulation is the conscious effort to impact the evolution of precedent in order to achieve some goal.[68] With the development of stare decisis in the late nineteenth century, it became possible for an entrepreneurial lawyer to invest in future lawsuits.[69] Prior to that point, each case was an isolated event on the judicial landscape and had minimal impact on the disposition of future cases. Even if a litigant was likely to be a repeat player, there was little benefit from efforts to change the dominant rule because precedent was seen as the combined wisdom of judges rather than a binding rule.[70] That all changed as common law courts began to

[68] Lederman, *supra* note 33, at 235.

[69] Todd J. Zywicki, *The Rise and Fall of Efficiency in the Common Law: a Supply-Side Analysis*, 97 NW U. L. REV. 1551, 1556 (2003). *See also* Stearns, *supra* note 60, at 1351-53 (arguing that precedent, rather than *stare decisis*, creates path dependence in the law).

[70] Zywicki, *supra* note 67, at 1578-79.

adhere to stare decisis, and judges were seen as having the ability to declare binding legal rules.[71] From that point on, legal decisions became a capital good, with a stream of future benefits, and an incentive arose for lawyers to engage in rent-seeking behavior in order to nudge the common law toward favorable rules.[72]

The emergence of contingency fee arrangements served to strengthen those incentives by allowing lawyers to capture a percentage share of each present and future lawsuit. In other words, each binding legal decision became an even more valuable capital good to the lawyers who prosecuted the cases. As contingency fee lawyers became more sophisticated, they developed ways to capture more of the future benefits by specializing in certain types of litigation, allowing them to generate reputational capital. That is, the lawyer who is able to convince a judge, a jury, or both, to create new liability becomes associated in potential litigants' minds with that particular type of case. In essence, the savvy lawyer can establish brand recognition for the new area of litigation and can thereby capture a large portion of the future damages awarded under the new theory of liability. Even the process of rent-seeking would have generated certain economies of scale within firms, so that a firm could more cheaply process large numbers of claims, giving it an advantage over competing firms.

All of these effects served to increase the potential rewards to lawyers from pushing the boundaries of litigation. After all, the greatest rewards were available to those firms that were able to generate novel areas of liability not previously contemplated. Presently, a contingency fee lawyer may be willing to bring a series of claims known to be non-meritorious, knowing that

[71] *Id.* at 1576-78.

[72] *See id.* at 1579. As with legislative rent-seeking, judicial rent-seeking is likely not limited to pursuing benefits from those currently in a position to bestow them, but will extend to pursuing the appointment of those who are more likely to look favorably on the bestowal of benefits. In the legislative realm, rent-seeking therefore takes the form of both lobbying and campaign contributions. *See id.* at 1555-56. In the judicial realm, rent-seeking will take the form of path manipulation and either electioneering for sympathetic judicial candidates or pressuring elected executives during the judicial appointment or merit-selection processes. *Id.* at 1579.

one favorable decision can create precedent that instantly opens the door to new avenues for recovery.[73] For example, prior to their eventual acceptance, the courts repeatedly rejected tobacco and asbestos claims, but the size of the payout more than compensated those attorneys who pursued the long-term strategy.[74] In other words, the plaintiffs' bar has strong monetary incentives to *create* liability through repeated litigation of presently non-meritorious claims.

The same incentives will drive third-party financiers, whose long-term investment strategy will allow for initial losses in order to achieve greater returns in the future. In fact, assuming financiers follow traditional investment practices and diversify their risk, they may be far more willing than contingency fee lawyers to accept the financial risks of path manipulation. Similarly, because financiers such as hedge fund managers will be able to tap into far more funding than is currently available to contingency fee lawyers, they will be able to increase the number of cases brought—in quick succession in the same jurisdiction or simultaneously across multiple jurisdictions—in efforts to speed up the process of path manipulation. To the extent that contingency fee lawyers compete in the litigation finance market, all of the rent-seeking by financiers would be on top of efforts that currently push at the boundaries of tort law. At the very least, lawyers would not be expected to oppose expanded liability, as it would increase demand for lawyers' services.

