

Overview of Alternative Litigation Financing in the United States

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Consumers, law firms, and businesses are increasingly turning to nontraditional sources of financing to support their litigation. Alternative litigation financing (ALF)—often called “third-party” litigation financing—refers to litigation-related financing provided by entities other than plaintiffs, defendants, their lawyers, and defendants’ insurers. Currently, almost all of this financing appears to support plaintiffs; in principle, however, ALF can support defendants as well. Although these activities are diverse and fairly new—and little is known about them or their current or future effects—some have advocated prohibition or heavy regulation of ALF.

A recent RAND paper, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, draws on available empirical information, interviews, and microeconomic principles to (1) describe the main currently active segments of this industry, (2) consider likely effects on outcomes of social concern, along with arguments made by ALF opponents, and (3) suggest lessons for policymakers for the next five to ten years.

Types of Alternative Litigation Financing

The policy debate often overlooks the fact that there are three distinct types of ALF that are fairly prevalent in the United States today, each with its own suppliers, customers, and types of deals. Moreover, there are good reasons to expect that the effects of ALF differ substantially across these three currently active industry segments.

Consumer Legal Funding. This type of financing involves the provision of “non-recourse loans” or “cash advances” to individuals who are represented by attorneys in personal-injury lawsuits, many arising from auto accidents. A financing company typically contracts with a consumer, who agrees to repay the company the amount of financing plus contracted financing

Abstract

This research brief reviews alternative litigation financing—often called “third-party” financing—in the United States, synthesizing what is known and highlighting what is unknown about these fairly new activities. It describes three main segments of the industry, considers potential effects on litigation, and suggests lessons for policymakers for the next five to ten years. It urges policymakers to avoid fundamentally interfering with market developments that could attenuate information problems that impede efficiency.

fees—but the consumer is obligated to repay no more than his or her recovery from the underlying lawsuit. As of early 2010, several dozen companies were offering consumer legal funding in the United States.

The average size of these transactions may be in the range of \$2,500 to \$7,500, with monthly financing fees that can be considerably higher than the monthly interest rates on credit card balances or consumer bank loans. Presumably, many consumers who accept this type of funding have exhausted more common sources of financing and are attracted to it because they need to meet pressing financial obligations or because non-recourse loans guarantee them some recovery from their lawsuits.

Loans to Plaintiffs’ Law Firms. In this industry segment, loans and lines of credit are provided to plaintiffs’ law firms. In contrast to consumer legal funding, these contracts are secured by all of the assets of the firms, including future fees from cases and real property, such as land, buildings, and equipment. There are at least ten U.S. companies that provide this type of

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financing, and, according to their websites, they help firms maintain solvency or deal with irregular and unpredictable cash flows. Little is known about the interest rates typically charged in this segment, but some hints suggest that rates in the neighborhood of 20 percent per year are fairly common.

Investments in Commercial Claims. The newest and most rapidly evolving segment of the ALF industry provides capital directly to businesses or their outside counsel to finance the costs of their legal claims against other businesses. Currently, about a half-dozen companies provide capital in exchange for shares of the eventual recoveries. The lawsuits most commonly financed in this industry segment appear to be antitrust, intellectual property, and contract disputes. Typically, the deals appear to involve financing of up to several million dollars per commercial lawsuit in which an ALF company invests.

Effects on Litigation

Opponents of ALF have raised concerns related to laws governing lawyers and rules of professional conduct, and the paper briefly reviews these legal and ethical issues and cites related literature. The heart of the paper, however, is early-stage, empirically grounded theorizing about the potential effects of ALF on litigation activity and outcomes, such as the volume of civil litigation, the legal merit of legal claims supported by ALF, the timing and fairness of settlements, and transaction costs. The author pays particular attention to how these effects are likely to differ across the three industry segments and emphasizes that the differences could be important for policy design. Moreover, in many instances, the effects are far from obvious.

The paper also considers the reliability of various claims about effects of ALF made by those who advocate prohibiting or heavily regulating this activity. For example, it seems more likely than not that ALF will increase the quantity of lawsuits filed—as ALF opponents have predicted—but to different degrees in the three industry segments. But another prediction of ALF critics seems more dubious: namely, that most or all of such additional lawsuits will be lacking in legal merit—“frivolous,” in common parlance. Nonetheless, a substantial policy concern in this regard is that in some instances, some litigation financiers will support “nuisance”

lawsuits—that is, lawsuits that are not legally meritorious but are likely to be settled because defendants will choose not to incur the costs and risks of going to trial.

Will Market Responses Enhance Efficiency?

The analyses of longer-term effects of ALF emphasize the efficiency of ALF markets and litigation attributable to ALF. The main impediments to efficiency appear to be the potential profitability of investing in nuisance lawsuits and information problems faced by ALF market participants. A key issue is the extent to which market developments will attenuate these information problems. For example, will brokers emerge to help consumers find the best offers for legal funding? Will the capacity to reliably evaluate commercial claims expand to help investors choose wisely?

Policy Lessons for the Near Term

Several lessons emerge from this analysis for bar associations, courts, legislatures, state attorneys general, and other policymakers who may affect the future of ALF in the United States:

- Claims about ALF that apply broadly across all segments of the industry are likely to be misleading. The economic effects of ALF, for example, almost surely differ substantially across the three segments and new forms of ALF that may emerge.
- One-size-fits-all policy prescriptions are also suspect. Context matters, and it seems implausible that policies affecting all segments of the industry will be broadly effective in promoting social goals.
- Claims about the effects of ALF in other countries, such as Australia and the United Kingdom, cannot provide simple or direct lessons for the United States because of these countries’ very different legal rules—such as “loser pays” rules and the impermissibility of contingency fees.

The vast uncertainties about the future effects of ALF suggest that policymakers might best limit themselves over the next five to ten years to policies that (1) will not fundamentally impede potentially beneficial market developments and (2) apply no more broadly than necessary to address problems that are too pressing to wait to see whether market developments will alleviate them. ■

This research brief describes work done for the Law, Finance, and Capital Markets Program within the RAND Institute of Civil Justice documented in *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, by Steven Garber, OP-306-LFCMP (available at http://www.rand.org/pubs/occasional_papers/OP306/), 2010, 66 pp., \$22, ISBN: 978-0-8330-4990-2. This research brief was written by Laura Zakaras. The RAND Corporation is a nonprofit institution that helps improve policy and decisionmaking through research and analysis. RAND’s publications do not necessarily reflect the opinions of its research clients and sponsors. RAND® is a registered trademark.

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