Each of these first-best solutions will likely cause not only an increase in the total amount of litigation and an increase in the percentage of frivolous lawsuits that make it through screening procedures, but also an increase in frivolous lawsuits filed with the purpose of changing precedent. Of course, as the examples below illustrate, change is not inherently unfair

[73] Paul H. Rubin & Martin J. Bailey, *The Role of Lawyers in Changing the Law*, 23 J. LEGAL STUD. 807, 814-21 (1994). *See also* Martin J. Bailey & Paul H. Rubin, *A Positive Theory of Legal Change*, 14 INT'L REV. L. & ECON. 467, 467-77 (1994).

[74] WALTER K. OLSON, THE RULE OF LAWYERS: HOW THE NEW LITIGATION ELITE THREATENS AMERICA'S RULE OF LAW 13-21 (2003).

or unjust; our legal history is replete with examples of doctrinal changes that made society more just or improved economic efficiency. In fact, some amount of path manipulation is probably inevitable under a system such as ours, and some scholars have argued that justiciability doctrines such as standing have arisen in an attempt to minimize path manipulation.[75] What makes path manipulation troublesome under a litigation financing regime is the dramatic increase in cases it makes possible and the impact it has on the goals pursued.

As described above, increases in quantity will arise out of the ability of financiers to marshal far larger quantities of resources and to diversify risk. Each frivolous case represents wasted resources because no remedial or deterrence benefits are recouped by society; increasing the quantity of frivolous lawsuits serves only to further burden society and innocent defendants.

The goals that drive path manipulation under a financing regime will not be the noble and just goals that have been used in the past by public interest groups like the National Association for the Advancement of Colored People (NAACP) and the Women's Rights Project.[76] Financiers' goals will not even be the sympathetic goals of a lawyer who knows her client has no valid claim under current law, but pushes ahead with the case because she believes strongly that justice requires liability. Instead of these laudable goals, path manipulation under a financing regime will be motivated by a pursuit of investment returns and risk diversification. In the words of one litigation financier:

> We're fundamentally a capital provider. We take a share of the ultimate recovery, having taken the risk of funding the case. Forget this being about the law or litigation - we're providing risk funding for an investment in the same way as in

[75] Stearns, *supra* note 60, at 1350-52.

[76] Lederman, *supra* note 33, at 239-41 (discussing how the NAACP used path manipulation to defeat segregation and the Women's Rights Project used path manipulation in seeking heightened protection for women under the Equal Protection Clause of the Fourteenth Amendment).

> any other sector of the market. If the investment pays off we make a return on the capital we're investing.[77]

This is not intended as a disparagement of profit, generally, or even the pursuit of profit. So long as profits include all of the costs and benefits, profits are socially beneficial and provide a useful motivation for activities that benefit others. If pursuit of profit leads to tortious injuries, however, then costs result that, if internalized, might have made the endeavor unprofitable. By requiring that the tortfeasor correct whatever wrongs it has inflicted, those costs are internalized. Even in a perfectly free market, therefore, tort damages provide a valuable check on the actions of profit-motivated individuals and companies. Because financiers could become dominant players in the tort system, profit motive would drive case selection, a result that seems incongruous with tort law's role as a check on profit motive.

Allowing profit, or investment returns, to influence case selection and prosecution could have harmful consequences to the system and society. At the very least, the promised benefits of litigation financing will be less than advertised. For example, the deterrent effect of litigation will be distorted as financiers demand compensation based on an external evaluation of the case rather than on the actual harm the victim suffers. Abramowicz argues that in an assignment regime, fears that assignment will corrupt the process are exaggerated because the adversarial process assures that each litigant "adequately represent[s] their own interests."[78] However, the fact that the financier is *not* the victim weakens this claim, so adequately representing the interest

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[77] Matt Byrne, *World's Largest Dispute Financier Targets US Litigation Market Uptick*, THE LAWYER (Nov. 29, 2010), http://www.thelawyer.com/%E2%80%98world%E2%80%99s-largestdispute-financier%E2%80%99-targets-us-litigation-market-uptick/1006248.article (internal quotation marks omitted). Some scholars have argued that our current system of justice is the result of consistent path manipulation in favor of the "haves," who have not faced financial barriers to justice. Maya Steinitz, *Whose Claim is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1299-1301 (2011). If true, litigation financing—to the extent it allows the poor and middle class to access the courts—could provide long-overdue path manipulation in favor of the poor, or "have-nots." *Id.* However, it is unclear why litigation financiers would systematically choose to finance the claims of the poor and middle-class.

[78] Abramowicz, *supra* note 3, at 734. Of course, path manipulation means that the assignee (or other financier) may be using the case strategically, with the interests of the present victim only partially considered.

of the victim will be far more difficult, even if the assignee were predisposed to ignore his own self-interest and bow completely to the victim's interests in seeking compensation. A financier will have only imperfect information regarding the true damages, which could lead to insufficient compensation and under-deterrence, but will more likely result in excess compensation and over-deterrence.[79]

It may also be that the profit motive also limits the willingness of financiers to fund lawsuits brought by the poor and middle class. Motivated by profit, financiers may limit the number of low-value claims they are willing to fund, in order to focus more on high-value claims. The wealthy will bring some low-value claims and the poor and middle class will bring some high-value claims. It will be much easier, however, to calculate a high dollar value for lost wages and related damages if the victim is wealthy. Wealthy individuals are also far less likely to require assistance with living and recuperation expenses. The combination of lower upfront expenditures and higher damage awards will be appealing to many financiers, and wealthy individuals could make up a larger percentage of funded cases than would otherwise be predicted based on their ability to finance their own lawsuit. If so, it could lead to a form of path manipulation that skews in favor of the wealthy. Skewing the justice system to the advantage of the wealthy not only seems highly questionable from a moral standpoint, but also betrays the promise that third-party financing will assist the poor and middle class.

One might argue that any distortions connected with the profit motive might be diminished by the presence of lawyers in the financing process. Lawyers are bound not only to their clients by fiduciary duties but are also obligated to abide by the legal profession's ethical

[79] *See* Stephen Gillers, *Waiting for Good Dough: Litigation Funding Comes to Law*, 43 AKRON L. REV. 677, 692-94 (2010) (describing how the fear of financed litigation may induce defendant's to make higher offers during settlement negotiations).

standards. Neither of these constraints would bind financiers, however.[80] Moreover, it is not clear what the ethical obligations would be for lawyers in a financing regime,[81] and it may be that the additional rewards from increased litigation and path manipulation would be too much for some lawyers to withstand.[82] Counsel will also have an incentive to develop a good working relationship with financiers, with the expectation that those financiers will provide the lawyer with more work in the future. In fact, one possible form of litigation financing would be a legal version of a health maintenance organization (HMO), with financiers essentially obtaining exclusive rights to a group of lawyers' services for the purpose of prosecuting the cases invested in by the financier.

3. Principal–Agent Problems

Litigation finance could also exacerbate the principal-agent problems already present in the legal profession. The specialized nature of the legal profession, as well as the asymmetric information that arises from the fact that lawyers are highly trained and clients are not, has long made principal-agent problems a concern. Under a traditional hourly-fee arrangement, there is little that the average client, who has no experience filing or maintaining a lawsuit, is capable of doing to adequately monitor her lawyer's efforts. Even receiving an itemized statement of fees would be of little help to all but the most sophisticated clients. Lawyers, therefore, would be

[80] JOHN BEISNER, JESSICA MILLER & GARY RUBIN, SELLING LAWSUITS, BUYING TROUBLE: THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES at 7-8 (2009), *available at http://www.instituteforlegalreform.com/sites/default/files/thirdpartylitigationfinancing.pdf*.

[81] *See* Molot, *supra* note 4, at 436-37 ("the lawyer who actually starts a risk-transfer business is more likely to test prevailing professional norms and provoke a broader reevaluation of the legal profession's self-conception. These lawyers would find themselves in the uncharted territory of forging relationships with capital providers and counterparties, rather than with clients."); Molot, *supra* note 13, at 110-11 ("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 example, 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.").

[82] Abramowicz, *supra* note 3, at 720 ("The ethical rules provide incentives for lawyers to act honestly, but these incentives are balanced by opportunities for financial and reputational gain. Increasing the amount at stake for attorneys in a given suit may well increase their incentives to perform well . . . but it may induce them to go too far. Greater rewards could make the potential risks less weighty in the moral decisionmaking process.").

incentivized to maximize profits by inflating hours worked. Of course, these incentives are balanced out somewhat by reputational factors; lawyers who are known to win (and win big) for their clients are more likely to receive additional work.[83] For the individual plaintiff, these two incentives may balance out, but for society at large, both factors serve to increase the cost of the tort system, increasing the work of lawyers and courts and increasing the amount of damages demanded by plaintiffs' lawyers.

When contingency fee arrangements are in place, the attorney has both reputational and monetary incentives to increase the value of the damages award. He also has an incentive to minimize his own inputs into the production function, as his payout will be a fixed portion of the total damages awarded. Because the lawyer's total allotment of time is fixed, each hour worked must be put to the best use possible. The lawyer's time constraints also serve to discourage bringing claims that have either a low-value payout or a low likelihood of winning a damages award.[84] This is in contrast to an hourly-fee system, where the primary choice variable in the profit maximization function is hours worked and the particulars of the case are secondary considerations.

Shifting to a third-party financing regime appears to promise the worst of both worlds, at least in the short run. The third-party financier now has the financial stake in the damages award and wishes to maximize damages subject to minimizing costs. Unlike the contingency fee lawyer, however, the financier has no direct control over those who are responsible for total costs, as the lawyers are external to the financier's organization. The financier, therefore, will find his ability to rein in costs severely obstructed. In the long run, financiers will likely become

[83] To be certain, many lawyers feel bound by rules of professional conduct, which would constrain their ability to inflate legal fees. However, it would seem an easy task to amass anecdotal evidence of lawyers who do not feel bound by the rules of professional conduct, leading to very little confidence that professionalism, alone, is an effective counter to the monetary incentives to cheat.

[84] BEISNER ET AL., *supra* note 79, at 5.

sophisticated customers capable of adequately policing their attorneys, but this promises only that, after a transition period, third-party financing will be no worse than under the current contingency fee regime. Financiers will have the ability to police costs and reduce the share of damages required to cover their costs, but there are no binding constraints on the share of damages they will be able to demand if they are otherwise able to increase the damages award they can reasonably promise.

Just as very few traditional producers would be content facing a flat demand curve, as is often depicted in very basic economic discussions of competitive markets,[85] very few law firms would be content to inhabit the bottom of the contingency fee scale. It is possible that certain classes of cases will become so standardized that competition will occur solely in damages share, but it seems unlikely that this effect will be widespread, so there is little hope that society will be able to avoid increased litigation and the tremendous costs that accompany it.

After considering all of the benefits of litigation financing—improvements to efficiency and increased fairness and justice to poor and middle-class victims—it is hard to escape the conclusion that litigation financing is a first-best solution. However, after considering all of the potential costs arising from litigation financing—increased litigation, increased frivolous litigation, and increased danger of profit-driven path manipulation—it is hard to escape the conclusion that we simply do not live in a first-best world. That does not mean, however, that we need reject entirely the idea of financing tort lawsuits. Instead, we should look for second-best solutions, those which would achieve the highest level of benefits while minimizing the costs. A few possibilities are discussed in the next section.

IV. Second-Best Solutions

[85] *See, e.g.*, WILLIAM J. BAUMOL & ALAN S. BLINDER, MICROECONOMICS: PRINCIPLES & POLICY 199-200 (11th ed. 2009).

Any second-best solution must be able to promise improvements in efficiency and justice above a zero-finance world. It may seem strange that some of the proposals in this section are currently in practice, but the fact that a doctrine is the status quo would not be sufficient to eliminate it from consideration as a second-best solution. After all, a zero-finance world is inefficient, as described previously, and if achievement of the first-best solution is impossible without severe consequences, the law may have been evolving towards a second-best solution for some time. However, too much weight should not be given to the status quo, either; the fact that a doctrine has evolved is some evidence of its usefulness to society, but each candidate proposal should be carefully considered, based on all its moral, economic, and other costs and benefits.

Two short clarifications are in order before commencing. The first is that a search for second-best solutions should not only encompass proposals for actual financing of lawsuits, but also possible changes to the underlying structural system that, when achieved, will enable greater levels of financing while minimizing the costs. The following list includes examples of both. Second, these proposals are not intended to comprise an exhaustive set. The range of possibilities for second-best solutions is broad, making it impossible to list them all, much less describe the costs and benefits in detail. Rather, the following proposals are but a sampling of some obvious and non-obvious possibilities, offered to show some common weaknesses of reform proposals and that second-best solutions may come in unexpected packages.

A. Contingency Fee Arrangements

Perhaps the most obvious possibility for a second-best litigation financing option is the contingency fee arrangement. Commonly recognized as a partial assignment of a plaintiff's

claims,[86] contingency fee arrangements obligate lawyers to obtain a percentage share in any settlement or damages award in return for financing the litigation expenses of a claimant. Prior to the twentieth century, contingency fee arrangements were thought to violate prohibitions on maintenance and champerty.[87] By the time Maine approved contingency fee arrangements by statute in 1965,[88] however, contingency fee arrangements had been approved in every jurisdiction.[89]

A plaintiff who is unable to bear the legal costs of a lawsuit will be able to proceed with her claims if she can find a contingency fee lawyer willing to take her case. The plaintiff is not completely protected from risk in this way, because there is still a chance that the claims will fail, but the risk to the plaintiff is reduced because there is no danger of losing legal fees.[90] In many cases, the contingency fee collected by the lawyer, if calculated on a per-hour basis, would appear to violate the rules of professional conduct, which require that lawyer fees be reasonable. The contingency fee lawyer, however, is not just being compensated for professional legal services; part of the contingency fee is payment for the risk assumed.[91]

By bearing the legal costs of a lawsuit, contingency fee lawyers provide a way for the poor and middle class to overcome some of the financial barriers to bringing a tort lawsuit. This provides efficiency and fairness benefits above a zero-financing world. However, there are also problems with contingency fee arrangements that are similar to those present in a broad

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[86] *See* Max Radin, *Maintenance by Champerty*, 24 CAL. L. REV. 48, 73 (1936) ("Contingent fees of lawyers, supported by a lien on the proceeds of a suit, can scarcely be differentiated from the assignment of a cause of action, or rather part of one.").

[87] *See, e.g.*, Key v. Vattier, 1 Ohio 132, 146 (1823).

[88] 1965 ME. LAWS 333 (codified as amended at ME. REV. STAT. ANN. tit. 17-A, § 516(2) (2006)).

[89] *See* Lester Brickman, *Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?*, 37 UCLA L. REV. 29, n.38 (1989). For a discussion of how contingency fees became exempted from restrictions on champerty in the United States, see Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 CHI.-KENT L. REV. 625, 639-40 (1995).

[90] Abramowicz, *supra* note 3, at 738.

[91] *Id*. at 739 ("the size of contingency fees reflects the risks that their lawyers assume").

financing regime. First, as with financiers, contingency fee lawyers choose which plaintiffs to fund, not the other way around, so some legitimate claims may be ignored if they do not promise sufficient return on investment. Second, while ethical and professional obligations should act as a means of limiting the drive for profit, it would be unrealistic to assume that contingency fee lawyers are not profit motivated. Therefore, there is a significant danger of path manipulation and an increase in the number of frivolous cases, with the resulting harms to efficiency and fairness.

Even with the potential for harm, contingency fee arrangements may still be beneficial as a second-best solution. There are important differences between a contingency fee lawyer and a financier, differences that make contingency fee arrangements preferable as a form of third-party financing. First, a contingency fee lawyer will have a closer relationship with the client than will be possible if the financier is a hedge fund or other investment firm. Professionalism standards will require that a lawyer have regular contact with the client, know the particulars of the client's injuries, and be involved in the day-to-day decisions of the case.[92] A lawyer who adheres to these standards will be far less likely to choose pursuit of profit over the interests of the client and the courts. Second, the scope of financing will be far smaller under contingency fee arrangements, as financiers will be able to aggregate financial capital on a scale that is beyond any law firm. Even if a law firm borrowed heavily against its assets to fund litigation, the amount of money would still pale in comparison to the funds available to large hedge funds or other investment firms. As a result, the speed of path manipulation will be far below that which would exist under a broad financing regime. Finally, contingency fee lawyers are prohibited

[92] *See supra* note 79 and accompanying text for a discussion of how lawyer ethics could change under a broad financing regime.

from paying for their clients' living or recuperation expenses,[93] which limits their ability to control the agenda in a lawsuit. Because a plaintiff will not be entirely dependent upon the contingency fee lawyer, as would be the case if a single financier was providing all living and legal expenses, the plaintiff's interests are less likely to be subordinated to the lawyer's interests.

These may be only marginal improvements, but they are improvements.[94] Contingency fee arrangements are an improvement over a zero-finance regime and, at the margin, they are also safer and more efficient than a broad financing regime. Whether the total benefits of contingency fee arrangements outweigh the total costs is a question for more in-depth analysis elsewhere. For now, it is sufficient to point out that they represent one possible second-best solution.

B. Collateral Source Rule

While not traditionally thought of as a form of litigation finance, the common law doctrine known as the "collateral source rule" provides some relief to poor and middle-class tort victims as they recuperate and attempt to recover from a tortfeasor. In essence, collateral payments to tort victims can be made without diminishing their ability to recover from the tortfeasor.[95] In other words, regardless of the source of the collateral payment (e.g., insurance, family and friends, or other philanthropic individuals), poor and middle-class tort victims can receive assistance in meeting their living and medical expenses without impacting the amount of

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[93] *See* Michael R. Koval, *Living Expenses, Litigation Expenses, and Lending Money to Clients*, 7 GEO. J. LEGAL ETHICS 1117, 1126-27 (1994) (discussing how courts have interpreted Section 5-103(B) of the Model Code of Professional Responsibility as prohibiting lawyers from providing living expenses).

[94] It has been argued that prohibitions on maintenance and champerty arise from an untenable distinction between "authentic" claims brought by the victim and "inauthentic" claims brought by a third party. Sebok, *supra* note 31, at 62-63. This distinction between contingency fee lawyers and litigation financiers may appear to be a similar distinction based on a "mistaken interpretation of corrective justice." *Id.* at 67. However, the arguments advanced here are consequentialist arguments, based on the incentives of the relevant parties. In that way, this research attempts the very "complex consequentialist argument . . . that 'inauthentic claims' must be prohibited, or, at the very least, limited," which Professor Sebok invites. *Id.* at 63.

[95] *See* RESTATEMENT (SECOND) OF TORTS § 920(A)(2) (1979).

damages that can be recovered from the tortfeasor. While the collateral source rule likely emerged to serve other purposes,[96] it also serves to lower the financial barriers to bringing a suit.

What is especially interesting about the collateral source rule is that it extends as far back in time as the maintenance and champerty rules that motivate this entire discussion. Because the collateral source does not obtain an interest in the litigation, it would not be considered a form of champerty, but if a collateral source provides living expenses or recuperation expenses that allow the victim to pursue litigation, it would qualify as maintenance.[97] Because the collateral source rule is only relevant when a lawsuit is pending, courts could regularly dismiss cases when collateral sources are present, based on rules against maintenance. However, this is rarely done, especially when the motivation of the collateral source is philanthropic or humanitarian. In these cases of "selfless maintenance,"[98] courts have long been unwilling to reject claims that have attracted collateral sources. Courts may not be as forgiving, however, in cases of "malice maintenance,"[99] where the collateral source contributes with the intent of harming the defendant by allowing the case to proceed. In malice maintenance cases, courts are far more likely to invoke anti-maintenance rules and dismiss the claims.

Whether the motivations behind the collateral source arise from philanthropy or revenge, the collateral source rule is still preferable to a broad financing regime. Some additional litigation will arise as the poor and middle class are able to partially overcome financial barriers to litigation with the help of collateral sources, but there is little danger of collateral sources attempting to engage in path manipulation. Even if a collateral source is motivated by revenge,

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[96] *See generally* Michael I. Krauss & Jeremy Kidd, *Collateral Source and Tort's Soul Rule*, 48 U. LOUISVILLE L. REV. 1 (2009) (tracing the history of the collateral source rule and its emergence in the United States, England, and Canada).

[97] *See* Sebok, *supra* note 31, at 100-08 (discussing the spectrum of maintenance rules across various states).

[98] *Id.* at 100-102.

[99] *Id.* at 102-107.

those negative attitudes are likely very focused on a particular defendant. That, combined with the collateral source's inability to profit from the present case or any future cases means that collateral sources will not be significant forces for the evolution of law in any direction, much less a profit-centered one.

By mustering positive forces in society, the collateral source rule brings many poor and middle-class tort victims one step closer to obtaining redress for their injuries. It is therefore an improvement on a zero-financing regime and a candidate as a second-best solution.

C. Regulation of Financing Contracts

One possible avenue to explore is the use of regulations to minimize the potential for harm from a broad financing regime. For example, in a non-assignment regime, states could require all financing contracts to contain language limiting the influence of financiers on all legal decisions. This could increase the tort victim's ability to manage such issues as the timing of settlement and the amount of damages demanded. That, in turn, could minimize the amount of path manipulation attempted by financiers because it would be harder to plan future strategies when control of each individual case is more difficult.

Unfortunately, this solution seems unlikely to work without significant enforcement costs. Financiers will not willingly surrender control and the potential for gain that accompanies it. As a result, they will find ways to circumvent the law, possibly by cultivating relationships with law firms that will agree to take the steps preferred by the financier. These agreements could never be written, but informal agreements would almost certainly arise. Informal agreements would necessitate increased government enforcement costs if the regulations were to be effective. Financiers would also have to expend resources maintaining relationships with law firms and assuring themselves that their wishes are truly being followed. As an example of the latter concern, consider that any action by the financier to police legal fees could be construed as

violative of the regulations. Knowing this, the lawyers would have additional incentives to inflate the hours worked.

It is tempting to conclude that the increased cost to financiers is an improvement, as it will make it more difficult for them to engage in path manipulation. However, the search for second-best solutions should be motivated by a desire to see society achieve the highest possible level of efficiency, fairness, and justice, not by a desire to obstruct the functioning of any individual or entity. Were it not for the dominant incentives presented by our present system, litigation finance would be the optimal solution, so litigation financing, considered in a vacuum, is a beneficial service. The optimal second-best solution would likely be one that would allow financiers to operate efficiently, but in a way that minimized the harmful costs of path manipulation and frivolous lawsuits.

The particular regulation described here has sufficient costs that it is not a likely candidate as a second-best solution. Other regulations, however, might be more successful.

D. Better Case Management by Judges, Made Possible by More Funding

Perhaps it would be possible to salvage litigation financing by strengthening the courts' screening procedures. Judges have a difficult task—they and their chambers are asked to process an increasing number of claims and sort the meritorious from the frivolous, all on relatively stable budgets. They have it in their power to curb any increase in frivolous lawsuits by simply holding the line on new liability. Doing so requires two things: a willingness to act conservatively regarding tort liability and enough funding that proper analysis of each case is possible. Without sufficient funding, even the most dedicated judge may find herself unable to accurately diagnose and reject every frivolous lawsuit. Once it became common knowledge that frivolous lawsuits would always be rejected, the allure of path manipulation would significantly decrease and any remaining litigation financing would be largely beneficial.

Unfortunately, even if it were politically feasible to increase the budgets for state and federal judiciaries to a level that would allow perfect screening of cases, there is no indication that judges would be inclined to hold the line on new litigation and frivolous claims. The fact that judges are drawn from the ranks of lawyers[100] makes it more likely that, like their colleagues in the law, they favor expansion. Even without any sympathies for their colleagues in the law, judges favor expansion of liability and complexity for the same reason lawyers do—it provides them with continued employment. This principle has been understood since the time of Charles Dickens, who stated that "[t]he one great principle of the English law is, to make business for itself."[101] At the very least, the fact that judges have accepted and aided in the tremendous expansion of liability and complexity in the past century makes it highly unlikely that they can be trusted to act as a bulwark against any future expansion.

E. Abolish Stare Decisis

The opportunity for path manipulation would not have been present prior to the establishment of the doctrine of stare decisis. As described above, it is stare decisis that transforms precedent into a capital good with a future stream of benefits.[102] Without that future stream of benefits, the incentive to invest in path manipulation would disappear almost entirely and the costs of litigation finance would be severely reduced. A retreat from stare decisis would not reverse the past century's expansion of tort liability, but it could limit future expansion. However, there is virtually no judicial, political, or popular support for such a proposal, and it would appear to be a non-starter as a second-best candidate.

F. Caps on Financiers' Rate of Return

[100] Todd J. Zywicki, *Environmental Externalities and Political Externalities: The Political Economy of Environmental Regulation and Reform*, 73 TUL. L. REV. 845, 905-06 (1999).
[101] CHARLES DICKENS, BLEAK HOUSE 553 (A.L. Burt Co. 1900) (1853).
[102] *See supra* note 67 and accompanying text.

If it is the profit motive that makes litigation finance especially dangerous, perhaps an efficient financing regime would be possible if caps were placed on the percentage of any damages award that financiers could demand in return for financing a lawsuit. This would not entirely eliminate financiers' incentives to engage in path manipulation, but it is at least theoretically possible to set a limit on rates of return that would minimize the increase in total litigation, the increase in frivolous lawsuits, and the amount of path manipulation. However, lawyers would still favor expansion of tort liability as a means of increasing their own employment, so the reduction in the costs of litigation finance might be limited.

Lawyers would also be presented with perverse incentives, as their lucrative monopoly on plaintiffs' lawsuits would be at risk from the new entrants into the market.[103] If we adopt the reasonable assumption that there is a limit to the amount potential plaintiffs will be willing to surrender to financiers, lawyers facing a relegation to hourly fees would have the incentive to expand the hours billed in order to make financing unprofitable.

Finally, there is an inherent danger in empowering government to determine what is the appropriate rate of return. Not only could this lead to rent-seeking behavior, making it highly unlikely that the rate set by the government would contribute to efficiency, but once government has been given the power to determine the appropriate rate of return for third-party financing, expansion of that power into other areas of investment cannot be far behind.

G. Caps on Damages Awards

One reform popular with the tort reform movement is a cap on non-economic and punitive damages. These caps are designed to reduce the number of lawsuits brought by making

[103] *See* Painter, *supra* note 87, at 631 (suggesting that English rules against champerty give contingency fee lawyers market power); Coharis, *supra* note 3, at 480 ("Under contingency-fee arrangements . . . plaintiffs' attorneys, as oligopsonists, do not offer competitive rates").

them less profitable.[104] By limiting damages awards, a maximum return per lawsuit would be effectively established. Even if the financier is able to generate new liability, it will have a much smaller stream of future benefits. As a result, the total amount of money invested in seeking that new liability should decrease. If the damages caps are limited to non-economic damages and punitive damages, financiers might shift their attentions more heavily towards those cases where economic damages are likely to be highest. If these tend to be claims brought by the wealthy—due to higher lost wages—the law could potentially become distorted in favor of the wealthy, which could worsen current inequities.

Limits on damages awards also decrease overall deterrence of wrongful conduct and may limit an individual victim's ability to be fully compensated for real harms. It is impossible to know, *ex ante*, whether the improvements in deterrence arising from litigation finance, would be sufficient to outweigh the reductions in deterrence resulting from caps on damages awards. Because damages caps are imposed by legislation, the likelihood of rent-seeking makes it unlikely that the optimal level of deterrence would be achieved.

V. Conclusion

Every candidate for second-best solution status is likely to share some or all of the shortcomings identified in the solutions discussed above. However, the very nature of a second-best solution is that it need not be perfect—it only needs to be better. What this article shows is that the first-best solution, litigation finance, is likely unobtainable without significant harm to our judicial system. There should be greater effort made towards identifying appropriate second-best solutions. The options described in the previous section are merely a beginning.

As the litigation financing discussion progresses, certain avenues of related research present themselves. One such avenue is the question of whether litigation finance might be

[104] Coharis, *supra* note 3 at 451.

appropriate on a more limited scope. If there are areas of tort law where the dangers of frivolous lawsuits and path manipulation are lessened, litigation finance could be tried in those areas. Doing so would allow for empirical testing of the hypotheses of this and other litigation financing research. Another such avenue is to investigate the impact of litigation financing on the legal profession. Litigation financing might level the playing field, allowing smaller plaintiffs' firms to compete with larger, more established, and more famous firms. If so, would the advent of litigation financing lead to wholesale restructuring of the litigation marketplace? Hopefully, the limited discussion regarding the advisability of litigation financing is only the beginning.